# UFR

# AUDITOR'S COMPLIANCE SUPPLEMENT

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# /UNIFORM FINANCIAL STATEMENTS AND INDEPENDENT AUDITOR'S REPORT/

## AUDITOR'S COMPLIANCE SUPPLEMENT

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OMB Circular A-110 "Uniform Administrative Requirements for Grants and Agreements With Institutions of Higher Education, Hospitals and Other Nonprofit Organizations"
OMB Circular A-133 "Audits of States, Local Governments and Non-Profit Organizations"
(*SEE* http://www.whitehouse.gov/omb/circulars/index.html)

***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***

## Introduction

When an independent auditor is engaged to audit the Uniform Financial Statements, the financial audit must be conducted and reported in accordance with Generally Accepted Government Auditing Standards (GAGAS). Government Auditing Standards (commonly referred to as the "Yellow Book") have been promulgated by the Comptroller General of the United States Government Accountability Office (GAO). The guidance that follows has been adapted for use in audits of contractors contracting with the Commonwealth and excerpted from the "Yellow Book" and the GAO office policy publication, "Assessing Compliance with Applicable Laws and Regulations." GAO's standards require that all audits include an assessment of compliance with relevant laws and regulations that are material to the engagement objectives. For financial statement audits, the standard provides the following:

- Auditors should follow up on known material findings and recommendations from previous audits.
- Auditors should design the audit to provide reasonable assurance of detecting irregularities that are material to the financial statements.
- Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts.
- Auditors should be aware of the possibility that indirect illegal acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have material indirect effect on the financial statements, the auditor's should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.
- Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. If specific information comes to the auditors' attention that provides evidence of possible noncompliance that could have a material direct effect on the financial statements, auditors should apply audit procedures specifically directed to ascertaining whether that noncompliance has occurred.
- In addition, the audit of the UFR requires the auditor to employ certain reporting and fieldwork standards of GAGAS for performance audits when testing and reporting on contract compliance (2018 "Yellow Book" www.gao.gov/govaud/ybk01.htm ).

  The "Yellow Book" also requires that financial audits be performed in accordance with the fieldwork and reporting standards prescribed by the American Institute of Certified Public Accountants (AICPA). AICPA has issued a series of Statements on Auditing Standards (SAS), and the following are particularly applicable to detecting and reporting noncompliance with laws and regulations on financial and certain aspects of performance audits:

- Compliance Auditing Applicable to Government Entities and Other Recipients of Governmental Financial Assistance (SAS 74) – superseded by SAS No. 117 Compliance Audits
- Consideration of the Internal Control Structure in a Financial Statement Audit (SAS 78);
- Illegal Acts by Clients (SAS 54); and

- The Auditor's Responsibilities to Detect and Report Errors and Irregularities (SAS 53);
- Omnibus Statement on Auditing Standards 1983 (SAS 45) AU Section 334, Related Parties and Au Section 9334 Related Parties: Auditing Interpretations of Section AU 334;
- Audit Risk and Materiality in Conducting an Audit (SAS 47).
- Communicating Internal Control Related Matters Identified in an Audit (SAS 115).
- Compliance Audits SAS 117
- Audits of contractors for Single Audit purposes carry additional requirements that the auditor must be aware of to conduct the audit. These requirements are noted in the Executive Office of The President, Office of Management and Budget publication, OMB Circular A-133 "Audits of States, Local Governments and Non-Profit Organizations."

  In addition, see the OMB Circular A-133 Compliance Supplement at: http://www.whitehouse.gov/omb/circulars/a133_compliance_supplement_2011 which contains specific guidance for conducting audits in accordance with OMB Circular A-133.

## General Requirements

Audits must be properly planned and include steps to provide reasonable assurance-**not absolute or complete**-that material instances of noncompliance that directly relate to the engagement's objective(s) are detected and reported. Auditors should not presume the contractor is in compliance or not in compliance but should do sufficient testing to provide reasonable assurance that noncompliance, which is individually or in the aggregate material, would have been identified.

Sufficient steps must be performed to detect major noncompliance without spending an unreasonable amount of resources on those steps. Too much audit effort would waste valuable resources needed elsewhere, while not enough work risks instances of material noncompliance going undetected.

The standard does not expect auditors to uncover every impropriety; instead, it requires reasonable tests to assure detection of major noncompliance (errors, fraud, illegal acts, or irregularities) and abuse.

The "Yellow Book" requires auditors to perform audit steps as follows:

1. Determine if engagement objectives require that tests of compliance with laws and regulations be performed;
2. Identify laws and regulations that apply to the entity being audited and that are relevant to engagement objectives;
3. Assess the risk that noncompliance with these laws and regulations could significantly affect the program operations or financial statements being audited;
4. Consider whether internal controls deter or help detect noncompliance;
5. Design work steps to reasonably assure the (1) entity's compliance with relevant laws and regulations and (2) detection of errors, irregularities, abuse, or illegal acts that could significantly affect the engagement objectives;
6. Exercise appropriate caution in investigating illegal acts so as not to interfere with potential future investigations and/or legal proceedings;

7. Promptly prepare an audit report that includes irregularities, illegal acts and other material or significant noncompliance (for; example violations of contract provisions) and
8. In some circumstances, auditors should report irregularities and illegal acts directly to parties external to the audited entity.

## Terms Defined

Noncompliance with laws and regulations includes both intentional and unintentional acts as well as a variety of other terms, such as "fraud," "abuse," "errors," and "irregularities," and these and other terms are defined as follows:

Abuse is distinguished from noncompliance in that abusive conditions may not directly violate laws or regulations. Abusive activities may be within the letter of the laws and regulations but violate either their spirit or the more general standards of impartial and ethical behavior. This would include furnishing excessive services to beneficiaries; or performing what may be considered improper practices, none of which involves noncompliance with laws and regulations.

Civil act - An illegal act for which penalties that do not include incarceration are available for a statutory violation. Penalties may include monetary payments and corrective actions.

Criminal act - An illegal act for which incarceration, as well as other penalties, is available if the government obtains a guilty verdict.

Error - Unintentional noncompliance with applicable laws and regulations and/or misstatement or omission of amounts or disclosures in financial statements.

Fraud - Action that violates a fraud-related statute of the federal or state government.

Illegal act - Failure to follow requirements of laws or implementing regulations, including intentional and unintentional noncompliance and criminal acts.

Irregularities - Intentional noncompliance with applicable laws and regulations and/or misstatements or omissions of amounts or disclosures in financial statements.

## Identifying Laws and Regulations

During the early phase of an engagement, auditors should identify the laws and regulations that apply to the engagement subject area and might significantly affect engagement objectives.

The first step is to identify general laws and regulations applicable to the subject of the engagement. For example, when auditing the contractor's Uniform Financial Statements, the laws and regulations associated with the organization's charitable purpose and delivery of social services will apply.

The second step is to identify more specific laws and regulations applicable to the contractor's activity. For example, the contract that is executed between the contractor and the Commonwealth's purchasing agency is governed by the incorporation of general conditions, procurement regulations and contracting requirements.

The third step is to identify those provisions of laws, regulations and policies relating directly to the engagement objectives. For example, violation of contract provisions or regulations that govern reimbursement for services delivered by the contractor could have a material effect on the financial statements.

Sources of information that auditors can use to identify applicable laws and regulations include:

- Federal and State employment and labor laws.
- Internal Revenue Code, Massachusetts Department of Revenue and Division of Employment and Training laws.
- Commonwealth Terms and Conditions for Human and Social Services.
- Code of Massachusetts Regulations (available from State Bookstore).
- Code of Federal Regulations (available from Federal Bookstore).
- State agency contracting requirements (contained in purchasing agency contracts with the contractor) and in Secretariat guidance furnished to state purchasing agencies.
- Operational Services Division Contract Instructions and Forms.
- Commonwealth of Massachusetts Policies and Procedures Handbook for Human and Social Services.

**Materiality/Significance and Sensitivity**

The auditor should consider materiality and/or significance and sensitivity in planning the audit and in selecting the methodology and designing audit tests and procedures, as well as in deciding whether a matter requires disclosure in an audit report.

Materiality concerns the magnitude of omissions or misstatements of accounting information that, in the light of circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by omissions or misstatements. Materiality judgments involve both quantitative and qualitative considerations. One of the criteria to be considered in determining materiality includes the monetary value of the item. Qualitative factors include, but are not limited to, the cumulative effect and impact of immaterial items, the objectives of the work undertaken, and the use of the reported information by the users or groups of users of the information.

Significance concerns the importance, in relation to the audit objectives, of items, events, information, matters or problems the auditor identifies.

Sensitivity involves how given matters will be perceived by others. It is possible for matters to be both material/significant and sensitive. For example, a former high-level state official used influence to convince a state agency to fund a program operated by a contractor, and for minimal effort the former official was paid a large fee by the contractor.

In determining materiality and/or significance, sensitivity and audit risk, the auditor is expected to consider the following:

a. Amount of revenues and expenditures.
b. Newness of the activity or changes in its condition.
c. Adequacy of internal controls.
d. Results of prior audits.
e. Level and extent of review or other form of independent oversight.
f. Adequacy of the internal controls for ensuring compliance with laws and regulations.
g. Management's adherence to applicable laws and regulations.

h. Audit report users' expectations.
i. Public perceptions and political sensitivity of the areas under audit.
j. Audit requirements.

In government audits the materiality level and/or threshold of acceptable risk may be lower than in similar-type audits in the private sector because of the public accountability of the entity, various legal and regulatory requirements, and the visibility and sensitivity of government-supported programs, activities, and functions.

Generally the greater the materiality/significance and sensitivity, the greater the degree of required compliance testing.

## Determining the Extent of Compliance Testing

Compliance testing should provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and indirect material effect on program operations and the financial statement amounts. This is accomplished by first determining what to test and the degree of testing that is needed. Determining what and how much to test is achieved by completing the previously noted steps, two through five, in the General Requirements section.

These steps and procedures rely upon the professional judgment of the auditor to determine what to test and the degree of testing needed, rather than a series of predetermined audit tests.

### *Vulnerability Assessment*

After laws and regulations that apply to the audited entity have been identified, auditors must assess the risk that noncompliance with these laws and regulations could significantly affect the program operations or financial statements being audited. Once the risk has been determined, the extent of compliance testing to be performed can be established. This is attained by conducting a vulnerability assessment. A vulnerability assessment determines the probability that noncompliance and abuse, which is individually or in aggregate material, could occur and not be prevented or detected in a timely manner by internal controls. The assessment evaluates (1) the inherent risk of a law or regulation to noncompliance and abuse before considering internal controls and (2) whether internal controls will prevent or detect noncompliance and abuse (see table below).

*Relationships between Inherent Risk, Internal Controls, Vulnerability and testing Extent*

| *Inherent Risk X* | *Internal Controls* | *= Vulnerability/Testing extent* |
|---|---|---|
| **High** | Weak | High |
| | Adequate | Moderate to high |
| | Strong | Low to moderate |
| **Moderate** | Weak | Moderate to high |
| | Adequate | Moderate |
| | Strong | Low |
| **Low** | Weak | Low to moderate |
| | Adequate | Low |
| | Strong | Very low |

The extent of compliance testing is directly related to a contractor's degree of vulnerability. The higher the vulnerability, the more extensive the compliance testing needs to be and vice versa. Thus, even though a contractor may be inherently risky to noncompliance and abuse, strong internal controls can reduce vulnerability to a relatively low level, thereby reducing necessary compliance testing to a relatively low level.

The rationale for performing a vulnerability assessment is that auditors can limit testing and focus on those areas most vulnerable to noncompliance and abuse if internal controls are found to be adequately designed and reliable. This produces a more cost-effective and timely audit.

## A. Inherent Risk

Inherent risk is the probability that a law/regulation related to the audit (including the contractor's program operations and financial statements) will not be complied with, or that the area being reviewed is highly susceptible to noncompliance (e.g., pilferage of cash).

Inherent risk is assessed before considering whether the internal controls would prevent or detect such noncompliance or abuse. Assessing inherent risk involves:

- Considering the requirements of applicable laws and regulations;
- Establishing susceptibility to noncompliance;
- Assessing management's commitment to reduce and control noncompliance;
- Determining whether previously identified noncompliance problems have been corrected; and
- Testing transactions.

### *1. Considering Requirements of Laws and Regulations*

The Identifying Laws and Regulations' section of this document discusses how to identify the laws and regulations applicable to the engagement. Some questions to consider are as follows:

- Are the laws and regulations readily identifiable, vague, complex, or contradictory?

Laws and regulations that are clear, understandable and consistent with other laws and regulations are easier to adhere to and to check compliance than laws and regulations lacking these characteristics.

- Do the laws and regulations relate to a new program, or have they undergone recent or frequent major changes or have they not been enforced?

Laws and regulations that have recently been implemented or changed or that have not been enforced may be more likely to be violated because people are less familiar with them.

### *2. Susceptibility to Noncompliance*

Auditors should also identify the characteristics that increase the susceptibility to noncompliance. Some questions to consider are as follows:

- Do incentives of noncompliance outweigh the potential penalties?

If the law or regulation provides a benefit based on need or performance, individuals will have an incentive to overstate their need or performance in order to qualify or to get a larger benefit.

- Is it practicable or reasonable to expect compliance, or are the laws and regulations so burdensome or onerous that noncompliance could reasonably be expected?
- Does the entity have numerous transactions? The more transactions there are, the greater the chances that noncompliance could occur due to errors, irregularities, and abuse. Also, a large number of transactions increase the difficulty of detecting noncompliance.
- Have important government-supported activities and programs (e.g., payroll service or client services) been contracted out or delegated to those outside the contractor without ensuring that adequate internal control systems and active monitoring/oversight are in place?
- Does the contractor have a significant amount of assets that are readily marketable (i.e., cash, securities, or drugs) or could be used for personal purposes (i.e., tools, cars, auto repair parts, or computers)?

Such assets are very susceptible to improper use or theft.

- Are significant benefits of government-supported programs extended to individuals or corporations by contractor officials whose actions are generally not subject to public examinations and evaluations?

Auditors should be alert for and consider any "red flags" or indicators of susceptibility to noncompliance. Any such indicators would vary depending upon the organizational structure or type of services the contractor delivers. The following are examples of susceptibility indicators that might be identified:

- A pattern of certain contractors bidding against each other or, conversely, certain contractors not bidding against each other;
- Use of government-supported fixed assets and materials on activities that are unrelated to program services;
- A high rate of fines and penalty assessments from taxing authorities;
- Complex transactions;
- Poor records/documentation;
- Activities that are dominated and controlled by a single person or small group without adequate review and oversight;
- Unreasonable explanations to inquiries by auditors;
- Auditee's annoyance at reasonable questions by auditors;
- Employees' refusal to give others custody of records;
- Employees' refusal to take vacations and/or accept promotions; and
- Extravagant life-style of employees.

### *3. Management Commitment*

Auditors should consider management's commitment to reduce and control noncompliance. A strong commitment by management to comply is a positive factor in reducing the risk of noncompliance. Some questions to consider are as follows:

- Have problems been repeatedly disclosed in prior audits by your firm or other auditors?
- Does management promptly respond when problems are first identified?
- Are recurring complaints and allegations received by state agencies from the general public or state employees?
- Is management willing to discuss its approach toward compliance?
- Is management knowledgeable of the subject area and potential problems?
- Does management have a constructive attitude, including a willingness to consider innovative approaches?
- Is there a stable management team with continuity and a good reputation, or is there high turnover and/or poor management reputation?

### *4. Testing Transactions*

The final step of assessing inherent risk involves testing a limited number of transactions. This testing usually occurs during the stage of an engagement when information is gathered without verification for use in planning the audit (survey stage of government audits). This stage of the engagement is not intended to be a representative sample of transactions. Rather, the auditor should perform limited work to gain a better understanding of the processes followed by the contractor and to confirm other observations made about inherent risk of noncompliance.

## B. Internal Controls

Internal controls consist of policies and procedures used to provide reasonable assurance that goals and objectives are met; resources are adequately safeguarded, efficiently utilized, and reliably accounted for; and laws and regulations are complied with. The independent auditor should consult, review and consider the guidance furnished in the AICPA Standard Consideration of the Internal Control Structure in a Financial Statement Audit (SAS 78) and the 2011 Revision of the Yellow Book prior to evaluating internal controls.

Evaluating internal controls involves:

- Identifying internal control objectives that management has designed to provide reasonable assurance regarding the achievement of the entities objectives in the following categories: (a) reliability of financial reporting, (b) effectiveness and efficiency of operations, and (c) compliance with laws and regulations.
- Considering the five components of internal control that should reasonably assure compliance with the requirements of laws, regulations, and program compliance requirements.

- The five components of internal control are applicable to the audit of every entity. The components should be considered in context of:
    - The entity's size.
    - The entity's organization, culture, governance system, ownership or charitable organization characteristics.
    - The nature of the entity's business or non-profit purpose.
    - The entity's methods of transmitting, processing, maintaining, and accessing information.
    - Applicable legal and regulatory requirements.
- Testing control procedures; and
- Identifying needed follow-on actions.

In some instances, auditors may be able to make this evaluation on the basis of recently completed audits or evaluations.

### *1. Identifying Objectives and Components of Internal Control*

The internal control objective is a positive thing that management tries to attain or an adverse condition or negative effect that management is seeking to avoid. For example, the contractor has an objective of not billing the Commonwealth for services to clients who are ineligible for benefits. Auditors should determine what objectives related to the engagement management has established. There is a direct relationship between objectives and components which represent what is needed to achieve objectives. Internal control components are relevant to the entire entity, or to any of its operating units or functions. Internal controls consist of five interrelated components.

The five interrelated components of internal control and their characteristics that represent what is needed to achieve the objectives of the entity and how to provide reasonable assurance of compliance with laws and regulations are as follows:

***Control Environment*** sets the tone of the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

- Sense of conducting operations ethically, as evidenced by a code of conduct or other verbal or written directive.
- Management's positive responsiveness to prior questioned costs and control recommendation.
- Management's respect for and adherence to program compliance requirements.
- Key managers' responsibilities clearly defined.
- Key managers' have adequate knowledge and experience to discharge their responsibilities.
- Staff knowledgeable about compliance requirements and being given responsibility to communicate all instances of noncompliance to management.
- Management's commitment to competence ensures that staff receives adequate training to perform their duties.
- Management's support of adequate information and reporting system.

***Risk Assessment*** is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

- Program managers and staff understand and have identified key compliance objectives.
- Organizational structure provides identification of risks of noncompliance:
- Key managers have been given responsibility to identify and communicate changes.
- Employees who require close supervision (e.g. inexperienced) are identified.
- Management has identified and assessed complex operations, programs, or projects.
- Management is aware of results of monitoring, audits, and reviews and considers related risk of noncompliance.
- Process established to implement changes in program objectives and procedures.

***Control Activities*** are the policies and procedures that help ensure that management's directives are carried out.

- Operating policies and procedures clearly written and communicated.
- Procedures in place to implement changes in laws, regulations, guidance, and funding agreements affecting Federal awards.
- Management prohibition against intervention or overriding established controls.
- Adequate segregation of duties provided between performance, review, and recordkeeping of a task.
- Computer and program controls should include:
  - Data entry controls, e.g., edit checks.
  - Exception reporting.
  - Access controls.
  - Reviews of input and output data.
  - Computer general controls and security controls.
- Supervision of employees commensurate with their level of competence.
- Personnel with adequate knowledge and experience to discharge responsibilities.
- Equipment, inventories, cash, and other assets secured physically and periodically counted and compared to recorded amounts.

***Information and Communication*** are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

- Accounting system provides for separate identification of State and Federal and non-State and non-Federal transactions and allocation of transactions applicable to both.
- Adequate source documentation exists to support amounts and items reported.
- Recordkeeping system is established to ensure that accounting records and documentation retained for the time period required by applicable requirements; such as the Commonwealth Terms and Conditions for Human and Social Services and 808 CMR 1.04(1), and the provisions of laws, regulations, contracts or federal grant agreements applicable to the program.
- Reports provided timely to managers for review and appropriate action.
- Accurate information is accessible to those who need it.
- Reconciliations and reviews ensure accuracy of reports.
- Established internal and external communication channels:
  - Staff meetings.
  - Bulletin boards.
  - Memos, circulation files, e-mail.

    - Surveys, suggestion box.
- Employees' duties and control responsibilities effectively communicated.
- Channels of communication for people to report suspected improprieties established.
- Actions taken as a result of communications received.
- Established channels of communication between purchasing agencies and through subcontractors.

***Monitoring*** is a process that assesses the quality of internal control performance over time.

- Ongoing monitoring built-in through independent reconciliations, staff meeting feed back, rotating staff, supervisory review, and management review of reports.
- Periodic site visits performed at decentralized locations (including subcontractors) and checks performed to determine whether procedures are being followed as intended.
- Follow up on irregularities and deficiencies to determine the cause.
- Internal quality control reviews performed.
- Management meets with program monitors, auditors, and reviewers to evaluate the condition of the program and controls.
- Internal audit and internal monitoring routinely tests for compliance with Commonwealth and federal requirements.

### *2. Understanding the Entity's Internal Controls*

The objectives represent those goals and actions management wishes to achieve, while the components are the specific steps designed and prescribed by management to provide reasonable assurance that its objectives will be achieved. For example, to limit spending to the amounts negotiated with the Commonwealth in program budgets; contractor organizations have implemented detailed procedures for controlling expenditures. The objective is to limit spending to the amount negotiated, and the control procedures are those steps that must be performed before funds can be obligated and/or spent. These steps may include such actions as requiring certification by the accounting department that sufficient funds are available in the budget before obligating or expending funds.

The auditor can obtain information on the internal control components by reading contractor accounting and procedures manuals, reviewing past audit reports and evaluations, interviewing management and employees, and making observations.

Because of inherent limitations in the design and the operations of any internal control system, auditors should not expect internal controls to prevent or detect all instances of noncompliance or abuse. The most pervasive limitations are that the cost of internal controls should not exceed their benefits. In deciding how extensive the system of internal controls should be, management compares the costs of more controls with the benefits to be gained.

Other limitations include the possibility that management may override the internal control system; employees may secretly be working together (collusion) to avoid or circumvent the controls; and employees may not be correctly applying the control technique due to fatigue, boredom, inattention, lack of knowledge, or misunderstanding. As a result, auditors should always test actual transactions to have a reasonable basis for evaluating internal controls.

The auditors' understanding of the internal control system should be documented in the workpapers. This can be done through flowcharts; narratives; questionnaire responses, records of interviews, and copies of policies and procedures, documents, and records.

### *3. Testing Controls*

For internal controls to be effective, they must be designed to achieve the intended objective(s) and must be correctly and consistently applied by the authorized employee(s). The best designed internal controls are of little value if the procedures are not correctly followed. For example, if the entity has a procedure requiring the manager's approval for all purchases over a specified dollar amount, but the manager does not review the purchase orders, this procedure will not be very effective in preventing or detecting unnecessary purchases.

Testing internal controls consists of the following steps:

- Defining what constitutes effective internal controls;
- Selecting a small sample of transactions, either randomly or non-randomly;
- Evaluating whether the sample transactions were executed in accordance with the laws and regulations and internal controls;
- Documenting the evaluation results; and
- Determining the probability that noncompliance will not be detected or prevented by the internal controls.

Auditors can use the results of the transaction tests to assess the probability that internal controls will not prevent or detect noncompliance.

### *4. Needed Corrective Actions*

If testing reveals material noncompliance or abuse, the auditor should determine what internal controls were intended to prevent, or detect the noncompliance or abuse and ascertain the reasons they did not. If internal controls are weak or nonexistent, many more transactions may be in noncompliance. Auditors should consider expanding tests to determine the impact of weaknesses on engagement objectives and of doing follow-on work.

* * * * *

Auditors should consult the fieldwork and reporting standards for internal controls in financial and performance audits as discussed in the GAO's "Yellow Book."

A sample Audit Risk Assessment Form has been provided as an attachment to this document. Government auditors often use a combination of tools, including forms for documenting and assisting in assessing risk components that estimate the possibility of error and irregularities in account balance, classes of transactions or procedures. The attached form has been designed to be used in conjunction with the guidance provided in pages 5 through 13 of this document for determining materiality and/or significance and audit risk, which govern the level of testing required or the inclusion of a potential finding in the report.

## Reporting Requirements

GAO's government auditing standards require the following:

The auditors should prepare a written report on their tests of compliance with applicable laws and regulations. This report, which may be included in either the report on the financial audit or in a

separate report, should contain a statement of positive assurance on those items which were tested for compliance and it should include all material instances of noncompliance and all instances or indications of likely irregularities or illegal acts which could have occurred.

If auditors find no instances or indications of material noncompliance, the compliance report must include:

- A statement of positive assurance that the test results indicate that with respect to the items tested, the entity complied in all material respects with the laws and regulations referred to in the scope.

If auditors find instances of material noncompliance, they should state that they considered these instances in forming their opinion on the financial statements and whether these instances affected their opinion and how. The statement on assurance should be similar to the following:

> **"Except as described above, the results of our tests of compliance with laws and regulations indicate that with respect to the items tested, the contractor complied in all material respects with the provisions referred to above and nothing came to our attention that caused us to believe that the contractor had not complied in all material respects with those provisions."**
>
> Instances of noncompliance with laws and regulations that are clearly inconsequential and nonmaterial from a quantitative and qualitative perspective must be reported to top management of the contractor via a management letter. If applicable, the compliance report should state that the auditors found instances of immaterial noncompliance with laws and regulations that are being separately reported to management. Instances of noncompliance with laws and regulations that occurred because of a weakness in the system of internal control must be reported in the report on internal control if such weakness is a significant deficiency, material or immaterial weakness.

In all cases, instances of noncompliance with laws and regulations in the audit of a UFR should be reported by identifying:

- the condition of noncompliance;
- the effect of noncompliance in monetary and/or qualitative terms, if it can be determined;
- the criteria by which noncompliance was established;
- the cause of noncompliance, if it can be determined;
- recommendations for eliminating the noncompliance, if they can be developed.

Material findings of noncompliance should also be presented in their proper perspective:

- the size of the universe in number of items and dollars;
- the number and dollar amount of transactions tested by the auditors;
- the number of corresponding dollar amount of instances of noncompliance.

Further information on compliance reports can be found in the "Yellow Book" and Statement on Auditing Standards 74, issued by the American Institute of Certified Public Accountants; Compliance Auditing Applicable to Government Entities and Other Recipients of Governmental Financial Assistance. In addition, contractor audit reports that are subject to the requirements of OMB Circular A-133 must include a written report on compliance with laws and regulations that have a direct and material effect on each major federal program.

Audits of contractors for the purpose of Single Audit carry additional requirements that the auditor must be aware of to conduct the audit. These requirements are noted in the Executive Office of The President, Office of Management and Budget's publications, OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations and the Office of Management and Budget Compliance Supplement.

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Auditors should consult the reporting standards for compliance in financial and performance audits as discussed in the GAO's "Yellow Book."

A sample Audit Risk Assessment Form has been provided as an attachment to this document. Government auditors often use a combination of tools, including forms for documenting and assisting in assessing risk components that estimate the possibility of error and irregularities in account balance, classes of transactions or procedures. The attached form has been designed to be used in conjunction with the guidance provided in this document for determining materiality and/or significance and audit risk, which govern the level of testing required or the inclusion of a potential finding in the report.

## Suggested Areas of Compliance Testing

The majority of program services purchased by the Commonwealth are reimbursed through negotiated unit rate payments. Programs of social service purchased by the Commonwealth using negotiated unit rate payments deliver a program of discrete services which have performance and productivity requirements. These programs are disclosed in the Statement of Functional Expenses of the UFR and reported on in the Independent Auditor's Report on the Financial Statements. **Accordingly, independent auditors are expected to concentrate their testing and reporting efforts at the program and supporting service level as illustrated in the Statement of Functional Expenses of the UFR.**

Other unit rate payments are commonly and mistakenly identified as negotiated unit rate payments. These payments are usually for certain medical and social services priced using non-negotiated capitated and managed care rates, Medicaid eligible services, or for the delivery of goods and services such as pharmaceuticals, x-rays, accounting or temporary employment services rather than a program of social services. The organization, which is usually classified as a vendor, is being paid for the delivery of goods or units of service and is responsible for cost overruns.

The negotiated unit rate system of pricing and payment utilizes a rate calculation (unit rate/maximum obligation calculation page of contract Attachment B Program Budget) to establish a fixed price (maximum obligation) for a program of discrete services that is paid on a unit-of-service basis. Funding levels for these programs are established by considering the need for allowable program costs and performance and productivity levels. Programs that receive funding in this manner are often referred to as negotiated unit rate programs. The calculated rate reimburses the contractors for social services outputs, outcomes and market based program costs previously identified in a negotiated program budget. Negotiated program budgets may be changed by amending the contract. Conditions for amendment of the contract include:

- Operating costs change because statutory and regulatory modifications cause funding decreases and increases;

- Type and quantity of services are modified because of change in statute or regulation;
- A change in the amount or availability of off-setting income from other sources of funding;
- Client's safety and well-being is gravely threatened because program costs increase beyond the control of the contractor;
- Reimbursable costs become greater or less than negotiated amount; and
- Changes in expected client utilization; and
- Program reconfiguration occurs during the life of the contract.

The negotiated unit rate system of pricing and payment utilizes the market prices for negotiation purposes which accomplishes the following:

- Eliminates program costs that are not needed or should not be reimbursed with public funds;
- Accommodates program reconfiguration or other changes through contract amendment;
- Provides for adequate cash flow by permitting the retention of five percent of excess program revenues generated by good management practices and;
- Removes contractor responsibility for cost overruns.

The contractor's contract with the Commonwealth for the delivery of a program of social services has minimum and mandatory program requirements. The contract also includes specific and measurable criteria and standards for evaluating the contractor's productivity and performance in relation to desired individual client outcomes or overall program objectives. The contract mandates that the organization reports and meets these performance and productivity requirements and complies with applicable laws, non-reimbursable cost requirements and other regulatory requirements. Productivity and performance output and outcome measurements are the primary standards used in negotiated unit rate programs to determine if the contractor has fulfilled its contractual obligations.

The terms of the contractor's contract with the Commonwealth require the contractor and its subcontractors to maintain records of all types of expenses and income or other funds pertaining to the program paid to the contractor by every source, including each client. The contract specifies that the contractor and subcontractor(s) shall keep all data as necessary to satisfy applicable reporting requirements of OSD, the Center for Health Information and Analysis and purchasing departments. Contractors are also required to maintain financial books, supporting documents, statistical records, and all other records that reflect revenues associated with and costs incurred in or allocated to any program of services rendered under the Service Contract. In addition, the contract requires the contractor and subcontractor(s) to maintain adequate internal controls and books and records in accordance with generally accepted accounting principles. Accordingly, the independent auditor must observe the GAGAS auditing standards for financial statement audits and performance audits concerning internal controls in the 2007 revision of the Yellow Book when conducting field work and reporting on an audit of the UFR. The audit of the UFR requires the independent auditor to pay particular attention to internal controls over compliance with laws, regulation and management controls that are discussed in the 2007 revision of the Yellow Book.

The **cost reimbursement method** of pricing and payment is also utilized for the purchase of social services by the Commonwealth. The cost reimbursement pricing structure reflects a

purchase arrangement in which the purchasing agency pays the contractor for budgeted costs that are actually incurred in delivering the services specified in the contract, up to a stated maximum obligation. In cost reimbursement situations, any budgeted cost that is not actually incurred, including the allocation of administration, can neither be billed by the contractor nor reimbursed by the purchasing agency. **All excess revenues that are generated as a result of budgeted costs not being incurred by the contractor but reimbursed by the purchasing agency in cost reimbursement contracts must be passed on to the Commonwealth. Any overbilling in a cost reimbursement contract requires the independent auditor to write a finding of overbilling in the compliance report.** The contractor should initiate a corrective action plan in response to the auditor's finding.

The final signed corrective action plan should indicate that the contractor disclosed a liability to the Commonwealth in its financial statements and agreed to a schedule of repayment(s) that has been identified in the corrective action plan with the Commonwealth purchasing agency(s) that is a party to the written corrective action plan. **Please Note:** Effective with Fiscal Year Ending June 30, 2002, the Operational Services Division has assumed responsibility for determining and recovery of all overbilling applicable to Commonwealth cost reimbursement contracts.

Regulations and contract terms and conditions that govern the establishment and administration of rates of payment and contracts are attached to this document.

For negotiated unit rate and cost reimbursement programs, the auditor's examination should be directed to areas that could, by virtue of noncompliance with laws and regulations and disallowance, have a direct and material effect on the financial statement amounts. Given that the Independent Auditor is opining on the amounts disclosed in the Statement of Functional Expenses the auditor's examination should be directed to the program services and supporting services disclosed in the Statement of Functional Expenses and Supplemental Schedule(s) A_OSI and B_PSI of the UFR.

The auditor should obtain an understanding of management's responsibilities concerning the contractual requirements established in the general conditions of its Master Agreement with the Commonwealth (including the internal control requirements noted above) and the non-reimbursable cost provisions of 808 CMR 1.05 (Effective 11/17/06).

The Operational Services Division will determine the annual excess revenues generated through negotiated unit rate programs pursuant to the provisions of 808 CMR 1.03 (7) Not-for-Profit Provider Surplus Revenue Retention (Effective 11/17/06, 808 CMR 1.03 (7)). Given this fact, the auditor's examination should not be directed to this area for compliance with the revenue retention provisions of 808 CMR 1.03 (7) other than to ensure that appropriate disclosure occurs.

Each compliance requirement below is generally considered to be inherently risky and highly susceptible to noncompliance. Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements are also included. The auditor should consider these areas when performing the vulnerability assessment for determining the extent of compliance testing needed in each program of service and supporting service. The need or extent of compliance testing in these areas has not been mandated but instead is directly related to the contractor's degree of vulnerability.

The suggested audit procedures associated with the compliance requirements below are intended to be illustrative, not comprehensive or mandatory. The design of appropriate audit tests should be based upon the auditor's professional judgment.

***Allocation of Costs***

***Compliance Requirement***: Contractor organizations must maintain financial books and records which distinguish the direct expenses of each program receiving Commonwealth funds and which make a reasonable allocation of the organization's costs which pertain to various functions to such programs. Indirect expenses that are not related to direct services such as management and general/administration and certain administrative expenses should normally not be allocated to various functions on the basic financial statements.

**Source*:*** 808 CMR 1.04 (1) Recordkeeping.

- Review the chart of accounts and books of original entry to determine if they distinguish and segregate the income and direct expenses associated with programs funded by the Commonwealth.
- Determine whether the contractor has written cost allocation policies and plans.
- Review indirect cost allocation policies, plans, worksheets, etc., to determine if allocations are reasonable and in accordance with recommendations of the AICPA guidelines for Voluntary Health and Welfare Organizations regarding allocation of costs which pertain to various functions and the instructions of the *UFR Audit & Preparation Manual*.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements***:

Incorrect interpretation of the AICPA recommendations for allocation of costs which pertain to various functions or recording and reporting through error; or

Committing irregularities, such as the intentional allocation of administrative costs for the overall direction of the organization to program or fund-raising functions, in an effort to portray the contractor (for the benefit of contributors, financial lending institutions and governmental jurisdictions) as having minimal administrative expenditures; or

Allocation of administrative costs to programs receiving funding from the Commonwealth in a fraudulent or illegal manner for the purposes of increasing reported reimbursable program costs used to support billings and formulas for reimbursement which could result in a disallowance,

Debarment and legal action. These actions would result in a direct and material effect on the financial statement amounts, including a misstatement of administrative, program and fund-raising functions on the Statement of Functional Expenses and a liability to the Commonwealth on the Balance Sheet.

The AICPA recommendations prohibit allocation of administrative (management and general) costs for the overall direction of the organization to program and fund-raising functions. The portion of time spent directly supervising program, fund-raising or service activities, such as salaries and expenses, should be prorated among those functions. Administrative costs for the overall direction of the organization, including general record maintenance, general board activities, and salaries and expenses of the chief officer of the organization and/or his staff, could be incorrectly allocated to program and fund-raising functions, as noted above.

### *Allowable Services*

***Compliance Requirement***: The contractor organization must ensure that the amounts reported as program expenditures for programs funded by the Commonwealth were for allowable services as defined in the contractor's standard service contract or agreement with the Commonwealth.

***Source:*** Commonwealth of Massachusetts Standard Contract Form Attachment 1.

***Suggested Audit Procedures:***

- Review contractor program descriptions and interview staff to determine if the services delivered are consistent with the allowable services defined in the standard service contract.
- If the use of fixed assets is an integral part of the program, determine by observation that the resources are available and being utilized.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of allowable service criteria or recording and reporting through error; or

Committing irregularities, such as intentionally reporting or billing for services that are not allowed, in an effort to provide services other than those covered in the contract and/or portraying the contractor as having fulfilled all of its contract service delivery obligations; or

Fraudulent or illegal reporting and billing for services that have not been provided in accordance with the terms and conditions of the contract with the Commonwealth could result in disallowance, debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement of program functions on the Statement of Functional Expenses and a liability to the Commonwealth on the Balance Sheet.

### *Eligible Clients*

***Compliance Requirement***: The contractor organization must ensure that the amounts reported as program expenditures for programs funded by the Commonwealth were for eligible clients as defined in the contractor's standard service contract or agreement with the Commonwealth.

***Source:*** Commonwealth of Massachusetts Standard Contract Form Attachment 1.

***Suggested Audit Procedures:***

- Review contractor admission and client eligibility determination procedures and determine if program services are being delivered to eligible clients in accordance with the client profile, admission and financial eligibility criteria of the standard service contract or agreement.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of client eligibility criteria or recording and reporting through error; or

Committing irregularities such as intentionally reporting or billing for ineligible clients in an effort to provide services to individuals not meeting contract eligibility criteria and/or

portraying the contractor as having fulfilled its service delivery obligations to eligible clients of the contract; or

Fraudulent or illegal reporting and billing for services provided to clients who do not meet client contract eligibility criteria could result in a disallowance, debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a liability to the Commonwealth on the Balance Sheet.

***Performance and Service Documentation***

***Compliance Requirement***: The contractor organization must ensure that performance information and amounts reported as program income and expenditures for programs funded by the Commonwealth in the UFR were supported by a system that measures performance and establishes targets to be achieved in the form of outputs and outcomes. Contractor organizations must maintain a system of documenting and reporting client attendance, client encounters or services delivered which:

- identifies individual consumers/clients with the services and attained output measures each has received;
- identifies, by program, all attained output measures and service units actually rendered or delivered;
- identifies whether and to whom services were billed; and
- identifies and relates attained output measures to service units and desired outcomes.

***Source:*** Commonwealth of Massachusetts Standard Contract Form Attachment 1 and 2.

***Suggested Audit Procedures:***

- Review contractor performance monitoring and evaluation system to determine if management is furnished with attained performance information derived from an internal performance reporting system. Determine if monitoring and evaluation system evaluates attained output measures and units of service rendered in relation to targets to be achieved and the desired outcomes in accordance with program performance and utilization criteria of the standard service contract or agreement.
- Ascertain whether the contractor maintains a system which documents and records, as appropriate, client attendance, client encounters, attained output measures and units of service delivered.
- Review the system and records to determine if they satisfy the above criteria.
- Selectively sample and trace invoices to the Commonwealth for services rendered to supporting documentation (service delivery records).
- Selectively sample internal and UFR performance reports to output measurement supporting documentation.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of performance and service documentation requirements or recording and reporting through error; or

Committing irregularities, such as intentionally reporting or billing for services not supported by accurate performance and service delivery documentation for measuring outputs and units of service delivered, in an effort to provide services to ineligible individuals and/or to

embellish service delivery attained outputs and client utilization or to portray the contractor as having fulfilled these requirements; or

Fraudulent or illegal reporting or billing for services in accordance with performance and service delivery requirements of the contract or for services that have not been provided could result in disallowance, debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a liability to the Commonwealth on the Balance Sheet.

Contractor organizations that are reimbursed for a program of social services through the negotiated unit rate system of pricing and payment, which utilizes a formula to establish a fixed price (maximum obligation), are paid on a unit of service basis. The contracts for these programs have minimum or mandatory program requirements and specific and measurable criteria and standards for evaluating the contractor's productivity and performance. Productivity and performance measurements are the primary standards used in negotiated unit rate programs to determine if the contractor has fulfilled its contractual obligations.

### *Program FTE Documentation*

***Compliance Requirement:*** Contractor organizations must maintain a system of documenting each full- and part-time employee's attendance, hours worked, program assignments and payroll expenses to enable the organization to prepare an accurate schedule of full-time equivalent employees and associated payroll expenses by job category and program.

***Source***: 808 CMR 1.04 (1) Recordkeeping and Commonwealth Terms and Conditions for Human and Social Services, Recordkeeping and Retention, Inspection of Records

***Suggested Audit Procedures:***

- Ascertain whether the contractor maintains a system of documenting employees' time and attendance, payroll expenses and program assignments.
- Review the system's records to determine whether they identify:
  - individual employee's total time and attendance;
  - individual employee's job category;
  - individual employee's program assignments or, in the case of employees assigned to work in more than one program, the proportion of time devoted to each; and
  - individual employee's payroll expenses.
- Selectively test and trace "Employee Compensation" reported on the Statement of Functional Expenses to supporting documentation (time sheets, attendance records, etc.).

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Absence of a system for documenting employee's time and attendance, payroll expense and program assignments or the incorrect interpretation of its maintenance requirements could increase the risk of recording and reporting through error; or

Committing irregularities, such as intentionally reporting or billing for services not supported by accurate documentation for supporting employee's time and attendance, payroll expense and program assignments, in an effort to provide services with less or different employee staffing than what is required in the contract or to embellishing staffing assignments and

employee-related expenses or portraying the contractor as having fulfilled licensing requirements; or

Fraudulent or illegal reporting or billing for services not in accordance with staffing, related employee expenses and licensing requirements of the contract could result in disallowance, debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a liability to the Commonwealth on the Balance Sheet.

### *Client Funds*

***Compliance Requirement***: A contractor organization which serves as a client's representative payee for Social Security Administration (SSA) Social Security Income (SSI) benefit purposes, which, as a fiduciary, holds and manages the personal funds of clients specifically identified, referred or deemed eligible for the program by the Commonwealth under a contract or agreement, must do so in accordance with the guidelines of applicable Commonwealth of Massachusetts purchasing agencies.

***Source*:** Commonwealth Purchasing Agency Regulations and Policies and Commonwealth Terms and Conditions for Human and Social Services, Human and Social Services Contracting Provisions b. Client Care and Use of Funds

***Suggested Audit Procedure:***

- Determine (client representation) whether the contractor acts as a representative payee or otherwise acts as a fiduciary with respect to client personal funds.
- Determine whether the appropriate Commonwealth of Massachusetts agency has promulgated rules, regulations or policies governing the contractor's fiduciary duties with respect to client funds by inquiry to the contractor's contact officer for that agency, i.e. DMH 104 CMR 30.00 and DMR 115CMR 3.00.
- Obtain an understanding of the requirements of said rules, regulations, etc., including guidelines set by SSA at www.socialsecurity.gov/payee
- Determine whether the contractor has established representative payee internal controls and procedures
- Obtain and review the SSA annual SSI reports for representative payee and any audit and/or findings relating to representative payee.
- Selectively sample and test transactions to determine whether the material provisions of said rules, regulations, etc., have been followed.
- Determine if contractor is entitled to receive charges for care and test whether they were properly calculated and recorded. (DMR 115CMR 3.05 to 3.06)

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of client fund record maintenance requirements or recording and reporting through error; or

Committing irregularities, such as intentionally recording or reporting client funds in a manner not in accordance with established accounting principles, purchasing agency policies, regulations or legal requirements, in an effort to use these funds for unauthorized purposes or to portray the contractor as having fulfilled fiduciary responsibilities; or

Fraudulent or illegal reporting and use, including defalcation of client funds, could result in debarment and legal action, including fines and imprisonment. .

### *Contractor Reimbursements/Stipends*

***Compliance Requirement:*** Contractor organizations which operate family day-care or foster-care programs funded by a Commonwealth contract or agreement must pay third-party, family day-care or foster-care contractors at the rate established by the Commonwealth. The third-party payments must be the same as the contractor's reimbursement/stipend expenses.

***Source:*** Commonwealth Purchasing Agency Policies

***Suggested Audit Procedure:***

- Determine whether the contractor organization operates family day-care, foster-care, or other programs in which third-party contractors are required to be reimbursed at rates established by the Commonwealth.
- Reconcile total contractor reimbursement/stipend expenses and report any differences.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of contractor reimbursements and stipend payment (pass through) and record maintenance requirements or recording and reporting through error; or

Committing irregularities, such as intentionally recording or reporting payments to third-party contractors not in accordance with established purchasing agency policies, in a effort to use these funds for unauthorized purposes or to portray the contractor as having fulfilled financial management responsibilities; or

Fraudulent or illegal reporting and use, including defalcation of third-party reimbursements or stipends, could result in disallowance, debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement of custodian funds or a liability to the third party and the Commonwealth on the Balance Sheet.

### *Assets Held in Trust for the Commonwealth*

***Compliance Requirement***: Title to all furnishings, equipment and other assets furnished to the contractor organization by the Commonwealth or wholly purchased with funds received from the Commonwealth pursuant to a contract or agreement may vest with the Commonwealth or the Contractor in accordance with the provisions of the Purchase of Service Capital Items Procurement Policy effective September 1, 1998. The contractor organization must establish a capitalization threshold for capitalizing assets in accordance with generally accepted accounting principles (GAAP) and maintain a written inventory of all such property, including a description and location of each item.

***Source***: Commonwealth of Massachusetts Purchase of Services Capital Items Procurement Policy and the Purchase of Service Contract Form Attachment 6 Capital Budget and 808 CMR 1.04(5)

***Suggested Audit Procedure:***

- Determine (client representation with respect to assets acquired in prior years and review of current year contracts and agreements) whether the contractor has possession of any assets furnished by the Commonwealth or wholly purchased with funds received pursuant to a contract or agreement.
- Determine if the Contractor's capitalization threshold has been established in accordance with GAAP.
- Determine if all capital items furnished by the Commonwealth met the contractor's criteria for capitalization in accordance with GAAP.
- Determine whether the contractor maintains asset records which identify and account for such furnishings and equipment.
- Selectively sample and test the records maintained and inventories performed for the following requirements:
  - Written Inventory of all such property;
  - Description of each item; and
  - Location of each item.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of free use of facilities and other asset record maintenance requirements or recording and reporting through error; or

Committing irregularities, such as intentionally recording or reporting free use items or contractor owned assets not in accordance with established accounting principles, purchasing agency policies, regulations or legal requirements, in an effort to portray the contractor as having the use or ownership of more or less assets than it actually has or to represent that all custodial responsibilities have been fulfilled; or

Fraudulent or illegal reporting and use, including defalcation of commonwealth assets, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

***Disclosure of Non-Reimbursable Costs***

***Compliance Requirement***: Contractor organizations are required to disclose the existence and value of all anticipated non-reimbursable costs, as identified in 808 CMR 1.05 (1) - (28), and identify the offsetting revenue used to defray the non-reimbursable costs in program budgets of contracts with purchasing agencies of the Commonwealth. All incurred non-reimbursable costs and their value must be reported in Supplemental Schedule B_PSI expenses of the Uniform Financial Statements and Independent Auditors Report (UFR) as either a state or federal non-reimbursable cost.

***Source***: Regulation 808 CMR 1.05 Non-Reimbursable Costs and Contract Instructions and Forms issued by the Operational Services Division.

***Suggested Audit Procedure:***

- Review and become familiar with the twenty-eight (28) non-reimbursable cost provisions of 808 CMR 1.05. These provisions also include by reference the federal cost principles of

OMB Circular A-122 and A-21 as appropriate when the contractor directly or indirectly receives federal assistance.

- Determine (contractor representation with respect to non-reimbursable costs in prior years and review of current year contract program budgets) whether the contractor has anticipated the existence of any non-reimbursable costs.
- Determine whether the contractor maintains records as part of its internal control structure which identifies and accounts for non-reimbursable costs.
- Review the records maintained for the following requirements:
  - Written definition of non-reimbursable costs;
  - Description of each anticipated and incurred non-reimbursable cost; and Identification of fund, program and dollar value related to each non-reimbursable cost.
- Selectively sample and test the expense records to determine that non-reimbursable costs were properly classified, valued and posted in the accounting records and disclosed in the contractor's current year contract program budgets and UFR.
- Determine that unrestricted revenues and revenues restricted by donors for use in defraying non-reimbursable costs were available and accurately reported in the UFR as
- being used to offset (defray) all non-reimbursable costs in programs that the Commonwealth purchases services.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of the definition and disclosure requirements of non-reimbursable costs and other requirements or recording and reporting through error; or

Committing irregularities, such as intentionally recording or reporting non-reimbursable costs not in accordance with established accounting principles, purchasing agency policies, regulations or legal requirements, in an effort to portray the contractor as having less non-reimbursable costs than it actually has or to represent that all disclosure responsibilities have been fulfilled; or

Fraudulent or illegal reporting and use, including defalcation of commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

***Related Party Disclosure***

***Compliance Requirement***: Contractor organizations are required to disclose the existence and non-reimbursable value of all anticipated related party transactions (related party is defined in accordance with SFAC No. 57 pursuant to 808 CMR 1.02 in program budgets of contracts with purchasing agencies of the Commonwealth. The non-reimbursable value of all incurred related party transactions must be disclosed in Supplemental Schedules A_OSI and B_PSI of the UFR. In addition, all related party relationships must be disclosed in the Notes to the Financial Statements of the UFR. The following OSD related party materiality and disclosure guidance should be considered in determining if disclosure is required in the GAGAS audited financial statements of the UFR.

- <u>Contractors that receive funding from the Commonwealth for the operation of social service programs</u>:

Generally, OSD recommends that all related party relationships and transactions, as defined by 808 CMR 1.02, associated with contractors receiving funding for the operation of social service programs from the Commonwealth (state agencies and local education authorities) be considered material related party transactions in accordance with GAGAS. These material related party transactions should be disclosed in the notes to the financial statements of the UFR. Two exceptions to this consideration may, to the extent allowed by the **qualitative materiality factors** of GAGAS, as noted below, include the following:

* Individual or aggregated monetary related party transactions where the total value of transactions with the related party was less than one hundred dollars ($100) within the year.
* Gifts furnished to the contractor by an official, administrator or manager of the contractor.

This greater degree of GAGAS materiality is predicated upon the sensitive nature of contractors operating Commonwealth-purchased programs and the penalties and sanctions associated with failure to provide disclosure of related party transactions and relationships in the UFR. Failure to disclose material related party transactions in accordance with GAGAS could result in penalties or a disallowance of related party costs which could materially affect the financial statement amounts. These possible actions dictate that most contractor related party relationships and transactions should be considered material in accordance with GAGAS. In addition, the GAGAS materiality level for disclosure of related party transactions is further magnified by the prior disclosure requirements for related party transactions and relationships established pursuant to Chapter 495, Section 99 of the Acts of 1993 and 808 CMR 1.04 (4). Audit risk associated with disclosure of related party transactions in the contractor's financial statements and/or the auditor's report on compliance would be substantially increased if the contractor did not comply with these prior disclosures of related party transaction requirements. Noncompliance with the prior disclosure requirements could include the following penalties that may materially affect the financial statement amounts: Failure to furnish prior disclosure of **all contractor related party transactions in excess of $100** (Except for gifts furnished to the contractor by an official, administrator or manager of the contractor) pursuant to 808 CMR 1.04 (4) could result in OSD ordering that the service contract or service contracts directly affected by the violation of related party prior disclosure requirements be terminated or the assessment of a civil penalty of no more than $2,000 or 10% of the contractor's annual maximum obligation under such contract or contracts, **whichever is greater** and the debarment of the contractor for a period not to exceed five years in the event of repeated willful violations of 808 CMR 1.04 (4).

***Source:*** Regulation 808 CMR 1.04 Filing and Reporting Requirements, regulatory standards and instructions of the UFR and Contract Instructions and Forms issued by the Operational Services Division.

***Suggested Audit Procedure:***

- Review and become familiar with the definition of a related party as defined in 808 CMR 1.02 and Financial Accounting Standards No. 57 (SFAS No. 57), incorporated by reference, and disclosure requirements. The auditor should also become fully acquainted with the requirements and recommendations as codified in the AICPA Professional Standards, Statement on Auditing Standards No.45 (SAS No. 45) and Auditing Interpretations of Section

Au 334 (Au Section 9334) and the Generally Accepted Government Auditing Standards (GAGAS) definition of material.

- Determine (contractor representation with respect to related party relationships and transactions in prior years and review of current year contract program budgets) whether the contractor has anticipated the existence of any related party relationships.
- The auditor should consider and obtain representations from the contractor's senior management and its board of directors as to whether they or any other related parties engaged in any transactions with the contractor during the period, as recommended in Au Section 9334.
- Determine the existence of related party relationships and transactions by utilizing and applying the accounting considerations audit procedures prescribed by SAS 45 and Au Section 9334 to the contractor's activities.
- Determine that the contractor has disclosed all material related party relationships and transactions as the following requires:

  In government audits and in the Purchase of Service System, the materiality level and threshold for related party disclosure is lower than in similar-type audits in the private sector because of public accountability of the entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions. All related party relationships or transactions, as defined by 808 CMR 1.02 and SFAS No. 57, that are associated with programs that are purchased by the Commonwealth are considered material and must be disclosed in current year program budgets and the UFR.

  All related party transactions in programs that are not purchased by the Commonwealth that could affect the contractors financial statements and all instances of common ownership or management control relationships for which 808 CMR 1.02 and SFAS No. 57 requires disclosure even though there are no transactions should be considered material in accordance with the criteria established by GAGAS and must be disclosed in the UFR.

- Determine that the contractor has disclosed the following information for all material (GAGAS definition of material) related party relationships and transactions:

  a. Nature of related party relationship;
  b. The receivables or payables associated with related party transactions for each period the balance sheet or program budget is presented, and, if not clearly determinable, the conditions and methods of settlement;
  c. For each period that an income statement or program budget is presented, the following is required:
     (1) A description of transactions and other necessary information needed for an understanding of the impact of the transactions; and
     (2) Dollar amounts assigned to transactions, and the impact of determining the terms of the transactions, if different from prior periods;

  d. If two or more companies are under common control via ownership or management, the disclosure in a. above is required, even though no transactions occurred, if the existence of that control <u>could</u> result in operating results or financial position significantly different from that which would have been obtained if the enterprises were autonomous.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of the definition and disclosure requirements of related party relationships and transactions, and other requirements or inaccurate recording and reporting through error; or

Committing irregularities, such as intentionally recording or reporting the nature and value not in accordance with established accounting principles, purchasing agency policies, regulations or legal requirements, in an effort to portray the contractor as having no related party relationships or a lesser value of related party transactions than it actually has, or to represent that all disclosure responsibilities have been fulfilled; or

Fraudulent or illegal reporting and use, including defalcation of commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

### ***Record Keeping***

***Compliance Requirement***: Contractor organizations are contractually required to maintain their financial books and record keeping systems in accordance with generally accepted accounting principles (GAAP) as set forth in the American Institute for Certified Public Accountants AICPA industry audit guide, Audits of Voluntary Health and Welfare Organizations, as specified in 808 CMR 1.04. The record keeping system of contractor organizations must keep on file data as are necessary to satisfy applicable reporting requirements of the Operational Services Division (OSD). Contractor financial statements prepared in accordance with generally accepted accounting principles as set forth in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (Codification and audited in accordance with generally accepted government auditing standards (GAGAS) are contractually required to be filed with OSD. Financial books and records of contractors must reflect revenues from every source, including each client, associated with and costs incurred in or allocated to any program of services rendered.

***Source:*** 808 CMR 1.04 (1) Recordkeeping

***Suggested Audit Procedure:***

- Ascertain whether the contractor maintains a system of recording and documenting all revenues and expenses related to every source by fund and program on a functional and natural basis.

Determine whether the contractor has written cost allocation policies and plans that have been established in accordance with the recommendations of the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (Codification) and the OSD UFR Instructions for "Allocation of Costs Which Pertain to Various Functions."

- Ascertain whether the contractor maintains records and procedures in accordance with the following provisions of GAAP which are contractually required:
  - Preparation and maintenance of up-to-date statement of job description and responsibilities.
  - Preparation and maintenance of a statement of job qualifications.
  - Maintenance of resumes and job applications of employees, including name, address, social security number, education and/or experience, and copies of all licenses and certifications required to perform the job.

- Payroll and time and attendance records documenting program assignment and hours and days worked as prescribed by Federal Fair Labor Standards Act of 1938, as amended part 516 and MGL c. 151 the minimum Fair Wage Law.

- Ascertain whether the contractor maintains other records and procedures in accordance with GAAP that provide internal control over the classification of expenditures as follows:
  - Preparation of a detailed budget which incorporates Commonwealth purchased program services that are reviewed periodically by a committee of directors or trustees.
  - Preparation of studies of the services performed by employees who serve more than one function, to determine the bases for allocating their salaries and expenses.
  - Use of written instructions to employees on the preparation of time and expense reports covering the method to be followed in determining and indicating services being performed.
  - Preparation and maintenance of up-to-date organization charts.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of the record keeping requirements of the contract could result in an inability to meet reporting requirements or inaccurate recording and reporting through error; or

committing irregularities, such as intentionally recording or reporting the nature and value not in accordance with GAAP, purchasing agency policies, regulations or legal requirements, in an effort to portray the contractor as having financial program activities other than it actually had or to represent that all contractual and legal responsibilities have been fulfilled; or

fraudulent or illegal reporting and use, including defalcation of Commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

### *Offsetting Income*

***Compliance Requirement***. Client resources and/or third-party payments made on behalf of a client as well as other off-setting revenue in a Commonwealth-funded social service program must first be used by the contractor to reduce the amount of the appropriate purchasing agency's obligation for the service rendered to the client (note the maximum financial obligation of the purchasing agency does not include non-reimbursable costs pursuant to 808 CMR 1.05). Further, even if client resources or third-party payments made on behalf of a client is not anticipated in the program budget or otherwise in the computation of the price, the amount of the resources or third-party payments actually received must be used to reduce allowable costs related to the purchasing agency's obligation for client services. The contractor's social service program budget may also anticipate voluntarily designated unrestricted revenues and support or donor restricted revenues and support to be used as offsetting income for reducing allowable costs related to the purchasing agency's obligation for client services. In addition, social service programs that receive federal financial assistance are subject to similar provision promulgated by the Presidents Office of Management and Budget (OMB).

(See *administrative compliance requirements* for *program income* in OMB Circular A-133 Compliance Supplement.

***Source:*** The provisions of 808 CMR 1.02 Offsetting Revenue and 808 CMR 1.03(5), applicable to all contractors

***Suggested Audit Procedure:***

- Ascertain whether the Attachment 3 of the contract includes offsets and the source and amount of the offsets used to reduce the Commonwealth's maximum obligation by reviewing cost reimbursement offsets and unit rate offsets (unit rate calculation page).
- Determine whether the contractor received client resource, third-party revenues, voluntarily designated unrestricted revenues and support and/or donor restricted revenues and support during the contract period and if these revenues were used in the Attachment 3 to reduce the Commonwealth's rate calculation/maximum obligation.
- Determine whether the contractor's contract was amended or if invoices submitted to the Commonwealth during the year were reduced to further offset the Commonwealth's maximum obligation for any additional unanticipated client resource and/or third-party revenues received during the year.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of the offsetting income requirements of the contract (includes federal program income provisions if federal assistance is furnished by the Commonwealth) could result in an inability to meet budgeting requirements or inaccurate recording and reporting through error; or

committing irregularities, such as intentionally recording or reporting the nature and value not in accordance with, Division of Purchases Services and purchasing agency policies, regulations or legal requirements, in an effort to portray the contractor as not having offsetting income that it actually had or to represent that all contractual and legal responsibilities have been fulfilled; or fraudulent or illegal reporting and use, including defalcation of Commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

### *Cost Reimbursement Contract Overbilling*

***Compliance Requirement***. The cost reimbursement pricing structure reflects a purchase arrangement in which the purchasing agency pays the contractor for budgeted costs that are actually incurred in delivering the services specified in the contract, up to a stated maximum obligation. In cost reimbursement situations, any budgeted cost that is not actually incurred, including the allocation of administration, can neither be billed by the contractor nor reimbursed by the purchasing agency. **All excess revenues that are generated as a result of budgeted costs not being incurred by the contractor but reimbursed by the purchasing agency in cost reimbursement contracts must be passed on to the Commonwealth. <u>Any overbilling in a cost reimbursement contract requires the independent auditor to write a finding of overbilling in the compliance report</u>.** The contractor should initiate a corrective action plan in response to the auditor's finding. The final signed corrective action plan should indicate that the contractor disclosed a liability to the Commonwealth in its financial statements and agreed to a schedule of repayment(s) that has been identified in the corrective action plan with the Commonwealth purchasing agency(s) that is a party to the written corrective action plan.

***Source:*** State Finance Law; Policies and Procedures Handbook for Human and Social Services, Principles of Program Pricing.

***Suggested Audit Procedure:***

- Determine whether the contractor was reimbursed for any budgeted costs billed to the Commonwealth that were actually not incurred.
- Determine that all costs reimbursed by the Commonwealth were included in the cost reimbursement contract program budget.
- Determine whether the contractor was reimbursed for any costs exceeding any one of the four program component cost categories maximum obligations of the program budget.
- Determine if total reimbursements form the Commonwealth exceeded actual allowable and reimbursable costs incurred by the contractor.
- Determine if the contractor maintains adequate internal controls to avoid overbilling the Commonwealth for costs not actually incurred, costs not previously approved in the program budget and total costs exceeding all component costs categories maximum budget obligations.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Incorrect interpretation of the requirements for cost reimbursement contracting or recording and reporting through error; or Committing irregularities, such as intentionally recording or reporting and billing for costs not in accordance with established, purchasing policies, regulations or legal requirements, in an effort to portray the contractor as having more reimbursable costs than it actually has or to represent that all disclosure responsibilities have been fulfilled; or Fraudulent or illegal reporting and use, including defalcation of commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

***Internal Controls***

***Compliance Requirement.*** The Commonwealth Terms and Conditions for Human and Social Services requires the contractor to maintain records, books, files and other data as required by 808 CMR 1.04(1) and the instructions of the UFR is such detail as shall properly substantiate claims for payment. The contractor is also required to maintain adequate written policies and procedures for accounting management and personnel activities in accordance with GAAP, including but not limited to conflict of interest and nepotism policies. If a non-profit organization, the contractor shall comply with the principles in the Massachusetts Attorney General's "Guide for Board Members of Charitable Organizations" and with the standards for boards contained in the AICPA's statements on auditing standards, as may be amended from time to time. Organizations receiving federal financial assistance must adhere to the internal control requirements contained in OMB Circular A-110.

Auditors should consult the compliance supplement for OMB circular A-133 for more information concerning specific internal control requirements).

***Source***: Commonwealth Terms and Conditions for Human and Social Services**.**

***Suggested Audit Procedure:***

- Assess the adequacy of the Contractor's internal controls in accordance with statement on auditing standards (SAS) number 78 and OMB Circular A-110 if applicable. The compliance supplement for OMB Circular A-133 and this publication provides information that can be used for assessing the adequacy of the Contractor's internal controls by providing sample characteristics relating to each of the five components of internal control;

- Assess the adequacy of the Contractor's internal controls pertaining to compliance requirements for Commonwealth funded organizations, activities and programs.

***Examples that increase the risk of noncompliance and could have a direct and material effect on the financial statements:***

Inadequate internal controls could result in the preparation of unreliable financial statements, reduced accountability over assets and noncompliance with laws, regulations and other compliance requirements. Inadequate internal controls permits recording and reporting through error; or Committing irregularities, such as intentionally recording or reporting and billing for costs not in accordance with established, purchasing policies, regulations or legal requirements, in an effort to portray the contractor as having more reimbursable costs than it actually has or to represent that all disclosure responsibilities have been fulfilled; or Fraudulent or illegal reporting and use, including defalcation of commonwealth funds, could result in debarment and legal action. These actions would have a direct and material effect on the financial statement amounts, including a misstatement or a liability to the Commonwealth on the Balance Sheet.

## AUDITOR'S COMPLIANCE SUPPLEMENT ATTACHMENTS

# OPERATIONAL SERVICES DIVISION BUREAU OF AUDIT RISK ASSESSMENT FORM

Contractor Name:_____

Vendor Code Number:_____ Audit Number: _____

Area of Testing/Reporting: _____

In determining materiality and/or significance and audit risk which governs the level of testing required or the inclusion of a potential finding in the report, the auditor must consider the following:

***Risk Level***

| **Factors to be Considered** | **High** | **Moderate** | **Low** | **or %** |
|---|---|---|---|---|
| a. Amount of revenue and expenditures. | _____ | _____ | _____ | _____ |
| b. Newness of the activity or changes in its condition. | _____ | _____ | _____ | _____ |
| c. Adequacy of internal controls | _____ | _____ | _____ | _____ |
| d. Results of prior audits | _____ | _____ | _____ | _____ |
| e. Level and extent of review or other form of independent oversight | _____ | _____ | _____ | _____ |
| f. Adequacy of the internal controls for ensuring compliance with laws and regulations | _____ | _____ | _____ | _____ |
| g. Management's adherence to applicable laws and regulations. | _____ | _____ | _____ | _____ |
| h. Audit report users' expectations | _____ | _____ | _____ | _____ |
| i. Public perceptions and political sensitivity of the areas under audit. | _____ | _____ | _____ | _____ |
| j. Audit requirements (tests required by audit objectives). | _____ | _____ | _____ | _____ |

Total risk level developed from above considerations during survey/planning stage of engagement: _____

Level of initial testing required: _____

Revised level of testing developed from initial test: _____

Potential finding included or dropped because of materiality: _____

## Selected Sections of the Executive Office of Health and Human Services Secretariat Guidelines for the Procurement of Social and Rehabilitative Services

(MM Subsidiary Contracting, Effective January 31, 1992 and Until Further Notice)

### Primary/Secondary Procurement Coordination

Provisions for notification of budget information for new programs and amendments to secondary governmental purchasing agencies are set forth at 808 CMR 1.09: (2) (a) and 808 CMR 1.11: (2). For annual budget re-negotiations under 808 CMR 1.07 EOHHS requires that providers and primary purchasing agencies also provide advance notice to known secondary purchasing agencies, so that they can have input in the budget development process. Final responsibility for rate negotiation remains with the primary purchasing agency. Secondary EOHHS purchasing agencies must adhere to the contract provisions established with the primary purchasing agencies.

### Cost Reimbursement

EOHHS strongly discourages the use of cost reimbursement procurement, except under certain limited circumstances, as established by 808 CMR 1.06 (3). The cost reimbursement program must be available for purchase exclusively by the governmental unit. This should be interpreted by EOHHS purchasing agencies to prohibit cost reimbursement procurement for programs which receive other support from Medicaid, third party payers, or other governmental and non-governmental unit rate purchasers (excluding client sliding fees, donations/grants, or client resources such as rent payments and food stamps). The billing, under cost reimbursement contracts, of indirect costs or activities, which are already indirectly reimbursed through outpatient class rates or similar direct service rates, is also prohibited.

### Program Budget Amendments

The following guidance is provided to supplement the guidelines for budget adjustments set forth at 808 CMR 1.11.

For negotiated unit rate contracts, EOHHS purchasing agencies should treat a variance in operating costs or offsetting support which results in a substantial net change to Unit Rate Calculation Page line 3 (Net Reimbursable Adjusted Expense) as a “substantial difference” requiring budget review and amendment where appropriate. The provider is responsible for notifying the purchasing agency and the budget should be amended and the price/. maximum obligation adjusted accordingly.

For cost reimbursement contracts, formal amendments are not required where the maximum obligation is not increased and variances between cost categories (as set forth in applicable Program Budget Form lines) do not exceed ten percent. However, for invoicing and audit trail purposes, all agreed-upon changes to line items should be documented in writing and retained at both provider and purchasing agency offices for subsequent review.

Agencies and providers also should consider executing amendments whenever possible to obviate the need for retroactive recovery action pursuant to 808 CMR 1.19 (3), Non-Profit Maintenance Expense.

OPERATIONAL SERVICES DIVISION
Gary J. Lambert
Assistant Secretary for Operational Services

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Secretary

# ***FY '20* Policy Guidance/Regulatory Interpretation of 808 CMR 1.05 (24) Salaries of Officers and Managers**

## MEMORANDUM

TO: Interested Parties

FROM: Jacquiline Brown, Director of Financial Compliance
Operational Services Division (OSD)

DATE: July 7, 2019

RE: Policy Guidance/Regulatory Interpretation of 808 CMR 1.05 (24)
Salaries of Officers and Managers

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Effective July 1, 1998, the salaries of officers and managers as defined by OSD shall be non-reimbursable under Operational Services Division regulation 808 CMR 1.05 (24) as amended to the extent that they exceed an annual rate of $187,111.79. Contractors must maintain documentation and justification for the selection of a salary reimbursement rate up to $178,036.35. Where officers and managers devote less than full time to state programs, the level of reimbursement should be prorated accordingly. See 808 CMR 1.05 (24).

Officers and Managers are defined as: Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Officers and Managers normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management. *In most instances, management of a social service program will include program directors and program managers.*

# QUESTIONS AND ANSWERS ON AUDIT AND PREPARATION

# OF THE UFR AUGUST 1994

**Division of Purchased Services**
**Bureau of Audit**

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***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***


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***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***

Participants in recent UFR training sessions have raised a number of questions that we will attempt to address, regarding audit and administrative issues in the UFR preparation. The following questions and answers have been prepared from questions frequently asked. The purpose is to provide clarification and additional practical working guidance to those participating in the purchase of service system. We will be forwarding other clarifications in the future as additional issues are brought to our attention.

1. **Are the Division of Purchased Services (DPS) nonreimbursable cost provisions in regulation 808 CMR 1.15 applicable to programs supported by funding from special education unit rate payments and negotiated unit rate contracts and agreements?**

   Yes: Special education and negotiated unit rates that are utilized for the purchase of social services are subject to the nonreimbursable cost provisions of regulation 808 CMR 1.15. Special education and negotiated unit rates, unlike traditional fee-for--service unit rates such as Medicaid (class rates), are reimbursements for attained performance and resource usage previously identified in an amendable program budget. The fiscal year 1994 UFR Auditor's Compliance Supplement provides extensive guidance concerning the establishment of reimbursement and contractual and regulatory requirements beginning on page 12 in the Suggested Areas of Compliance Testing section.

2. **Why does DPS communicate directly with provider organizations concerning some UFR reporting deficiencies?**

   The UFR Audit and Preparation Manual (KEY CONCEPTS) and DPS training programs have always stressed the respective responsibilities of the independent auditor and management concerning the UFR financial statements and supplemental information. This guidance is consistent with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). These auditing standards provide that preparation of the financial statements and supplemental information is management's responsibility, and the auditor's responsibility is to audit and express an opinion on certain of the financial statements that are considered necessary for presentation of financial position and the results of operations and changes in fund balances in conformity with generally accepted accounting principles (GAAP). Accordingly, issues concerning the reporting of deficiencies related to GAAP, GAAS and GAGAS potentially affecting the opinions and assurances made by the auditor in auditor's reports are referred to the independent auditor. Other reporting issues such as failure to secure appropriate audit services and to prepare or adequately prepare supplemental letters and schedules are referred to the provider.

3. **Do independent auditors from the Office of the State Auditor employ different standards of materiality and significance when conducting and reporting on GAGAS audits than do independent auditors employed by public accounting firms?**

   No: All independent auditors conducting and reporting on GAGAS audits must exercise due professional care (sound judgment) and consider materiality and/or significance as required in the third general standard of the 1988 revision of GAGAS. This care and consideration must be applied when planning the audit and in selecting the methodology and designing audit tests and procedures, as well as in deciding whether a matter requires disclosure in an audit report (similar provisions are contained in the third general standard and field work standards of the 1994 revision of GAGAS, which must be used for UFR audits of periods ending on or after January 1, 1995). The standard indicates that professional judgment must be used in decisions concerning quantitative and qualitative criteria for determining materiality and significance. The materiality level and/or threshold of acceptable risk may be lower in GAGAS audits than similar type audits in the private sector. The professional judgment used in vulnerability and risk assessments employed by governmental independent auditors has traditionally placed great emphasis on qualitative criteria resulting in lower materiality thresholds for selecting methodology and designing audit tests and procedures and deciding whether a matter requires disclosure. These lower materiality thresholds are different from what public accountants are accustomed to (see question 4 for related issue). The fiscal year 1994 UFR Auditor's Compliance Supplement provides further information on pages four through ten concerning materiality/significance and sensitivity and risk and vulnerability assessments in GAGAS audits.

4. **Are there different reporting requirements for internal control and noncompliance deficiencies when performance audit standards of GAGAS are used by governmental agencies like the Office of the State Auditor rather than the financial audit standards of GAGAS that are used to audit the UFR?**

   Recent audits of providers by the Office of the State Auditor have assessed the provider's performance regarding economy and efficiency of operations and attainment of program outcomes. The 1988 revision of GAGAS (yellow book) lists nine examples of the types of issues related to performance audits that the Office of the State Auditor has considered when conducting performance audits of providers as follows: Is the entity following sound procurement practices? is the entity acquiring appropriate type, quality, and amount of resources when needed at the lowest cost? Is the entity complying with requirements of laws and regulations that could significantly affect the acquisition, protection and use of the entity's resources? Is the entity avoiding duplication of effort by employees and work that serves little or no purpose? Is the entity avoiding idleness and overstaffing? Is the entity using the minimum amount of resources (staff, equipment, and facilities) in producing or delivering the appropriate quantity and quality of goods or services in a timely manner?

Is the entity complying with requirements of laws and regulations that could significantly affect acquisition, protection, and use of the entity's resources? And has the entity an adequate system for measuring and reporting performance on economy and efficiency?

INTERNAL CONTROLS:
The performance audit standards of GAGAS require the Office of the State Auditor to identify any significant weaknesses (generally the importance in relation to a problem the auditor identifies) in the internal controls found during the audit. The field work and reporting performance audit standards of GAGAS require the Office of the State Auditor to review and report on any significant weaknesses in the internal controls for accounting and administrative functions established to ensure economic and efficient performance. The financial audit standards of the yellow book (used for most of the UFR audit) requires that reportable conditions in the entity's internal control structure that are considered material weaknesses or that represent significant deficiencies in the design or operation of the internal control structure must be reported. The yellow book stresses that an understanding of internal controls to ensure compliance with laws and regulations must be obtained. The fiscal year 1994 UFR Auditor's Compliance Supplement highlights many compliance requirements related to items in the suggested area of the compliance testing section beginning on page twelve. Many of these compliance requirements are the same issues that the Office of the State Auditor must review and report on when assessing internal controls in conjunction with a performance audit of a provider's economy and efficiency and performance.

NONCOMPLIANCE: The performance audit standards of GAGAS require the Office of the State Auditor to report all significant instances of noncompliance found during or in connection with the audit, even those not resulting in a legal liability. In addition, the Office of the State Auditor must also report all significant instances of abuse (furnishing excessive services to beneficiaries or performing what may be considered improper practices, none of which involves noncompliance with laws and regulations) as part of the performance audit. Audit findings concerning significant issues of abuse generally note that the abusive condition is not prohibited by law or regulation and recommend that an abusive condition be considered for inclusion into law or regulation. The Office of the State Auditor is required to assess compliance with laws and regulations when necessary to satisfy the audit objectives. The Office of the State Auditor, in accordance with the field work standards for performance audits, would examine compliance with laws and regulations that could significantly affect the acquisition, protection, and use of the provider's resources, and the quantity, quality, timeliness, and cost of the services it produces and delivers when conducting a performance audit of a provider's economy and efficiency and performance.

The 1988 revision of the financial standards of the yellow book that is used for most of the audit of the UFR requires that all material instances of noncompliance related to the entity's financial statements or the program, award, claim, fund, or group of accounts being audited must be reported. In addition, several instances of noncompliance that separately may not be material, but cumulatively could have a material effect on the financial statements must be reported. All material instances of noncompliance related to a program of the UFR must be reported because the statement of functional expenses reports activity by program and it is a basic financial statement of the UFR. Further, the field work standards of the 1988 revision of the yellow book also indicate that the auditor must assess the risk of noncompliance with laws and regulations occurring and having a direct and material effect on the financial statements. The field work standards of the 1994 revision of the yellow book, which must be used for UFR audits of periods ending on or after January 1, 1995, extend these provisions to include material indirect effect on the financial statements. The new 1994 revision also includes an additional standard that the audit is designed to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. The fiscal year 1994 UFR Auditor's Compliance Supplement highlights many compliance requirements, in the Suggested Area of Compliance Testing section beginning on page twelve, that could have a material effect on the UFR financial statements that include the programs reported in the statement of functional expenses. Many of these compliance requirements are the same issues that the Office of the State Auditor reviews and reports on when examining compliance with laws and regulations that could significantly affect the acquisition, protection, and use of the provider's resources, and the quantity, quality, timeliness, and cost of the services it produces and delivers as part of a audit of a providers economy and efficiency and performance.

**5. Should any of the performance audit standards of GAGAS be followed when conducting an audit of the UFR?**

Chapter two of the 1988 and 1994 revision of the yellow book indicates that auditors should follow the standards that are applicable to the individual objectives of the audit. Audits may have a combination of financial and performance audit objectives or may have objectives limited to only some aspects of one audit type. For example, auditors conduct audits of government contracts and grants with private sector organizations, as well as government and nonprofit organizations, that often include both financial and performance objectives. The reporting standards for financial audits of GAGAS concerning reporting on noncompliance and internal controls indicate that in presenting the findings, the auditor must follow the report content and presentation standards of the performance audit standards for reporting, as appropriate. The applicable sections of these standards are as follows: **report contents standards -** objectives, scope, and

methodology, audit findings and conclusions and cause and recommendation (audit results), and views of responsible officials; **report presentation standard** - complete, accurate, objective, convincing, clear and concise. This requirement includes all of the reporting standards for performance audits except for the requirements concerning statement on auditing standards, internal controls, compliance with laws and regulations and the report distribution standards. It may be necessary to follow certain field work standards for performance audits while conducting an audit of the UFR in that many of the regulatory and contractual requirements relate to economy and efficiency and performance issues that may have a direct and material effect on the determination of financial amounts in the financial statements. Economy and efficiency and performance issues are generally related to performance audit activity and the standards for performance audits rather than to financial statement audits. The 1994 UFR Auditor's Compliance Supplement provides guidance and criteria concerning many of these regulatory and contractual requirements that could have a direct and material effect on the financial statements. The audit objectives concerning requirements associated with economy and efficiency and performance may require, as appropriate, that the planning, legal and regulatory requirements, internal control and evidence field work standards for performance audits be followed.

6. **What would the end-of-the-year entry for surplus revenues that are subject to the DPS Not-for-Profit Surplus Revenue Retention Policy be?**

   The provider should follow the customary practice of transferring the surplus funds to the unrestricted fund balance at the end of the year. Surplus funds that are under the 5 % threshold must be segregated from the funds that are over 5 % (and which are subject to recoupment) in the fund balance. Segregating the funds permits the provider to report the accumulated value of the surplus funds under the threshold as the surplus fund pool in the notes to the financial statements, and the surplus funds over the threshold as a liability to the Commonwealth on the balance sheet.

7. **What is considered adequate evidence for the questions asked about the independent auditor on the UFR Audit Services Checklist & Certification?**

   A positive statement in a letter from the auditor affirming that the auditor has met all the training requirements, experience and qualifications noted in the checklist is considered adequate evidence.

8. **Are employees of provider organizations that are related by family relationship to members of the provider's board of directors considered related parties?**

   No: Related party transactions and relationships, as governed by DPS regulations, are transactions made between the provider and directors, stockholders and external individuals and entities.

Provider employees are considered internal individuals and are not subject to the DPS related party provisions; though, a related party relationship would exist if the transaction related to a situation where the employee is acting as a representative of an external entity or as an independent contractor or consultant. However, potential conflict of interest and nepotism situations could exist when employees that set policy and are in a position of responsibility are related to board members. Nepotism is not in keeping with the principles for good internal controls.

**9. Does DPS charge a fee for attending UFR training sessions?**

No: A fee has never been charged for a DPS UFR training session. However, DPS is considering, in conjunction with other organizations, conducting future training sessions at a commercial facility and providing a light lunch. This of course would require DPS to charge a fee to defray costs for providing these additional amenities.

**10. What procedures should be followed when surplus funds are accrued in a cost reimbursement contract?**

Cost reimbursement is defined as: A payment arrangement under which the purchasing agency reimburses the provider for budgeted costs actually incurred in rendering the services specified in the agreement, up to a stated maximum obligation. State France law does not permit provider organizations to retain any portion of surplus funds generated through overbilling in cost reimbursement contracts. This provision also prevents purchasing agencies of the Commonwealth from establishing any method of resolution other than a scheduled repayment plan to recover surplus funds in a cost reimbursement contract. The DPS Audit Resolution Policy indicates that when expenses are undocumented in cost reimbursement contracts, other evidence, in the form of alternate documentation, cannot be considered and recovery of funds is appropriate as a basis of resolution. To avoid overbilling in cost reimbursement contracts, providers should reconcile any payments made for budgeted expenses with the actual expenses incurred before submitting the final payment voucher for the year. The last month's billing can then be adjusted accordingly and no surplus funds will remain that would be subject to an audit finding. The independent auditor should, as part of the tests on compliance with laws and regulations and internal control, write an audit finding in the report on compliance when overbilling is detected and write a finding in the report on internal control concerning the material weakness that permitted the overbilling to occur.

**11. What procedures should an independent auditor and provider follow when state or federal nonreimbursable costs are incurred in a program that is subject to DPS reimbursement provisions and the provider does not have an adequate level of unrestricted or donor restricted revenues that was earned in prior reporting periods, borrowed funds or revenues not derived from public funds to defray the nonreimbursable costs?**

The independent auditor should, as part of the tests on compliance with laws and regulations and internal control, write an audit finding in the report on compliance if overbilling is detected because support that does not include public funds was not available to defray nonreimbursable costs, and a finding in the report on internal control should also be written concerning the material weakness that permitted the overbilling to

occur. The provider should report on schedule B-1 of the UFR that there was no support, not derived from public funds, available to defray the nonreimbursable costs and work with Commonwealth purchasing agencies to adequately resolve the overbilling and internal control findings using the DPS Audit Resolution Policy.

**12. What appeal process or input does the provider have when the Office of the State Auditor or the providers' independent auditor writes a compliance or internal control finding that the provider does not agree with?**

All audits of the Office of the State Auditor and all audits of the UFR, that contain findings, are conducted in accordance with GAGAS. These standards require that sufficient, competent, relevant evidence must be obtained to afford a reasonable basis for the auditors' judgments and conclusions regarding the provider, program, activity, or function under audit. The provider has the ability to provide the independent auditor representing the Office of the State Auditor with any available evidence to modify or change the auditor's judgments and conclusions. In addition, the standards also require that the auditor's report include the pertinent views of responsible officials of the provider (usually in the finding) concerning the auditor's findings, conclusions, and recommendations, and what corrective action is planned.

Further, the standards also require that audit reports are to be submitted by the audit organization to the appropriate officials of the provider and to the appropriate office of the organization requiring or arranging for the audit (at times DPS and state purchasing agencies). Copies of the reports must also be sent to other officials who have legal oversight authority or who may be responsible for taking action. For purchase of service related issues, state purchasing agencies have primary responsibility for taking action and DPS has oversight responsibility. The DPS Audit the Resolution Policy has been established pursuant to this oversight responsibility and the need for DPS to adhere to the standards of GAGAS. All audits by independent auditors from the Office of the State Auditor, federal government and public accounting firms auditing the UFR of provider organizations that receive state or federal funding from the Commonwealth must be resolved using the DPS Audit Resolution Policy. This policy requires the provider's principal purchasing agency (PPA) of the Commonwealth to enter into a written corrective action plan (CAP) to resolve the deficiencies related to the purchased services. The PPA must-review the audit findings (resulting from testing and reporting compliance with the existing standards in the auditor's reports) containing the provider's views and any additional views (the provider organization's response to auditor's report in the UFR) or evidence furnished by the provider that could potentially affect the finding prior to resolving the finding. Any additional evidence furnished by the provider to the PPA must be evaluated for sufficiency and relevance to the findings. Prior to the PPA making a resolution determination concerning the finding, the PPA must also furnish the independent auditor with the additional evidence for the purpose of determining if the auditor's judgments and conclusions should be modified or changed.

13. **What responsibility does a provider and its independent auditor have concerning surplus funds accrued through social service contracting with the Commonwealth prior to fiscal year 1993?**

    The Commonwealth's Surplus Revenue Retention Policy for unit rate contracting will administratively commence by utilizing the fiscal year 1993 UFR. Surplus revenues accrued in programs receiving Commonwealth unit rate funding prior to fiscal year 1993 will not be analyzed. Providers that have been carrying a liability to the Commonwealth as a result of unit rate contracting may write off the liabilities. Surplus revenues through cost reimbursement contracting with the Commonwealth, regardless of when they were accrued, must be treated as a liability to the Commonwealth and are subject to recoupment. The independent auditor should follow the guidance in question 10 above concerning testing and reporting on compliance with laws and regulations for overbilling in a cost reimbursement contract if the provider has disclosed in the notes to the financial statements a liability to the Commonwealth derived from surplus funds accrued in cost reimbursement contracts.

14. **Does the bureau of audit utilize the telephone to notify providers and independent auditors about UFR filing deficiencies or to provide UFR filing guidance?**

    Yes: The bureau of audit attempts to notify providers and independent auditors about deficiency items requiring limited explanation over the telephone. Staff of the bureau of audit spends a substantial portion of their workday providing guidance on the telephone to providers and independent auditors concerning issues related to the fling requirements of the UFR.

15. **Why is it that no opinion is rendered in the independent auditor's reports of performance audits conducted by the Office of State Auditor in accordance with the performance standards of GAGAS?**

    Generally, at the completion of a performance audit the auditor does not express an opinion on the overall performance of the provider; therefore, the performance audit standards of GAGAS do not contemplate that the auditor will be called upon to give such an opinion.

Rather, the auditor would report findings and conclusions on the extent of adequacy of performance, and on specific processes, methods, and internal controls (including compliance with laws and regulations) that can be made more efficient or effective. If potential for improvement were found, the auditor would recommend appropriate corrective action.

**Additional questions are welcomed by DPS. Questions may be forwarded to the Director, Bureau of Audit at the following address:**

**Executive Office for Administration & Finance**
**Department of Procurement & General Services**
**Division of Purchased Services**
**One Ashburton Place, Room 1017**
**Boston, Massachusetts 02108**

# ADDITIONAL QUESTIONS AND ANSWERS ON AUDIT AND PREPARATION OF THE UFR FOR PROVIDERS AND INDEPENDENT AUDITORS

**MAY 1995**

Division of Purchased Services
Bureau of Audit

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***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***


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***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***

This is the second installment of commonly asked questions and answers concerning the audit and preparation of the Uniform Financial Statements and Independent Auditor's Report (UFR). As was the case with the August 1994 publication of Questions and Answers, the purpose of this document is to provide answers to commonly asked questions and additional, practical guidance to individuals working in the purchase-of-service system. While this document will assist in the preparation and audit of the UFR it also should help providers in making decisions relating to their operations. We will be forwarding additional information in the future as issues are brought to our attention.

**1. What are the most common UFR filing deficiencies?**

The most common UFR filing deficiencies are the deficiencies classified as ***minimum filing deficiencies***. Minimum filing deficiencies are failures to meet the minimum filing requirements of the Division of Purchased Services (DPS) and the provisions of OMB Circular A-133, if applicable. Filings containing these deficiencies require correction by the provider and/or independent auditor and resubmission of one or more statements, schedules or reports. Examples of the types of deficiencies in this category include failure to meet the items noted in the UFR Preparation and Audit Checklist that is included in the 1994 UFR Audit and Preparation Manual as follows:

- One or more of the following elements of the UFR have not been filed as required:
  - ◊ UFR Cover Page (must always be filed)
  - ◊ Auditor's Reports (at least 3 for audited Financial Statements and I for reviewed Financial Statements)
  - ◊ Balance Sheet
  - ◊ Statement of Revenue and Expenses and Changes in Fund Balances
  - ◊ Statement of Functional Expenses
  - ◊ Notes to the Financial Statements
  - ◊ Schedule of Federal Financial Assistance and appropriate OMB Circular A-133 Auditor's Reports (if required)
  - ◊ Board of Directors' Acknowledgment Letter

- OMB Circular A-133 audit was not conducted when required.
- Audit was not conducted in accordance with generally accepted government auditing standards (GAGAS).
- Supplemental information paragraph was not included in Independent Auditor's Report or separate report as required by Auditing Standards SAS 29 and 52.
- Independent Auditor's Reports did not meet reporting standards of Generally Accepted Auditing Standards.
- Information in supplemental schedules does not reconcile and is not in agreement with the basic financial statements.
- Independent auditor did not opine, when required, on the Statement of Functional Expenses.
- Financial statements were not prepared in accordance with the AICPA Audit Guide for Voluntary Health and Welfare Organizations, as required by 808 CMR 1.00 and General Conditions of the Master Agreement.
- Administration (Management and General) costs were not reported in the administration column but rather in the program columns as direct program costs.
- Full-tine Equivalents (FTEs) were not reported as required.
- The program number that was used on the Service Contract cover page and the Attachment B program budget was not used consistently for reporting program activity in the UFR.
- UFR Audit Services Checklist & Certification Form was not completed by the provider and filed along with the UFR.
- The appropriate representative of the provider's independent auditor of the UFR did not attend the filing year's UFR training session.
- The auditor's management letters containing nonreportable conditions in the internal control structure and nonmaterial instances of noncompliance that were referred to in the Auditor's Reports on Internal Controls and Compliance were not submitted along with the UFR.
- All of the UFR Lotus disks were not completed and returned or an approved waiver request was not returned along with the UFR.

Other types of deficiencies are **considered *significantly inadequate or substandard*** filings. These filings include repeated failures to comply with the minimum filing requirements of DPS and OMB Circular A-133. They also include filings containing deficiencies that make the financial statements, schedules and reports unusable for fulfilling one or more of the objectives of financial statements and audits conducted in accordance with generally accepted government auditing standards.

Filings in this category have significantly failed to comply with applicable accounting principles and auditing standards. These filings are not considered received by DPS until the filing has been corrected by the provider and/or independent auditor and, as a result, the provider is deemed to not have met its filing requirements. Filings categorized as significantly inadequate or substandard may not be considered as adequate for meeting contract prequalification requirements and are not available to the general public. Significantly inadequate or substandard filings may warrant a Quality Control Review of the auditor's reports and workpapers or formal referral to other appropriate regulatory agencies and/or professional societies.

2. **How should surplus revenues calculated pursuant to 808 CMR 1.19 (3) and the DPS Not-for-Profit Provider Surplus Revenue Retention Policy be recorded in the provider's accounting records and disclosed in the UFR?**

   UFR report users and practitioners have asked that we consolidate and further explain previously furnished information concerning appropriate recording and disclosure of DPS not-for-profit provider surplus revenue retention revenue. This answer consolidates and further explains information previously furnished by DPS in the following publications: Question number six (6) of ***Questions and Answers on Audit and Preparation of the UFR, issued August 1994***, and question number ten (10) of the ***Revised Policy: Not-for-Profit Provider Surplus Revenue Retention Pursuant to 808 CMR 1.19 (3), issued August 31, 1994***. See also 808 CMR 1.08 effective January 27, 1995. UFR report users and practitioners should be aware that some information previously furnished in these questions, which continues in effect, has not been included in the following consolidated answer.

   The provider needs to take the following steps:

   - Make an entry in a segregated unrestricted fund balance account of the provider's books of account at the end of the year.
   - Disclose an ***accounting estimate*** (see AICPA Statement on Auditing Standards No. 57) of the beginning and ending balances and results of changes in the surplus revenue retention fund pool in the Notes to the Financial Statements.
   - Disclosure of the activity of the surplus revenue retention fund pool in the Notes to the Financial Statements needs to identify how the prior year's surplus revenues were used by identifying the functional and natural classification (example administration/occupancy cost) of the reimbursable costs defrayed with the revenues (see question 5 for related guidance).

- If the provider accumulated a surplus in excess of the 5% threshold for the current year, or if the cumulative amount of the provider's surplus account exceeds 20% of the prior year's revenues from purchasing agencies, the following must occur:
- A liability, due to the Commonwealth, must be recorded and disclosed in the provider's books of account and financial statements of the UFR, respectively.

The Notes to the Financial Statements must disclose how the provider and the Commonwealth have agreed the liability, due to the Commonwealth, will be or has been met, e.g., Purchasing Agency has negotiated a lower rate.

3. **What are some of the financing requirements of the Commonwealth's purchase-of-service** (POS) **system that affect the use of surplus funds under 808 CMR 1.19 (3) and the Not-for-Profit Surplus Revenue Retention Policy?**

The surplus revenues retained by providers are ***public revenues*** and therefore their use is limited in the following manner:

- The revenues may only be expended for activities and programs that are in keeping with the **Massachusetts charitable** purposes of the provider organization.
- The revenues may not be spent on items that are prohibited by state or federal law and regulation, such as non-reimbursable state and federal costs set forth in 808 CMR 1.15, including depreciation expense for the purchase of capital items (except free care).

**4. Is it possible to apply Commonwealth surplus revenue subject to the provisions of 808 CMR 1.00 to program deficits incurred in prior years?**

**Yes and No:**

Yes: Net surplus/deficit revenue of 5 % or less may be retained by the provider and used from year to year to offset deficits. The surplus/deficit revenue must be maintained in a segregated unrestricted fund balance to be used for offsetting deficits related to the charitable purpose of the provider.

No: Net surplus revenue in excess of 5% is subject to recoupment and must be reported as a liability due to the Commonwealth. This surplus revenue must be used to liquidate the liability due to the Commonwealth rather than to reduce prior years' deficits. However, the purchasing agency may at times find that it is in the Commonwealth's best interest to apply the surplus revenues to prior year deficits and approve such actions. Such a determination would be made by the purchasing agency on a case by case basis.

As noted in the surplus revenue retention policy-and-in 808 CMR 1.08 (1) (e), there are four options to reduce the liability of excess surplus revenue due to the Commonwealth as follow:

1) The Purchasing Agencies may enter into an agreement with the provider, which would stipulate the use of excess funds.
2) DPS or the Purchasing Agencies may request that the excess funds be returned to the Commonwealth.
3) Future prices set by DPS or negotiated by Purchasing Agencies may be reduced.
4) If a Chapter 71B program, the price set for the program may be adjusted pursuant to 808 CMR 1.08 (1) (e).

5. **How will the Commonwealth determine that the *public revenues* derived from the surplus revenue retention fund pool were appropriately spent for purposes net-prohibited by state and federal non-reimbursable cost provisions?**

   The Notes to the Financial Statements of the UFR must identify, through a disclosure, the dollar amount of surplus revenues retained that were 5 % or less of the amount of revenues that may be retained pursuant to the Surplus Revenue Retention Policy. The disclosure must also specifically identify the reimbursable costs that were defrayed with these ***public revenues*** in the subsequent years following the retention of the surplus revenues. In addition, providers are responsible for disclosing the existence of revenues that are used to defray non-reimbursable costs associated with programs funded by the Commonwealth in Schedule B-1 of the UFR. The DPS Bureau of Audit reviews Schedule B-1 to ensure ***that public revenues*** (surplus revenue retention fund pool revenues are public revenues) were not used to defray nonreimbursable costs. Furthermore, the Auditor's Report on Compliance with Laws, Regulations, Contracts and Grants Based on an Audit of the UFR Financial Statements Performed in Accordance with Generally Accepted Government Auditing Standards (GAGAS) will provide the Commonwealth with an additional level of assurance concerning compliance with the provisions of the Not-for-Profit Surplus Revenue Retention Policy.

6. **Is unrestricted administrative revenue and Commonwealth Capital Budget revenue that is disclosed and allocated to programs in Supplemental Revenue Schedule A of the UFR subject to the Surplus Revenue Retention Policy?**

   No: The intent of the Surplus Revenue Retention Policy is to exclude revenue derived from a Commonwealth Capital Budget Contract and unrestricted administrative revenue reported in Supplemental Schedule A from the calculation. The Surplus Revenue Retention Policy will be modified to explicitly indicate that these revenues should not be used in the

calculation of surplus revenue subject to the Surplus Revenue Retention Policy. The previously issued Revised Policy: ***Not-for-Profit Surplus Revenue Retention Pursuant to 808 CMR 1.19(3) Questions and Answers, DPS Publication Number: DPS-PO38A-93*** will be revised in Question 8, "What formula will DPS use to determine a surplus?" as follows**: *(Changes have been emphasized with italic bold print)***

For purposes of implementing 808 CMR 1.19(3), the annual surplus under review is limited to Commonwealth funds, including funds from cities and towns for special education programs***, and excluding Commonwealth funds from Capital Budget contracts***. DPS will use the financial information documented in the UFR as reported in Supplemental Schedules A and B. DPS will determine the amount of Commonwealth revenue supporting the provider on a program-by-program basis (total of lines 7, 8, 11, 16-20 (a&b), 22-31 (a&b) and 34 on Schedule A, currently: Supplemental Revenue Schedule). Next, an Adjusted Total Revenue will be calculated by subtracting the sum of Unrestricted Revenue **funds *plus revenue from a Commonwealth Capital Budget Contract(s)*** (currently, lines 1, 4, 13, 42, 45, 48, 51, ***57 and a line to be designated*** on Schedule A: Supplemental Revenue) from Total Revenue (currently, line 58 Schedule A: Supplemental Revenue Schedule) for each program. Then the percentage of Commonwealth Revenue will be determined by dividing the Total Commonwealth Revenue by the Total Adjusted Revenue for each program. Total of Unrestricted Revenue and Commonwealth ***Capital Budget Revenue*** will then be subtracted from line 47, Excess/Deficit Support Over Expense, Schedule B: Supplemental Expense Schedule. This will yield an adjusted surplus/deficit.

The adjusted surplus/deficit is then multiplied by the percentage of revenue attributable to the Commonwealth. This will yield the total surplus/deficit attributable to the Commonwealth for the program. DPS will then calculate a grand total for the Commonwealth revenue ***(which will not include revenue from Capital Budget Contracts)*** and a grand total for the allocation of Commonwealth surplus and deficit from the sum of all of the programs. The percentage of the surplus/deficit allocated to the Commonwealth is calculated by dividing the grand total of the Commonwealth surplus/deficit by the grand total of the Commonwealth

revenue. If this percentage is less than or equal to five percent, then the provider may retain the funds pursuant to 808 CMR 1.19 (3).

Although cost reimbursement funds are included in the formula for the determination of total funds, it is a violation of state finance law for Commonwealth cost reimbursement contracts to accumulate surpluses. Any surplus attributable to or generated by Commonwealth-related income and expenses in cost reimbursement contracts will be subject to recoupment.

**7. Whose responsibility is it to calculate the Commonwealth Surplus/Deficit Revenue Retention amounts?**

It is management's responsibility to calculate the estimated surplus revenue that is subject to the Surplus Revenue Retention Policy. In addition, it is also management's responsibility to record the excess surplus revenue as a liability, due to the Commonwealth, if applicable. Management's calculations are subject to challenge by a final calculation conducted by the Pricing Bureau of DPS as is necessary. Generally, final calculations conducted by DPS will not be forwarded to the provider unless it is determined that the amount reported in the Notes to the Financial Statements by management may have been in error. To facilitate the calculation for Fiscal Years ending on or after June 30, 1995, a template will be furnished to the provider for use in calculating the amount of the Surplus/Deficit Revenue Retention and the amount of excess Surplus Revenue Retention Revenue that must be reported as a liability due to the Commonwealth.

**8. May *client resources* or *third-party payments* furnished to a provider on behalf of a client for services furnished in a Commonwealth-funded program be used to defray state and federal non-reimbursable costs?**

No: The provisions of 808 CMR 1.18, applicable to all providers, and the POS contract forms and instructions issued pursuant to 808 CMR 1.07 require client resources or third-party payments when made on behalf of a client to first be used by the provider to reduce the amount of the

appropriate purchasing agency's obligation for the service rendered to the client (please note that the maximum financial obligation of the purchasing agency does not include non-reimbursable costs pursuant to 808 CMR 1.15).

Further, the provisions of 808 CMR 1.18 also require that even if client resources or third-party payments made on behalf of a client are not expressly recognized or anticipated in the program budget or otherwise in the computation of the price, the amount of the resources or third-party payments actually received shall be used to reduce the allowable costs related to the purchasing agency's obligation for client services. The reduction in the purchasing agency's obligation may occur in a number of ways, including but not limited to, through price adjustments carried out through contract amendment under 808 CMR 1. 11, administrative reviews pursuant to 808 CMR 1.14 and audit. The most frequently used mechanism to reduce the purchasing agency's financial obligation that occurs because the provider has received unanticipated client resources or unanticipated third-party payments is through offsets to invoices (reduced billings) submitted to purchasing agencies. In addition, it should be noted that 808 CMR 1.18 also specifically prohibits a provider from charging more to a Commonwealth-funded client than the approved rate. The regulation states, in part, the following: ***Each provider shall as a condition of acceptance of payment made by one or more purchasing agencies for service provided, accept the program's authorized price, as established by the Division, pursuant to 808 CMR 1.00, as full payment and discharge of all obligations for the services provided. There shall be no duplication or supplementation of payment from sources other than those expressly recognized or anticipated in the computation of the price***. The use of client resources or third-party payments to defray nonreimbursable costs in Commonwealth funded programs would also violate these provisions.

The federal government has similar regulatory provisions that require program income to be used in a certain manner. For federal purposes, program income consists of earnings from federally supported activities, i.e., income from service fees (including client resources), sales of commodities or fabricated items, usage or rental fees, interest on loans made with federal award funds and royalties on patents and copyrights, etc. (A full definition of program income may be found in OMB Circular A-110, Section-.2 Definitions (x).)

OMB Circular A-110 further provides that program income may only be used in the following ways:

1) Program income must be used as a deduction from total allowable program costs for determining the net allowable costs on which the federal share of the cost is based.

2) If permitted by the federal awarding agency in the terms of the federal award (usually only occurs in federal awards received directly from the federal government), such income may instead be used to further eligible program objectives.

3) If permitted by the federal awarding agency in the terms of the federal award (usually only occurs in federal awards received directly from the federal government), such income may instead be used to finance the nonfederal share of the program (cost sharing or matching requirements).

Client resources and third-party payments made on behalf of clients in a federally funded program are considered program income (service fees) of the program (the usage provisions of program income may be found in OMB Circular A-110 Section -.24 Program Income).

**9. What are the testing, reporting and management responsibilities for the independent auditor, provider and the Commonwealth when client resources or third-party payments made on behalf of a client are part of a federal and/or Commonwealth funded program?**

The independent auditor should test for the proper use of client resources and third-party payments in a federally funded program as part of the

program income compliance requirements and suggested audit procedures included in the OMB Circular A-133 Compliance Supplement under the "Administrative Requirements," part of "General Requirements"(*used to reduce federal share of costs, see question number 8 for compliance requirements).* The provisions of OMB Circular A-133 require the independent auditor to test and report on internal controls that the provider must have to ensure proper accountability for program income (OMB Circular A-1 10).

The independent auditor must also test for the proper use of third-party payments and client resources furnished on behalf of the client in programs funded by the Commonwealth as part of the auditor's test for the provider's compliance with laws, regulations and contract compliance *(used to reduce Commonwealth maximum obligation, see question number 8 for compliance requirements).* In addition, the auditor's objectives when testing for compliance with record keeping, maintenance and use of client resources and custodian funds, as noted in the suggested areas of compliance testing of the UFR Auditor's Compliance Supplement and purchasing agency policies and regulations, is to determine if the provider has met its fiduciary responsibilities concerning client resources and funds.

The following steps must be taken to report and act upon noncompliance concerning client resources and third-party payments by the independent auditor, the provider and the Commonwealth:

- The reporting standards of the 1994 Revision of GAGAS require auditors to report the results of these tests on client resources and third-party payments in the report on the financial statements or in a separate report if, based on evidence obtained, it is determined that a material irregularity *(intentional misstatements or omissions of amounts or disclosures in financial statements)* or illegal act has occurred or is likely to have occurred.

- Independent auditors must report noncompliance concerning client resources and third party payments that is material to the financial statements in the auditor's report on compliance and internal control.

- When independent auditors detect irregularities, illegal acts or noncompliance that are not material, they should communicate those findings in a management letter to the top management of the provider.

- The provider's management is responsible for taking timely and appropriate steps to remedy irregularities or illegal acts.

- Independent auditors are required by GAGAS to report irregularities or illegal acts directly to parties outside of the provider in the following manner, when circumstances occur, as follows:

    - ◊ When an irregularity or illegal act involves assistance received **directly or indirectly from a government agency** (example, Supplemental Social Security Income (SSI)), auditors may have a duty to report directly to the government entity if management fails to take remedial steps.

    - ◊ If the independent auditor concludes that such failure is likely to cause the auditor to depart from the standard report on the financial statements or resign from the audit, then the auditor should communicate that conclusion to the provider's governing board.

    - ◊ If the provider does not report the irregularity or illegal act as soon as practical to the government entity that provided the government assistance, the auditors should then report the irregularity or illegal act directly to that government entity.

- DPS is also required to follow the GAGAS guidance noted above by reporting the existence of irregularities or illegal acts to other government agencies as appropriate.

**10. How should the provider treat revenue that is restricted because it was received from the Commonwealth to purchase capital items under a Capital Budget Contract?**

The treatment of this revenue will change when Financial Accounting Standards Board (FASB) Statement No. 116 and No. 117 become effective in the future. Question number 11 below provides guidance on this issue under the new FASB No. 116 and No. 117. This answer addresses the issue under current standards.

Currently, *when an item is purchased under a Capital Budget and the provider is reimbursed,* the restriction is satisfied. The revenue should be recognized in a custodial fund when the asset is purchased and the asset should be recorded and depreciated in accordance with 808 CMR 1. 19. Assets purchased under a Commonwealth Capital Budget Contract are similar to costs incurred under a cost reimbursement contract in that all of the funds will be spent. Unlike a cost reimbursement contract however, the Capital Budget revenue has no offsetting expense except an appropriate value of non-reimbursable depreciation each year. Under current GAAP, the revenue should be recorded in a custodial fund rather than in programs. This will ensure that the revenue will not be included in the calculation of surplus revenue subject to the Surplus Revenue Retention Policy.

**11. How will the treatment of revenue that was received from the Commonwealth to purchase capital items under a Capital Budget Contract change with the Implementation of FASB No. 116 and No. 117?**

Under the new FASB No. 117, *the revenue should be recognized as current unrestricted revenue in a custodial fund when the asset is purchased.* By having a separate classification/group within the current unrestricted classification, the reader of the financial statement will be able to easily analyze the increase in revenue. The Supplemental Revenue Schedule A will have a separate line for revenue derived from Commonwealth Capital Budget Contracts. Commonwealth Capital Budget Revenue will not be subject to the Surplus Revenue Retention Policy.

This new treatment will assist the provider in meeting its fiduciary responsibilities for Commonwealth assets, along with meeting the reporting requirements of GAAP, which require that purchases that have a future economic benefit beyond one year to be capitalized and depreciated over a certain time period. In addition, the provisions of FASB No. l l 6 indicate that the revenue should not be recorded in a temporarily or permanently restricted class as these classifications are restricted for donations.

**12. Should non-reimbursable program costs be classified and disclosed as a separate cost category in a supporting service (such as Non-Program), or in a separate program, and are there audit Implications if they are?**

No: All costs, whether reimbursable or non-reimbursable, associated with programs or supporting services *(administration, fundraising, and non-program (non-charitable) activities are supporting services)* should be classified and reported in the program or supporting service that they relate to. Reporting non-reimbursable costs related to a program activity in a supporting service (such as Non-Program) as a separate cost category or program is not in keeping with generally accepted accounting principles (GAAP).

Reimbursable and non-reimbursable costs should be categorized and allocated to, the programs or supporting service (such as non-program and fund-raising) that they were incurred in, irrespective of any other source of funds that may be available in other programs or supporting service to defray these costs.

Often, non-reimbursable costs are inappropriately reported in a separate cost category or program when a provider does not have an adequate level of non-public funds available in the program, or in other programs, or in supporting services, to defray the nonreimbursable costs. Contributing to this issue is the requirement that the fund balance of the Surplus revenue retention fund pool may not be used to defray non-reimbursable costs because the balance in this account was derived from public funds.

Misclassification of expenses is not in keeping with GAAP (the use of GAAP is mandated by the General Conditions of the Master Agreement) which would require the independent auditor to determine if the misclassification constitutes a reportable condition that should be included in the auditor's reports on internal controls and compliance or a management letter. If the provider has materially misclassified expenses in the financial statements, the independent auditor may need to express a qualified or adverse opinion in the auditor's report and provide information about the misclassified expense that was not disclosed in the financial statements. This would occur as part of the auditor's obligation to consider whether the particular matter concerning the misclassification should be disclosed in light of the circumstances and facts of which the auditor is aware at the time, as required by the AICPA Statement on Auditing Standards No. 32, to determine if management has omitted information that is required by generally accepted accounting principles. In addition, if the misclassification occurred because there were no nonpublic sources of support available to defray the non-reimbursable costs, the independent auditor is obliged to consider this as an overbilling deficiency which would be subject to inclusion in the auditor's reports on compliance and internal control (see question 11 in Questions and Answers on Audit and Preparation of the UFR, issued August, 1994, for further clarification).

**13. How should non-reimbursable costs be disclosed in the UFR?**

Non-reimbursable costs must be reported in the program, or supporting service, (i.e., fund-raising or non-program activities), in which they were incurred.
Non-reimbursable costs that were incurred in state or federally funded programs must be reported in Supplemental Schedule B on line 43 and/or line 44. Administrative non-reimbursable costs must be distributed to programs or supporting services on line 44a. In addition, the Supplemental Itemized Non-Reimbursable Cost Schedule B-1 must be used to itemize and identify the non-reimbursable costs and the source of nonpublic funds that was used to defray the non-reimbursable cost.

**14. Why is depreciation on assets furnished under a Commonwealth Capital Budget Contract considered a non-reimbursable cost?**

The provisions of a Commonwealth Capital Budget Contract recognize that assets purchased with revenues from the contract will be owned by the Commonwealth. Other assets that are purchased with revenues not derived from a Commonwealth Capital Budget Contract (such as revenues from the surplus revenue retention fund pool or revenues derived from non-Commonwealth sources) are owned by the provider and their related depreciation expense is reimbursable. Reimbursing the provider for depreciation of an asset furnished under a Commonwealth Capital Budget Contract would allow the provider to be reimbursed for something it did not pay for and would result in the Commonwealth paying for the asset more than once. Nevertheless, the non-reimbursable depreciation associated with the asset should be reported by the provider to permit the UFR report user to associate the basic value of the asset over a period of time, usually the life of the asset with current revenues.

The depreciation should be reported on Supplemental Itemized Non-Reimbursable Cost Schedule B-1. The obligation to report funds not derived from state and federal sources to offset non-reimbursable cost of depreciation from Capital Budget Contracts with the Commonwealth will be met by indicating on the Schedule B-1 that the depreciation and the offsetting revenue was derived from a Commonwealth Capital Budget Contract (in essence, no off-setting revenue is necessary).

**15. May employee bonuses, the purchase of flowers and other similar costs incurred in Commonwealth-funded programs ever be considered reimbursable state or federal costs?**

Yes: The reimbursable and non-reimbursable cost provisions of DPS regulations and federal OMB Circular A-122 indicate that under certain circumstances these costs may be reimbursable. Reimbursable operating costs (808 CMR 1.02) must be reasonably incurred or expected to be incurred in the provision of program services purchased by the Commonwealth and not excluded from reimbursement by 808 CMR 1.15.

The concept of reasonableness as it relates to reimbursement is discussed in the DPS Summary Sheet "Reimbursable and Non-Reimbursable Operating Costs," document number DPS-A035-93, dated August 1993. Operating costs in federally supported programs (including administration costs allocated to the program for reimbursement) must meet the general tests of allowable costs by being reasonable and allocable as shown in Attachment A of OMB Circular A-122.

Employee bonuses, flowers, house publications, recreational activities, health, first-aid clinics, employee counseling services as well as other costs associated with the provider's employee morale, health, and welfare activities that are incurred as part of an established practice and custom for the improvement of working conditions, employer-employee relations, employee morale and employee performance may be allowable, or considered reasonable, as follows:

- The provider's employee morale, health and welfare activities must be incorporated into the provider's written policies and the activities must have been expected and must not have been disapproved by the purchasing agency or DPS (if the provider is a Chapter 71B Approved Private School). Prior notice of the expected activities must be furnished to the purchasing agency or DPS (if the provider is a Chapter 71B Approved Private School) through the program proposal review process, award or renewal of the contract, through the program price approval process, or by separate notification prior to the expenses being incurred. In the latter case, the purchasing agency or DPS may disapprove the expense by written notice.

- The costs associated with the employee morale, health and welfare, activities are not considered excessive or unreasonable as defined in 808 CMR 1.15 (1) or, if federally supported, are considered allowable as shown in Attachment A and Attachment B (11) of OMB Circular A-122.

  Providers that utilize a purchase of service contract for contracting with the Commonwealth must include the costs associated with the employee morale, health and welfare, activities as budgeted Administrative Support, Direct Care or Occupancy costs in Attachment B.: Fiscal Conditions/Program Budget of the purchase-of-service contract.

- The provider's employee, morale, health and welfare activities must be available to all employees and not operated in discriminatory manner. Disparities in the availability of these activities may occur based on the employee's status as a member of management, length of service, collective bargaining agreements or regular hours of employment. Disparities may not occur within classes of employees. The costs of the program must be equitably apportioned to all activities of the organization.

- Income generated from any of the fees charged or monetary collections taken for employee functions, such as dinner dances, must be used to defray the operating costs of the employee, morale, health, and welfare activities unless the income has been designated to be furnished to employee welfare organizations such as an employee benevolent society.

The costs associated with the employee morale, health and welfare, activities must be adequately supported through written documentation.

**16. May organizational memberships, subscriptions, professional or board of director related costs In Commonwealth-funded programs ever be considered reimbursable state or federal costs?**

Yes: The reimbursable and nonreimbursable cost provisions of DPS regulations and federal OMB Circular A-122 indicate that these costs may under certain circumstances be reimbursable. Reimbursable operating costs (808 CMR 1.02) must be reasonably incurred or expected to be incurred in the provision of program services purchased by the Commonwealth and not be excluded from reimbursement by 808 CMR 1.15. The concept of reasonableness as it relates to reimbursement is further explained in the DPS Summary Sheet "Reimbursable and Non-Reimbursable Operating Costs," document number DPS-A035-93, dated August 1993. Operating costs in federally supported programs (including administration costs allocated to the program for reimbursement) must meet the general tests of allowable costs by being reasonable and allocable as shown in Attachment A of OMB Circular A-122.

Costs that are generally considered administrative in nature, or related to the board of directors, and contribute to the overall benefit of the agency and the programs receiving financial assistance from the federal government and the Commonwealth such as the organization's membership in civic, business, technical, and professional organizations are allowable as noted below.

Such costs may be reimbursable if their monetary value is relatively low compared to the program-related benefits derived from the results of these activities. For example, these costs may be associated with meetings and conferences, including the cost of meals and fees, held to conduct the general administration of the organization. These costs could be composed of a relatively inexpensive purchase of food and beverage (example, salad and cold-cut buffet, piece and sandwiches) that would permit the board of directors to conduct critical provider business during dinner hours. In addition, the costs of attendance by employees and board members at meetings and conferences, sponsored by others when the primary purpose is the dissemination of technical information that benefits federal and Commonwealth-funded programs, including cost of meals, transportation, and other items incidental to such attendance are allowable as follows:

- The provider's administrative and board-related costs, including organizational memberships, subscriptions, and professional activity costs must be incorporated into the providers written policies and must have been expected and not have been disapproved by the purchasing agency or DPS (if the provider is a Chapter 71B Approved Private School). Prior notice of the expected activities must be furnished to the purchasing agency or DPS (if the provider is a Chapter 71B Approved Private School) through the program proposal

review process, award or renewal of the contract, through the program price approval process, or by separate notification prior to the expenses being incurred.

- The costs associated with administrative and board-related costs, including organizational memberships, subscriptions, and professional activity are not excessive or unreasonable as defined in 808 CMR 1.15 (1) or if federally supported, are considered allowable as shown in Attachment A and Attachment B (24) and (25) of OMB Circular A-122. See also 808 CMR 1.15 (23) prohibiting luxury items.

- Providers that utilize a purchase of service contract for contracting with the Commonwealth must include the costs associated with the administrative and board-related costs, including organizational memberships, subscriptions, and professional activity as Administrative Support or Direct Care costs in Attachment B.: Fiscal Conditions/Program Budget of the purchase-of-service contract.

- The costs associated with organizational memberships, subscriptions, and professional activity must be adequately supported through written documentation (See 808 CMR 1.15 (26)).

Additional questions are welcomed by DPS Questions may be forwarded to the Bureau of Audit at the following address:

Director, Bureau of Audit
Executive Office for Administration & Finance
Department of Procurement & General Services
Division of Purchased Services
One Ashburton Place, Room 1017
Boston, Massachusetts 02108

***Caution some guidance contained in this document may not still be appropriate because of regulatory and policy changes that have occurred since being issued.***

The Director of the Bureau of Audit met with Massachusetts Society of CPAs Grantees and Not-For-Profit Accounting and Auditing Committee on October 17, 1995 and answered the committee's prepared questions concerning the UFR. The following questions and answers were provided in a subsequent mailing to interested parties in the month of November 1995.

## MASS SOCIETY OF CPAs QUESTIONS

1. **What is the definition of a program? Are there any exceptions to the requirement that cost reimbursement contracts should not be combined with unit rate contracts? What reporting is DPS expecting when this occurs?**

   **What is a Program?**

   The definition of a program is contained in 808 CMR 2.02, which is established pursuant to Massachusetts General Laws, Chapter 29, Section 29B, and is defined as follows:

   *The delivery of ore or more discrete services in an organized and coordinated fashion in order to achieve objectives comment to all program participants.*

   Overall specifications for programs furnished to Commonwealth agencies are established in the request for proposal (RFP) published by the Commonwealth. The specifications for each program to be furnished are contained in the proposal for the program which has been negotiated with the primary purchaser and incorporated into the contract awarded to the provider.

   UFR program numbers are assigned to programs by the primary purchaser and provider for each program during contract/program negotiations, amendment or renewal.

   Secondary Commonwealth purchasers of the program must utilize the program specifications negotiated by the primary purchaser. Regulation 808 CMR 2.07 indicates that other purchasing agencies' negotiations for the purchase of a portion of the program is limited to additional terms and conditions which do not materially modify the statement of work, fiscal terms (cost reimbursement/unit rate basis of payment or budget for the program) or other terms and conditions agreed to by provider and primary purchaser (such amount and source of offsetting income used to reduce negotiated program costs). The fiscal terms and conditions of a program will be inappropriately modified and in conflict if a combination of negotiated unit rate and cost reimbursement contracts are utilized to fund a program.

Additional guidance concerning primary and secondary procurement coordination is available in Selected Sections of The Executive Office of Health and Human Services (EOHHS) Secretariat Guidelines. For the Procurement of Social and Rehabilitative Services of the UFR Compliance Supplement.

**Why is it that a program may not be reimbursed by both negotiated unit rate and cost reimbursement contracts?**

Provisions governing when a reimbursement may be made using a cost reimbursement contract are noted in 808 CMR 1.06 (3). These provisions indicate hat purchasing agencies may purchase services on a cost reimbursement basis only if:

a) The contract is in the start-up year, or

b) the purchasing agency has reason to monitor the actual expenditures of the provider, or

c) special circumstances exist which make service delivery under the fee-for-service or accommodations purchase provisions impractical or undesirable.

Permission to utilize a cost reimbursement contract under the provisions of 808 CMR 1.06(3)(c) may be authorized by the Division of Purchased Services in accordance with Division's policy.

The ability to monitor a start-up program or actual expenditures of a programmatically sensitive program, unstable program, or a program susceptible to, abuse is inhibited when both cost reimbursement and negotiated unit rate methods of payment are utilized to reimburse the program.

The need to monitor these types of programs has historically caused the Commonwealth to require that only one cost reimbursement contract be executed for a program and that program is to be available exclusively to the primary purchasing agency.

There is no ability to determine, in the UFR, if overbilling occurred in a program reimbursed by a cost reimbursement contract if the program is also reimbursed using a negotiated unit rate contract(s).

**How do purchasing agencies and providers inappropriately enter into program procurements that are reimbursed by both negotiated unit rate and cost reimbursement contracts?**

A secondary purchaser of a program may not communicate with the primary purchaser or be aware of the existence of a primary purchaser of a program and may inadvertently use a different basis of reimbursement to procure a portion of the program.

The primary purchaser may inappropriately use a cost reimbursement basis of payment to reimburse a provider for a line item or portion of a line item that is used to purchase specialized services subject to unexpected and fluctuating price increases or for services that may not be needed for the full term of the contract.

**Are there exceptions to the restrictions placed on the use of cost reimbursement contracts or other types of unit rates that may be used with a cost reimbursement contract to fund a program?**

- The Division of Purchased Services (DPS) may grant a waiver of its regulations in limited situations when warranted.

- Third-party payments (Medicaid billable class rates) may be utilized as an offset in a cost reimbursement contract.
- Non-negotiated unit rates (class rate) established by the Rate Setting Commission for Medicaid reimbursable services may be used by a Commonwealth purchasing agency to reimburse a provider for one or more services (ex. Early Intervention 114.3 CMR 7.00) furnished by a program that is reimbursed with a cost reimbursement contract.
- The program and its contracts may be amended during the year and the method of reimbursement for the program also changes (negotiated unit rate contracts become one cost reimbursement contract or a cost reimbursement contract becomes one or more negotiated unit rate contracts).

**What audit steps should the independent auditor employ in the audit of the UFR when it is determined that a program is reimbursed on a negotiated unit rate basis and a cost reimbursement basis?**

The provisions of Massachusetts General Laws, Chapter 29, Section 29B, require the purchasing agency and the provider to adhere to DPS regulations. Current DPS regulations as noted above do not provide for the reimbursement of a provider program with a combination of cost reimbursement and negotiated unit rate contracts.

Failure to follow the General Laws of the Commonwealth or DPS regulations is a condition of noncompliance which should cause the independent auditor to write a material finding of noncompliance with laws and regulations and/or a finding of a material weakness in the internal control structure (internal controls for compliance with laws and regulations) of the provider. The element of cause in the provider's internal control and/or compliance finding should in most cases indicate that the internal control structure of Commonwealth purchasing agency permitted the noncompliance to occur.

**What action will DPS and the principal purchasing agency take when a material finding of noncompliance and/or a material internal control finding has appropriately been written or inappropriately not been written by the independent auditor?**

- The DPS audit resolution policy requires the principal purchasing agency and the provider to correct material findings through a written corrective action plan that is made part of an administrative audit compliance agreement signed by both parties. When there are indications that material findings were not written and they may have been warranted, DPS would be required to take the following action:

  DPS would conduct further audit work or request the Office of the State Auditor (OSA) to conduct such world to determine the extent of any noncompliance or internal control deficiency when material internal control and compliance findings are not written by the independent auditor in accordance with the supplemental procedures (1994 "Yellow Book" paragraph 5.10) that are noted in the UFR Audit and Preparation Manual and the
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Auditor's Compliance Supplement and the OMB Circular A-133. Such material findings of noncompliance and internal control may be warranted because it is probable that overbilling would occur or not be detected if a cost reimbursement contract is used to reimburse a program that is also reimbursed with a negotiated unit rate contract. Such additional audit work by DPS or OSA may have audit results that could prevent the provider from being prequalified to contract with the Commonwealth or could result in the Commonwealth recouping any overpayment that occurred in a cost reimbursement contract or requiring the return of any inappropriately retained revenues furnished through the surplus revenue retention policy. Such actions taken by the Commonwealth would most likely have a direct and material effect on the financial statements of the provider.

2. **What is the basis for requiring a reconciliation on overhead in the final billing of a cost reimbursement contract? It seems to be a consistent claim of providers that purchasing agencies have never required this. If this reconciliation is necessary, as a practical matter, how can this be accomplished without closing the books and preparing the UFR before completing the final billing.**

   - Cost reimbursement contracting carries with it the need for a greater degree of oversight and monitoring by the purchasing agency and the provider in that cost reimbursement contracting is a payment arrangement under which the purchasing agency reimburses the provider for budgeted overhead actually incurred in rendering the services specified in the agreement up to a stated maximum obligation. Overhead (administrative support) in cost reimbursement contracts is billed to the Commonwealth and reimbursed on a budgeted basis until the twelfth month when a reconciliation is conducted to ensure that actual and reimbursable overhead costs for the term of the contract meet or exceed the amount billed to the Commonwealth. The amount of actual overhead costs billed to the Commonwealth must be less than the negotiated administrative support cap for the program (contract). Purchasing agencies have not required that providers furnish evidence or exhibit the existence of the reconciliation of overhead in the past because it has always been believed that actual overhead costs generally exceeded the negotiated administrative support cap in the cost reimbursement contracts. Recent audits conducted by OSA and UFR reviews conducted by DPS indicate that overhead costs in UFRs reviewed and audited have not typically exceeded the negotiated administrative support cap as generally believed and many of these costs have contained nonreimbursable costs or non-program costs.

   - Conducting a reconciliation in the twelfth month of a cost reimbursement contract is needed to ensure that actual and reimbursable overhead costs for the term of the contract meet or exceed the amount billed to the Commonwealth and

the actual overhead costs billed to the Commonwealth are less than the negotiated administrative support cap for the program (contract). While the amount of overhead costs that need to be determined should not be materially different from the amount of overhead costs to be disclosed in financial statements or schedules of the UFR this accounting procedure requires far less accuracy, labor and time than would be needed for actual disclosure in the UFR.

- The reconciliation of overhead costs to ensure that overbilling does not occur in cost reimbursement contracts or unit rate contracts (actual incurred overhead costs are less than negotiated administrative support cap and amount billed on budgeted basis) billings to the Commonwealth should be attainable if the provider's accounting system can identify and segregate nonreimbursable items in overhead (as required by the General Conditions of the Master Agreement, 808 CMR 1.00 and OMB Circular A-110) and can estimate within reason overhead costs attributable to the purchased program.

3. **It was stated in the UFR training that a cost reimbursement contract should not show a surplus or a deficit. Since cost reimbursement contracts do not allow billing for accrued vacation (which is a GAAP requirement), how should the surpluses/deficits resulting from accrual differences be handled on the UFR?**

- The Commonwealth reimburses providers for employee services rendered and accrued vacation time (example 50 weeks of employee services and 2 weeks of accrued vacation) in cost reimbursement contracts as specified in program proposal (that becomes part of the contract) for the term of the contract year (generally 52-week year). The Commonwealth does not pay for employee services and vacation time in excess of the amounts defined in the proposal which is generally a 52-week period (these costs are considered nonreimbursable).

- Typically, these nonreimbursable costs are incurred when employees do not take vacations (vacation time is accrued and reimbursable under contract when this occurs) and they provide employee services in excess of the amount specified in the proposal (example: employees furnish employee services for 52 weeks rather than 50 weeks as specified in proposal and accrues 2 weeks of vacation tone). In the aforementioned example, the 2 weeks of accrued vacation time are considered reimbursable but the employee services furnished in excess of 50 weeks are considered nonreimbursable because this payroll expense was not included in the negotiated contract budget or the proposal.

- Providers are encouraged to employ adequate internal controls and to use good business practice by utilizing policies that require employees to take vacations and/or loose vacation time if not taken within a specified period of time. Providers are also encouraged to adequately budget for staff coverage or use relief staff in a manner that permits employees to take vacation without loss in program performance. These measures, if adequately employed, would prevent or limit nonreimbursable costs attributable to excess employee services.

**4. What is the understanding or expectation of DPS as to the level of work that a CPA should perform on the unaudited schedules of the UFR when they are prepared by the provider?**

- The DPS bureau of audit expects that the independent auditor should furnish the level of world to the unaudited schedules of the UFR as required by the appropriate AICPA statements on auditing standards. These standards require the auditor to report on all the information in the document by using a supplements information paragraph in the auditor's report on the financial statements or a separate report. The standards also require the independent auditor to read the supplemental information and consider whether
- the supplemental information, or the manner of its presentation is materially inconsistent with the information, or manner of its presentation, appearing in the basic financial statements.

  It is DPS's understanding that this would require the auditor to consider whether the supplemental information and the information in the basic financial statements is materially inconsistent as follows:

1) Different functional and natural classification is inappropriately used in the supplemental schedules and basic financial statements.
2) Fund, account, cost category and program totals of supplemental schedules do not reconcile with basic financial statements totals as required.
3) The amounts and classification of revenues, expenses and fund balances disclosed in supplemental schedules are materially inconsistent with the information or manner of its presentation in the basic financial statements.
4) Nonreimbursable costs disclosed in supplemental schedules are materially inconsistent with the independent auditor's audit results of testing and reporting on internal controls and for compliance with laws and regulations in a financial statement audit. In addition, nonreimbursable costs disclosed in supplemental schedules are materially inconsistent with the independent auditor's audit Exults of performing further supplemental procedures of testing and reporting on internal controls and compliance with laws and regulations in accordance with the requirements of OMB Circular A-133 and the UFR Audit and Preparation Manual and Auditor's Compliance Supplement.

If the information is materially misstated DPS, would expect and the SASs oblige the auditor to accomplish the following:

- Discuss matter with the provider and propose revision;

- if the client refuses to revise the supplemental information, the auditor should modify the report on the financial statements or reports on internal controls and compliance;
- describe the misstatement, to include the information or the use of auditor's reports, or withdraw from the engagement.

**5. What flexibility exists when disclosing revenue retention amounts? Can the disclosure be included as supplemental information rather than included in the footnotes to audited statements?**

- Financial activity attributable to Commonwealth purchase of service (POS) contracting generally represents most of a provider's financial activity (approximately 70% of all revenues and expenses accrued by providers are related to POS contracting) and a substantial amount of other financial activity would not occur without POS contracting (third-party revenue, client resources, POS sponsored client fees, etc.). Disclosure of revenue retention amounts including liabilities and revenues to be retained should be made in the financial statements and notes to the financial statements. These disclosures should occur in that the liabilities and contingencies associated revenues to be retained as determined by the revenue retention estimates made by the provider could directly impact the classification and bases of amounts set forth by a provider in the financial statements and the ability of the provider to fulfill its regulatory and contracting obligations. Statement of Financial Accounting Standards No. 5 (FASB No. 5) provides guidance regarding appropriate accounting and disclosure requirements for gain and loss contingencies associated with the retained revenue retention amounts. In that the disclosure of revenue retention amounts are Squired through regulation and contract terms and conditions and such disclosures are subject to FASB No. 5, disclosure could in most cases only be made in the financial statements or as footnotes to the financial statements. Disclosure of the amounts could be included as supplemental information rather than included in the financial statements or the footnotes to audited statements if the amount of POS contracting that the provider participates in and the contingencies involved are not material to the Commonwealth and the provider's financial statements. A request to DPS for prior approval to disclose revenue retention amounts as supplemental information in the UFR should be made if the provider believes that the amount of POS contracting that the provider participates in and the contingencies involved are not material to the Commonwealth and provider's financial statements.

6. **It appears that when the DPS staff encounters "deficiencies" in a UFR that correspondence is immediately sent to the provider, the CPA & the purchasing agent regardless of the significance of the "deficiencies". When DHHS reviews audits, many issues are resolved over the telephone before any correspondence is generated. Is it possible to establish a level of reasonableness in the review process to determine when** Page 8**issues could be resolved over the telephone before sending unnecessary correspondence? Our committee would be happy to work with DPS staff in establishing parameters for determining minor vs. major issues.**

   The conclusions section of the DPS Bureau of Audit Desk Review Guide contemplates that minimum filing deficiencies (as listed in UFR Preparation and Audit Check List) should be communicated by telephone to the provider and/or independent auditor whenever possible and appropriate. The bureau previously furnished information regarding notification of UFR deficiencies by telephone in question number 14 of its document entitled Questions And Answers On Audit and Preparation Of The UFR, issued August 1994. The answer to question number 14 in this document noted the following: "The Bureau of Audit attempts to notify providers and independent auditor about deficiency items requiring limited explanation over the telephone. Staff of the Bureau of Audit spend a substantial portion of their workday providing guidance on the telephone to providers and independent auditors concerning issues related to the filing requirements of the UFR" As a general rule, items requiring limited explanation are defined as having approximately one to three minimum filing deficiencies. In addition, telephone notifications are used when providers and independent auditors are being notified of deficiencies when the notification does not need to be documented in writing. Filing deficiencies may need to be documented in writing to provide due process when numerous minimum filing deficiencies exist; when prior year deficiencies are -repeated in the current UFR filing; when deficiencies are not corrected after repeated written notifications and when the possibility and/or probability exists that sanctions and penalties will be imposed. Currently, a substantial number of UFR filings are determined to be deficient and the vast majority of deficiency letters contain more than three minimum filing deficiencies as well as other audit and preparation filing deficiencies. The Bureau of Audit would be happy to receive suggestions or discuss with the committee the possibility of deleting or adding items listed as minimum filing deficiencies in the UFR Preparation and Audit Check List, if appropriate.

7. **Is there anything that can be done in order to issue federal funding letters earlier?**

   Timing for the release of federal funding letters is predicated upon when the Commonwealth's accounts payable is closed out and providers' reimbursements are no longer being honored for the fiscal year. In recent years, the Commonwealth's accounts payable has closed out on the last day of August. In the current year, federal funding information could not be retrieved on a timely basis from the Commonwealth's accounting system because of computerization problems.

The Bureau of Audit has furnished federal funding letters to providers as a courtesy and in order to provide one additional measure of comfort to providers and auditors. These letters have always been careful to point out that the letters are not official documents of the Commonwealth and they are not being furnished for confirmation purposes. Unfortunately, providers and auditors have come to rely on these letters and to use them as the primary method of notification for federal funds furnished. The primary method that the Commonwealth uses to inform providers of the type and level of federal funds furnished is through listing of the CFDA number on the cover page of each contact with an accompanying federal award letter if the contract is not totally federally funded. The accompanying federal award letter notes the proportion of federal and state funding to be furnished. The vast majority of contracts are not accompanied with a federal award letter because the POS contract is totally federally funded.

There is one exception to notification practice which involves some federal funds furnished through POS contracts by the Department of Social Services (DSS) to providers being reimbursed through certain appropriation accounts. The cover page of these POS contracts do not include the CFDA number in that the Commonwealth uses its funds first then allocates the amount of federal assistance to be received from the federal government using a formula (which is less than the amount of Commonwealth funds first used) to all providers in certain Commonwealth appropriation accounts. This procedure prevents the Commonwealth from determining before the contract is executed the amount, if any, of federal financial assistance to be furnished to each provider through these appropriation accounts.

In the event that the Commonwealth does not furnish information concerning federal financial assistance, the provider and independent auditor should follow the guidance furnished in questions numbered 40, 54, and 55 in Questions and Answers on OMB Circular A-133, published by the President's Council on Integrity & Efficiency (enclosed).

The Bureau of Audit is currently considering the possibility of not furnishing federal funding letters in the future in that these letters furnished by DPS duplicate the notification made through the contract cover page, and when necessary, the accompanying federal award letters. The elimination of this notification process would free up bureau of audit staff to work on more pressing issues. The bureau would continue to furnish letters to the to providers contracting with DSS that have federally funded contracts being reimbursed through certain appropriation accounts for which the contract cover page does not include a CFDA number and when necessary, the accompanying federal awards letter. Each Commonwealth purchasing agency would be responsible for notifying providers directly through contract amendments or by other means of any additional federal funds furnished or changes in the amount or type of federal assistance furnished during the year.

8. **What is the DPS policy regarding making CPA firm referrals or recommendations?**
The DPS bureau of audit does not make any referrals of CPA firms to other state agencies or providers or recommendations concerning audit services. The Bureau of Audit conducts its affairs in accordance with generally accepted government auditing standards (GAGAS), such referrals or recommendations would constitute a departure from the second general standard of GAGAS concerning independence. Staff of the Bureau of Audit are required to sign an independence certification form for each UFR reviewed to ensure that departures from the second general standard of GAGAS do not occur. The Bureau of Audit has on occasion furnished to individuals a listing of all CPA firms auditing the UFR or has referred these individuals to the Massachusetts Society of CPAs for information concerning audit services. The Bureau of Audit has infrequently purchased training services from CPA films or has been furnished training services free of charge from CPA firms in the past. On occasion, the Bureau of Audit has furnished references limited solely to the training services that were furnished.

9. **What is the overall objective of DPS in the UFR review process and how can our committee work with your staff in facilitating the process?**

The UFR review process provides a level of assurance regarding the usefulness of the UFR. The review process ensures that the Auditor's Reports, financial statements, schedules and other supplemental information filed in the UFR meet applicable accounting principles and auditing standards in accordance with the regulations and instructions promulgated by DPS. The use of the DPS desk review guide in meeting these objectives is to ensure that the Division's legislative mandate in accordance with Chapter 110, section 274 of the Acts of 1993 to develop and administer a uniform system of financial accounting, reporting, allocation, and auditing of providers which conforms to generally accepted government auditing standards is accomplished. The review process enables report users composed of contributors, federated fund-raising organizations, other donor groups, organizations affiliated with the provider, contributor information bodies, governmental regulators, beneficiaries, lenders, bonding institutions, suppliers, federal, state and municipal grant and contract awarding agencies, legislators and concerned citizens to use the report for its intended purposes as follows:

- Testing and reporting on a provider's internal controls and compliance with laws and, regulations contribute to the evidence supporting the auditor's opinion on the financial statements and provides limited assurance to UFR report users concerning the auditor's understanding of the entity's internal control structure and compliance with laws and regulations material to the financial statements. Preparation of a corrective action plan by the provider and the execution of an administrative audit compliance agreement with the Commonwealth provides a measure of assurance to report users that findings reported in the auditor's reports on internal controls and compliance will be corrected. Audit follow-up by independent auditors on known material findings and recommendations from previous audits provides an additional level of assurance to UFR report users that findings will be corrected.

- The supplemental procedures of testing and reporting on a provider's internal controls and compliance with laws and regulations as prescribed in the UFR Audit and Preparation Manual and Auditor's Compliance Supplement and OMB Circular A-133 provides limited assurance to UFR report users concerning the auditor's understanding of the entity's internal control structure and compliance with laws and regulations material to Commonwealth and federal programs. Preparation of a corrective action plan by the provider and the execution of an administrative audit compliance agreement with the Commonwealth provide a measure of assurance to UFR report users that findings reported in the auditor's reports on internal controls and compliance will be corrected. Audit follow-up by independent auditors on known material findings and recommendations from previous audits provides an additional level of assurance to the UFR report users that findings will be corrected.

- When nonreportable items are included in the provider's management letter, a measure of assurance is furnished to UFR report users that management will be able, through this notification, to maximize the efficiency of its internal controls and compliance with-laws and regulations.
- The information disclosed in the basic financial statements and unaudited schedules provides UFR report users with a wealth of reliable information to make rational decisions about financing, endowing or subsidizing of the provider. The information provided concerns the results of the providers operations for the agency and its programs. The UFR report users have the opportunity to use this information to learn about the provider's economic resources, obligations, and net resources and for determining how the organization spends cash or other liquid assets. The information also informs the UFR report users about the effects of transactions, events and circumstances that change resources and interests in those resources. In addition, information about borrowing and repayment of borrowing, along with other factors that may affect the provider's liquidity, is also furnished to UFR report users.
- The information furnished in the unaudited Supplemental Schedule D, Service Efforts and Accomplishments, provides the UFR report users with information that will assist in assessing the performance of the provider. This information assesses what the UFR report users are getting for the use of public funds and how economically, efficiently and effectively these funds are being used. The UFR Auditor's Compliance Supplement indicates that the auditor should test the provider's internal controls and compliance with contract performance and service documentation requirements. The results of this testing provides a measure of assurance to UFR report users regarding the ability of the provider's collection, tracking and reporting of services furnished through the disclosure of indicators of economy, efficiency and effectiveness of the program's outputs and outcomes (accomplishments) reported in this schedule.

- The information reported in the unaudited Rate Setting Commission schedules is used to establish Medicaid reimbursable class rates of payment and to provide UFR report users with a level of comfort concerning the rates established using this cost information.

The UFR is a document which is very useful to UFR report users because it is an audited uniform document which permits the UFR report user to compare one provider to another or similar types of providers or one segment of the industry to another segment of the industry.

The information in the UFR data base is made available to agencies and other UFR report users for generating management reports and for establishing funding priorities. This would not be possible if the UFR was not an audited uniform document and if the DPS Bureau of Audit did not provide a level of assurance concerning the accuracy and adequacy of the UFR through its reviews. The UFR is also used by other Commonwealth management to conduct contract prequalification reviews to assess provider's financial viability and its compliance with laws and regulations prior to executing contracts. In addition, the UFR review process is also used as an indicator for determining if further audit work needs to be conducted by DPS or the OSA to establish the full extent of inadequate internal controls, irregularities, illegal acts, and other noncompliance.

Providers need to become more proficient and take more responsibility for the maintenance of adequate accounting systems and the preparation of financial statements in accordance with generally accepted accounting principles. The fourth general standard of GAGAS requires that the independent auditor have an appropriate internal quality control system to ensure that the organization has adopted, and is following applicable auditing standards and has established and is following, adequate policies and procedures. When establishing such a system the independent auditor needs to ensure that the UFR report users' needs are met by adopting policies and procedures that prevent UFR minimum filing deficiencies from occurring.

The Committee can help facilitate the review process in the immediate future by impressing upon practitioners and their clients through news letters, training or follow-up procedures of the need to ensure that the UFRs are adequately prepared and audited (includes reading and considering supplemental information) as is needed. There is also a need to impress upon the practitioner the need to improve the quality of audit findings that are written in UFRs by ensuring that they contain the required "Yellow Book" elements of a finding which result in clear, concise and convincing findings. Adequate audit findings will enable purchasing agency and provider staff to adequately correct deficiencies and improve the delivery of services to clients of the Commonwealth.

DPS-A035-97 (REVISION 3)
(Supersedes version dated August 1995)
August 1997

# DIVISION OF PURCHASED SERVICES

## SUMMARY SHEET

### SELECTED REIMBURSABLE AND NON-REIMBURSABLE OPERATING COSTS

***NOTE:*** *This summary sheet has been updated to reflect amendments to regulation 808 CMR 1.00 as of February 1, 1997 and supersedes the version dated August 1995 where inconsistencies exist.*

## INTRODUCTION

Funds received from a Commonwealth Department for the provision of a social service program may only be used by a Contractor agency for costs which are "reimbursable operating costs" as defined in Division of Purchased Services regulation 808 CMR 1.02. This rule applies to the expenditure of funds received by programs purchased pursuant to a purchase-of-service contract and pursuant to the Commonwealth's special education law, M.G.L. c.71B.

In addition, certain costs have been specifically identified as non-reimbursable in regulation 808 CMR 1.05 so that in no circumstance may Commonwealth funds be budgeted or used for these costs. Even funds from Commonwealth sources that are allocated to defray agency administration expenses or funds properly accumulated pursuant to the surplus revenue retention provisions of regulation 808 CMR 1.03(7) cannot be used for non-reimbursable items. Funds received in payment for an approved special education program, where the price used for payment purposes is the Commonwealth developed price, regardless of source of payment, also cannot not be used for non-reimbursable items. Expenses in a Commonwealth purchased program that are not reimbursable must be offset with other Contractor funds; public dollars which are used for non-reimbursable expenses are subject to recovery through a variety of mechanisms.

In this summary sheet, we attempt to assist Departments and Contractors in making the determinations necessary for deciding what are reimbursable operating costs under 808 CMR 1.02 and 808 CMR 1.05 in Commonwealth purchased programs.

### Regulatory Reference:

Division of Purchased Services regulation 808 CMR 1.00, (effective 2/1/97). in particular sections 808 CMR 1.02 (definition of "reimbursable operating costs") and 808 CMR 1.05 (listing of specific non-reimbursable costs)

### Other Informational Material:

Office of Management and Budget Circular No. A-122, "Cost Principles for Nonprofit Organizations," (recompilation May 14, 1997).

## REIMBURSABLE OPERATING COSTS

808 CMR 1.05 states as follows:

> *Funds received from Departments may only be used for Reimbursable Operating Costs as defined in 808 CMR 1.02. In addition, funds may not be used for costs specifically identified in 808 CMR 1.05 as non-reimbursable. Expenditures not in accordance with this paragraph are subject to recoupment, intercept, offset and where appropriate, the Authorized Price is subject to adjustment, as determined by the Commonwealth.*

808 CMR 1.02 defines reimbursable operating costs as follows:

> *Those costs reasonably incurred in providing the services described in the contract and/or, in the case of a Program approved under the provisions of M.G.L. c. 71B, in providing the services mandated by DOE or specifically included in an Authorized Price, with the exception of costs enumerated in 808 CMR 1.05 and costs excluded in the Authorized Price. Operating costs shall be considered "reasonably incurred" only if they are reasonable and allocable using the standards contained in Federal Office of Management and Budget Circular A-122or A-21, or successors thereto.*

The OMB Circular No. A-122 standards for <u>reasonable</u> are as follows:

> *3. Reasonable costs. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. .... In determining the reasonableness of a given cost, consideration shall be given to:*
>
> *a. Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award [*in this case, the performance of the contract or the delivery of program services*].*
>
> *b. The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award.*
>
> *c. Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Government.*
>
> *d. Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.*

OMB Circular No. A-122 describes <u>allocable costs</u> as follows:

> *4. Allocable costs.*
>
> *a. A cost is allocable to a particular cost objective, such as a grant, project, service or other activity, in accordance with the relative benefits received. A cost is allocable to a Government award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:*

*(1) Is incurred specifically for the award.*

*(2) Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received.*

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

*b. Any cost allocable to a particular award or other cost objective under these principles may not be shifted to other Federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of the award.*

Thus, in determining reimbursability, one must assess whether the cost is incurred for the program, is reasonable both in its nature and its amount, and is properly allocable.

**Costs Incurred in Providing the Contracted or Mandated Services**. The first step then in assessing whether a cost is reimbursable involves determining whether a cost would be "reasonably incurred in providing the services described in the contract" or, in the case of a special education program, "in providing the services mandated by DOE or included in an Authorized Price." This requires an examination of the agreement between the Contractor and Department to determine whether the Department anticipated paying for the cost because it was contained or described in the program budget or because the cost is necessary for the Contractor to deliver the program of services mandated by the Department of Education. The question for the Contractor then is not whether the cost satisfies some element of its agency's mission, but whether the cost is, to use OMB Circular A-122's terms, "ordinary and necessary" for the provision of the particular services that the Department has agreed to buy. In essence, the question to be answered is: Is the expenditure within the scope of the agreement?

**Reasonable in Nature**. OMB Circular A-122(3) requires that to be reimbursable, an expense must be reasonable in nature and be of the kind that "would be incurred by a prudent person under the circumstances." In making this determination, Circular A-122 suggests the expense be compared to the "type generally recognized as ordinary and necessary for the operation of the organization or performance of the award." Note that an expense is not reimbursable simply because it satisfies some element of its organization's mission. The cost must be "ordinary and necessary" for the provision of the particular services the Department has agreed to buy. Experience suggests that if the program budget is developed directly from the proposal or contract's description of services, then most of the resulting budget items will be ordinary and necessary for the program.

**Reasonable in Amount**. In order to be reimbursable, the expense must also be reasonable in amount. In considering the amount of an expenditure, Circular A-122 suggest that we consider whether the amount "exceeds that which would be incurred by a prudent person." Prudence is supported by the use of good business practices or demonstration of arms length bargaining. Webster's dictionary provides further guidance on what is reasonable by the use of the term "moderate". By contrast, unreasonable costs are defined in 808 CMR 1.05(1) as "any amount paid for goods or services which are greater than either market price or the amount paid by comparable Departments…"

**Allocable**. In addition to the above consideration to be reimbursable, expenses must also be properly allocable to Commonwealth programs. Generally, if an expense is contained in the program budget, contract description of services or is necessary for the delivery of the mandated program of services, then the resulting expense will likely be considered reimbursable. For a detailed discussion of general cost allocation principles governing Commonwealth contracts, please see OMB Circular A-122, 808 CMR 1.05(26), the audit and recordkeeping provisions associated with the Uniform Financial Statements and Independent Auditor's Report (UFR) and generally accepted accounting principles ("GAAP").

When it is still unclear if a cost is reimbursable, then the Contractor should seek the advice of its Department prior to the expenditure of funds for the questionable purpose. Early communication may prevent future misunderstandings, as well as may eliminate audit issues. Generally, it is prudent to assume a questionable cost is non-reimbursable, unless otherwise confirmed.

## NON-REIMBURSABLE COSTS

In addition to costs that are not reimbursable because they are not ordinary and necessary for the delivery of what the Commonwealth is buying, there are costs which have been specifically identified as non-reimbursable because of Commonwealth and Federal legal restrictions. These special "non-reimbursable costs" are delineated in Division of Purchased Services regulation 808 CMR 1.05.

A determination must first be made that an expense is potentially reimbursable under 808 CMR 1.02 (see discussion above) before considering the additional restrictions imposed under 808 CMR 1.05. 808 CMR 1.05 further emphasizes that in paying for a social service program the Commonwealth should only pay for program related, reasonable and documented expenditures. See in particular, 808 CMR 1.05(1), (12), and (26).

While all of the provisions of 808 CMR 1.05 should be reviewed, a number of them are highlighted below and certain sections of those provisions are further clarified:

*(1) Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.*

> This provision specifically says that costs which do not meet the criteria for reimbursable operating costs would be considered unreasonable and therefore non-reimbursable. In addition, costs which are above market price are unreasonable. Market price can be determined using appropriate sources of information. For instance, the market price and the price paid by other organizations for general transportation vehicles would be established by using the manufacturer's fleet price for general transportation vehicles or by consulting publications on vehicle costs issued by insurance companies. In addition, 808 CMR 1.05(23) provides that luxury items are not reimbursable in Commonwealth programs.

*(5) Certain Salaries and Consultant Compensation. Those salaries, wages, and consultant compensation considered to be excessive by DPS, in light of salaries, wages and consultant compensation of other comparable Contractors.*

In developing a program budget, in most instances the amount for program salaries, wages, and consultant compensation should not exceed the market price ranges for these positions or components. Again, salaries, wages and consultant compensation must be program related under 808 CMR 1.02 and 808 CMR 1.05(12) before further consideration. See also 808 CMR 1.05(21)(non-reimbursable litigation costs) and 808 CMR 1.05(24)(non-reimbursable salaries of officers and mangers).

*(6) Bad Debts. Those amounts (whether estimated or actual) which represent the portion of an account or note receivable that proves to be entirely uncollectible despite collection efforts including legal action, and any related legal cost.*

This provision is not intended to limit valid program debt collection efforts through the use of legal representatives, but is intended to discourage the frivolous pursuit of claims. The notion is that when a debt is ultimately uncollectible then its validity is questionable and therefore the expenses associated with the attempted collection should not be considered reimbursable by the Commonwealth. Expenses associated with the successful collection of valid/legally enforceable debts for programs being purchased by the Commonwealth are reimbursable. However, when all legal avenues of collection have not been exhausted, then any expenses incurred in the unsuccessful pursuit of such disputed debt are not reimbursable. In addition, should a court of law determine that a claim is not valid, then the expenses incurred in pursuing the claimed debt are also not reimbursable. Also, the amount of any debt attributable to others (i.e., owed by non-Commonwealth entities) is never reimbursable by the Commonwealth.

*(8) Related Party Transaction Costs. Costs which are associated with a Related Party transaction are reimbursable only to the extent that the costs do not exceed the lower of either the market price or the Related Party's actual costs. Notwithstanding the above provision, when the following conditions are satisfied Related Party transaction costs are reimbursable up to market price:*

*a) the transaction is for a good or service which the Related Party sells to the general public;*
*b) the Related Party's transactions with the Contractor in the reporting year comprise less than 10% of the Related Party's annual sales of that good or service to the general public (excluding sales to other parties also related to the Related Party under FASB 57); and*
*c) the Contractor has approved the transaction by a vote of independent directors, or a committee of independent directors, following full disclosure of the Related Party's interests.*

*Further, costs associated with a Related Party transaction which would not be Reimbursable Operating Costs to a Contractor under 808 CMR 1.02 and 808 CMR 1.05 are non-reimbursable. Transactions with a related party totaling less than $100 annually may be reimbursed at market prices.*

This regulatory language was revised by DPS in 1997 to allow greater flexibility for organizations to accept services or goods from a Board member or other Related Party, generally at some discounted price but not necessarily "at cost". However, the general rule continues to be that the reimbursable costs of related party transactions shall be limited to the actual cost of a particular good, service, or facility when incurred by the related party, or market price - whichever is lower. This general rule is modified by a provision that specifies that actual related party costs are reimbursable only to the extent that they would have been allowable under the reimbursable operating costs provision of 808 CMR 1.02 and the non-reimbursable cost provisions of 808 CMR 1.05 if the Contractor itself had incurred the costs.

When a market price is difficult to establish, the allowable reimbursement level for a related party transaction should be the actual cost of the item in question, adjusted to reflect those other limitations on reimbursement which would apply to the primary Contractor (as set forth elsewhere in 808 CMR 1.05 or in applicable Federal guidelines). For purposes of reimbursing for real estate, these allowable costs to the primary Contractor are typically construed to include depreciation (as limited by the provisions of 808 CMR 1.05 (2)), interest (as limited

by 808 CMR 1.05 (3)), and allowances for routine operating expenses, repairs and maintenance of the property in question.

Please note also that 808 CMR 1.04(4) requires that Contractors provide prior notice of a related party condition or transaction. This can occur through some of the already existing disclosure opportunities, such as in responses to a Request for Responses (RFR), on the organizational chart submitted for annual contract prequalification, or during contract and/or amendment negotiations. Failure to comply with the notice requirements may result in the imposition of penalties. See 808 CMR 1.04(11).

(9) *Certain Fringe Benefits*.
*(a) Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent they are not available to all employees under an established policy of the Contractor. Disparities in benefits among employees attributable to length of service, collective bargaining agreements or regular hours of employment shall not result in the exclusion of such costs.*
*(b) Employer contributions to pension, annuity and retirement plans which have been denied approval by the Internal Revenue Service.*

To be reimbursable, fringe benefits must be available to all employees under an established written policy (in accordance with GAAP) of the Contractor and must not be excessive in comparison to salary and benefit levels of other similar Contractors. The policy may include provisions that permit the availability of different levels and types of fringe benefits for employees based upon the employee's length of service, collective bargaining agreements or regular hours of employment. However, please note that fringe benefits available only to management, such a special pension benefit or reimbursement for college course work, are not reimbursable expenses to state contracts.

Bonuses are not considered a fringe benefit; rather, they are properly classified as a salary allowance when attributable to services rendered by an employee. Bonuses are a negotiable item, which are added to salaries in the budget and in the financial statements. The net salary amounts must not exceed what is considered reasonable compensation to be reimbursable. There are two ways to furnish bonuses to employees: one is a fixed bonus as part of an employee's salary based on terms incorporated into his or her written employment agreement, and the second is through a Contractor's written employee morale, health and welfare policy, which makes available bonuses to all employees based on exceptional employee performance. See section 162 of the Internal Revenue Code and 808 CMR 1.05(20) for further guidance.

A Contractor's employee, morale, health and welfare policy is also frequently confused with and inappropriately budgeted and/or reported as fringe benefits. Costs associated with the Contractor's employee, morale, health and welfare policy are not budgeted and/or reported on the UFR separately, as fringe benefits, but rather under Administrative Support, Direct Care or Occupancy costs, as applicable. However, unlike fringe benefits, the Contractor's employee, morale, health and welfare policy may exclude members of management from benefiting or participating in the employee, morale, health and welfare activities of the Contractor. Bonuses that are provided to management in addition to a fixed bonus awarded pursuant to the terms of an employment agreement and not as part of a Board approved employee morale, health and welfare plan are not reimbursable. Further information concerning the reimbursement of employee, morale, health and welfare activities is available in the DPS publication "Additional Questions and Answers on Audit and Preparation of the UFR for Contractors and Their Independent Auditors" issued May 1995, and in OMB Circular A-122.

*(10)* *Fundraising Expense.* *The cost of activities which have as their primary purpose the raising of capital or obtaining contributions, including the costs associated with financial campaigns, endowment drive and solicitations of gifts and bequests. However, if a Program does not, or cannot reasonably be expected to, receive federal funds, the raising of capital or obtaining contributions for Commonwealth programs may be off-set against the revenue generated, except no loss will be reimbursable. To be reimbursable, the Contractor must maintain accounting systems which adequately segregate those fundraising expenses and revenues associated with Commonwealth purchased programs from other Contractor programs in accordance with generally accepted accounting principles.*

Commonwealth program revenues may be used to defray fundraising costs in those Commonwealth purchased programs which do not receive federal assistance only if the fundraising activity generates revenues in excess of the expenses incurred for the fundraising effort.

*(12) Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service program purposes of the Contractor.*

Please see the discussion on reimbursable operating costs (beginning on page 2).

*(13) Security Deposits. Money deposited by the Contractor with a lessor of real property as security for full and faithful performance of the terms of a Contractor's lease.*

The Commonwealth does not reimburse for security deposits based on the assumption that security deposits will be returned to the Contractor upon faithful performance of the terms of the Contractor's lease.

*(14) Free Care. Costs associated with free service and use.*

Since a contract executed with a Department should fully and adequately describe the purchased program and the clients to be served, it would be inappropriate for Commonwealth resources to be used for services and/or clients not included in the contract. To the extent that Commonwealth dollars are used for "free care", the cost of the program to the Commonwealth could be inflated or the Commonwealth would be forced to pay for costs or services for which there has not been a legislative appropriation.

*(16) Management Agency Fees. Fees charged to the Contractor by a management agency which exceed the costs the Contractor would have incurred had it not entered into a management agreement.*

Management agency fees must be allocated to the agency administration and support component. As such, the limitations on agency administration based on 808 CMR 1.05(1) [unreasonable costs] apply to this circumstance and any portion of a management agency fee that brings agency administration costs above the allowable cap established in the contract is non-reimbursable. See the discussion on pages 4-5 for details.

*(19) Certain Reporting Year Expenditures. Reporting year expenditures in the operating fund for which restricted funds were available but not used.*

Consistent with generally accepted accounting principles and this provision, organizations are required to use restricted funds for their intended purpose (such as donations received to acquire program equipment) and must exhaust such funds before seeking any reimbursement from the Commonwealth for those program expenses.

*(21) Litigation Costs. All costs incurred in connection with the prosecution or defense of claims against the State or any of its subdivisions, including, but not limited to, legal, accounting and consulting costs. Reasonable expenses of a successful administrative price appeal under 808 CMR 1.06(6) will not be considered non-reimbursable.*

Reimbursement may not be provided for costs associated with legal disputes involving the Commonwealth or its subdivisions (including cities and towns), with the exception that reasonable expenses associated with successful administrative appeals of pricing decisions may be reimbursable.

*(22) Unallowable Costs under OMB Circular A-122 and A-21 or Successor Provisions. Costs which are not allowable under OMB Circular A-122 and A-21, or successor provisions, are non-reimbursable to Programs which receive federal financial assistance.*

These federal circulars identify the allowable and non-allowable portion of costs for over fifty types of costs. Copies of OMB Circulars A-122 and A-21 may be obtained on the Internet at http://www.whitehouse.gov/wh/eop/omb. The UFR Auditor's Compliance Supplement also contains copies of these documents.

*(23) Luxury Items. All costs associated with luxury items, including, but not limited to luxury passenger automobiles as defined in sections 4001 or 4002 of the Internal Revenue Service Code, airplanes, boats, vacation homes, alcoholic beverages, charitable contributions and donations, and all non-program entertainment expenses.*

State contracts may not be charged for luxury items even when the items are used in support of state funded program. For example, where a luxury automobile that is owned by the Contractor is used to provide client transportation, no portion of the vehicle or associated operating expense may be charged to state contracts. Furthermore, where luxury items are used in support of state programs, the Contractor must document and identify in the UFR the source of funds used to defray the luxury expenses.

*(24) Salaries of Officers and Managers. Salaries of officers and managers to the extent they exceed the rate paid to state managers in job group M-XII, step seven.*

See the Division of Purchased Services' Policy Guidance relative to reimbursement for officers and managers salaries which is contained in the UFR Compliance Supplement. See also the discussion above relative to 808 CMR 1.05(1)(unreasonable costs) and 808 CMR 1.05(5)(certain salaries and consultant compensation).

*(25) Mortgage Principal. Mortgage principal on an amortized or other basis: no Department shall reimburse a Contractor for the principal portion of any note secured by a mortgage on property owned directly or indirectly by the Contractor.*

Under the provisions of St. 1993, c.495, s.99, and consistent with prior practice, mortgage principal may not be charged to state contracts.

*(26) Undocumented Expenses. Costs which are not adequately documented in light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.*

Contractors are required to maintain documentation of expense in accordance with contract requirements and GAAP provisions. When questions are raised about expense, the Contractor is obligated to provide documentation supporting the nature and amount of the expense. Where sufficient documentation is not produced or available, the Commonwealth funds used to defray the expense may be recouped by the State.

*(27) Administration and Support Costs. Costs which are otherwise non-reimbursable under the provisions of 808 CMR 1.05 may not be reimbursed through Administration and Support Costs.*

*(28) Payments by the State for Contracted Services in Support of or in Opposition to Unions or Employee Organizations Support Costs. Pursuant to M.G.L. c. 7, § 56, costs associated with any attorney, consultant or other person to advise, consult or provide any other service to such contracting person or entity relative to persuading employees thereof to support or oppose any organization of said employees or any other employee self-organization or concerted activity for mutual aid or protection..*

Where expenses are specifically excluded from reimbursement under 808 CMR 1.05, they can be charged to the state as part of agency administration. For example, if the Contractor owns and operates a luxury vehicle, any costs related to its use may not be charged to state contracts directly nor could the expense be lumped into agency administration and charged to a state contract through the allocation process.

**SUMMARY: Checks for Avoiding Non-reimbursability Issues**

1. Build the budget from the service description (in the RFR and/or contract program description or in the Department of Education program approval documents).
2. Review the expenses to confirm they are specified in the contract or price approval.
3. Review any correspondence or price approval documents specific to your agency which describe or otherwise limit reimbursable and non-reimbursable costs.
4. Confirm that the costs are reasonable, using the definitions for reasonable and allocable as contained in Federal OMB Circular A-122 and, where appropriate, market prices, and actual costs. Keep in mind the notion of "moderate".
5. Confirm that the costs are not non-reimbursable costs under 808 CMR 1.05.
6. When in doubt about the reimbursability of particular costs, discuss the matter with your Department and, where appropriate, the Division of Purchased Services or the Department of Education.

A035-97
10/02/97

DPS-A034-97
August 1993
Update Note: July 1997

# DIVISION OF PURCHASED SERVICES

## SUMMARY SHEET:

## RELATED PARTIES

*NOTE: This document was originally prepared in August 1993 and its contents remain current as of July 1997, except the reference to citations in 808 CMR 1.00 have been updated to reflect the February 1997 version of the regulation.*

### WHEN DID ORGANIZATIONS BEGIN PROMULGATING RELATED PARTY CRITERIA?

FEDERAL AGENCIES : Securities and Exchange Commission >>1934
IRS >>1954

STATE AGENCIES : Attorney General >>1980
Rate Setting Commission >>1980
Division of Purchased Services >>1991

PROFESSIONAL ASSOCIATIONS : AICPA >>FASB 57, March 1982

### WHAT ARE CURRENT SOURCES OF INFORMATION FOR PROVIDERS OF SOCIAL SERVICE PROGRAMS TO COMMONWEALTH PURCHASING AGENCIES?

- Directions to the Uniform Financial Statements and Independent Auditor's Report for Fiscal Year 1997
- Regulation 808 CMR 1.00, sections 1.02, 1.04(4), 1.04(11)(c) and 1.05
- Guidance Package from DPS on Related Party Relationships and Disclosure under 808 CMR 1.02 and 1.04(4)

### WHY IS THE DISCLOSURE OF RELATED PARTY TRANSACTIONS NEEDED?

An organization's financial report users (regardless of whether that organization is for-profit or not-for-profit) need to know if all of the organization's relationships and transactions were carried out on an arm's length basis, as an arm's length basis is a prerequisite for competitive and free market dealings. Investors, lenders, and contributors assume that business is conducted on an arm's length basis and they assess the organization's activities with this assumption in mind. Where business is not conducted at arm's length, for the information contained in an organization's financial reports to be meaningful, the reports must disclose the nature and extent of any ownership and management influence and control on the organization's activities. Public taxing and regulatory bodies who are concerned with the payment of taxes and the reimbursement of costs with public funds need to know if all of the organization's relationships and transactions were carried out on an arm's length basis, as a requisite for determining the extent of tax liability and appropriateness of reimbursement demands. Taxing authorities need to determine that all appropriate taxes have been paid by the organization and its related entities. Regulatory bodies need to determine that only appropriate reimbursements have been made to the organization and its related entities.

**WHAT IS A GENERAL DEFINITION OF A RELATED PARTY?**

A related party has the ability to significantly influence ("control"), directly or indirectly, through ownership, contracts or other methods, the policies or actions of another organization or the management of another organization. In the case of Commonwealth human and social service contractors, it may be that another organization is able to influence the organization with whom the Commonwealth is doing business or it may be that the Commonwealth contractor is able to influence an organization with whom it is doing business and with whom the Commonwealth is not directly doing business.

## HOW DO THE AUTHORITIES ESTABLISH IF INFLUENCE EXISTS?

Each of the pronouncements issued by the authorities listed previously provides guidance for determining what conditions could result in the ability to influence the policies and actions of others. For instance, the IRS indicates that transactions are considered related when they are associated with the following relationships:

Husband, Wife and Relationships

Grantor and Fiduciary

Grantor and Beneficiary

Fiduciary and Beneficiary, Legatee, or Heir

Decedent and Decedent's Estate

Partner, or

Member of an Affiliated Group of Corporations (A test for consolidation within 5 years, certain ownership, voting stock, and board membership is applied to for-profit corporations, trusts and charitable corporations to determine affiliations)

**WHAT ASPECTS OF OTHER ORGANIZATION'S PRONOUNCEMENTS HAVE BEEN ADOPTED BY THE DIVISION OF PURCHASED SERVICES ?**

DPS's provisions incorporate all of the provisions of the AICPA and the additional prior written disclosure requirements of 808 CMR 1.04(4).

**WHAT ARE THE UFR DISCLOSURE REQUIREMENTS?**

Human and social service organizations that contract with the Commonwealth and file the Uniform Financial Statements and Independent Auditor's Report (UFR) are audited in accordance with generally accepted government auditing standards (GAGAS) and are subject to various Commonwealth and Federal regulatory and contract provisions. In audits conducted pursuant to government auditing standards as in the Commonwealth social service contracting system, the materiality level and threshold for related party disclosure is lower than in similar-type audits in the private sector because of the necessity for public accountability of the entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

The following DPS related party disclosure guidance should assist in determining if disclosure is warranted in the notes to the financial statements of the UFR:

*Programs and Supporting Services Purchased by the Commonwealth :*

Generally, all related party relationships or transactions as defined in 808 CMR 1.02 that are associated with

programs purchased by the Commonwealth (state agencies and local education authorities) are considered material and must be disclosed in the UFR notes to the financial statements. Two exceptions to this consideration, to the extent allowed by the qualitative materiality factors of GAGAS, include the following:

1) Individual or aggregated monetary related party transactions of less than one hundred dollars ($100) where the amount was defrayed by funds not derived from the Commonwealth.

2) Gifts furnished to the provider by an official, administrator or manager of the provider.

The sensitive nature of Commonwealth-purchased programs and the penalties and sanctions associated with failure to disclose related party transactions and relationships, including disallowance of related party costs and fines which could materially affect the financial statement amounts, dictate that related party relationships or transactions be considered material in accordance with GAGAS.

*Programs and Supporting Services not Purchased by the Commonwealth:*

All material related party transactions that are not associated with programs purchased by the Commonwealth or that could affect the provider's financial statements and all instances of common ownership or management control relationships for which 808 CMR 1.02 and the AICPA Statement of Financial Accounting Standards No. 57 (SFAS No. 57) require disclosure, even though there are no transactions, should be disclosed in the UFR notes to the financial statements. One exception to this consideration may, to the extent allowed by the qualitative materiality factors of GAGAS, include: Gifts furnished to the provider by an official, administrator or manager of the provider.

The materiality of related party transactions should be determined in accordance with the criteria established for materiality and significance in the field work standards of GAGAS.

The notes to the financial statements of the UFR should disclose material (GAGAS definition of material) related party relationships and transactions. The form of the disclosure of material related party transactions should meet the following requirements that have been derived from SFAS No. 57:

a. Nature of related party relationship;

b. The receivables or payables associated with related party transactions for each period that the balance sheet or program budget is presented, and if not clearly determinable, the conditions and methods of settlement;

c. For each period that an income statement or program budget is presented, the following is required:

   (1) A description of transactions and other necessary information needed for an understanding of the impact of the transactions; and

   (2) The dollar amounts assigned to transactions, and the impact of determining the terms of the transactions, if different from prior periods;

d. If two or more companies are under common control via ownership or management, the disclosure in a. above is required, even though no transactions occurred, if the existence of that control could result in operating results or a financial position significantly different from that which would have been obtained if the enterprises were autonomous.

**NOTE:** Preparers of the UFR should seek assistance from their independent auditor regarding appropriate interpretation of the requirements of 808 CMR 1.02 and the form and content of disclosure as noted above.

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# AUDIT RESOLUTION POLICY
# FOR
# HUMAN AND SOCIAL SERVICES

**Issued by:** **Operational Services Division**
**Audit Bureau**
**Updated:** **7/01/2009**

This revised Audit Resolution Policy supersedes the Audit Resolution Policy issued by Division of Purchased Services (DPS) on 1/1/98 and provides policy and procedures for use by Departments and Contractors to address the findings and recommendations in independent auditor's reports issued in accordance with Generally Accepted Government Auditing Standards (GAGAS) where follow-up is necessary. This revised policy is issued to address changes resulting from the issuance of AICPA Statement on Auditing Standards (SAS) No. 112 *"Communicating Internal Control Related Matters Identified in an Audit"* effective for audits of financial statements for periods ending on or after December 15, 2006.

This policy is issued pursuant to 808 CMR 1.04(10), which requires the Operational Services Division (formerly DPS) to maintain an audit resolution policy for audits of Contractors delivering human and social services and Contractors operating M.G.L. c.71B programs. For both Contractors and Departments, these audits serve as an important feedback mechanism on the management and financial operation of government funded programs. Audit resolution, thus, becomes a vital management tool to strengthen not only individual programs and agencies, but the entire Purchase-of-Service (POS) system. Departments are expected to assign a high priority to the resolution of audit recommendations and to corrective action related to findings contained in GAGAS independent auditor's reports. OMB Circular A-133 audits must be resolved in accordance with the additional provisions of OMB Circular A-133 as amended.

## AUDIT RESOLUTION SYSTEM

The system that Departments establish for audit resolution and corrective action must meet the standards listed below:

<u>Department Audit Resolution System</u>

1. *Manager*: A senior level official of the purchasing Department must be appointed to manage the system established for audit resolution and corrective actions.
2. *Management Decisions*: Department management decisions must entail an evaluation of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.
3. *Lead Agency*: Resolution and corrective action on recommendations involving more than one purchasing Department must be resolved and coordinated by the principal purchasing agency (PPA) as designated by the applicable Secretariat.
4. *Communication:* Purchasing Departments or principal purchasing agencies, as applicable, must provide a copy of the administrative agreement containing the corrective action plan and management decisions to OSD and the appropriate Secretariat.
5. *Referrals:* The Department is responsible for referring audit findings not subject to Department oversight responsibility to appropriate oversight entities.

Corrective Action Plan (CAP) Requirements

1. *Written Plan*: At the completion of the Uniform Financial Statements and Independent Auditor's Report (UFR) and/or the OMB Circular A-133 audit, the Contractor shall prepare a written corrective action plan to be submitted together with the audit. Written corrective action plans must be prepared and submitted by the Contractor after it receives a final audit report issued by the Office of the State Auditor (OSA) or by a Department contracted auditor.
2. *Content:* The corrective action plans must address all audit findings included in each of the independent auditor's reports issued by the Office of the State Auditor or issued in accordance with OMB Circular A-133. For non A-133 UFRs and Department contracted audits, OSD recommends that the corrective action plan address all audit findings as well; however, it is mandatory only for material non-compliance findings and reportable condition internal control findings (which includes material weaknesses). Immaterial non-compliance findings and non-reportable internal control findings are normally disclosed in a management letter but may also or instead be reported in GAGAS independent auditor's reports. When such findings are included in the auditor's report, they must be included in the CAP for A-133 or SAO audits and are encouraged to be included for non-A-133 audits. (See the charts below for guidance.)

## Financial Statement Audits for Periods Ending Prior to 12/15/2006 use:

| Types of Audits | Audit Findings Which Require Resolution | | |
|---|---|---|---|
| | **Compliance Report** | **Internal Control Report** | **Management Letter** |
| | *M = Material Non-compliance*<br>*IM = Immaterial Non-compliance* | *R = Reportable Condition*<br>*MW = Material Weakness*<br>*NR = Non-reportable Condition* | *IM = Immaterial Non-compliance*<br>*NR = Non-reportable conditions* |
| **A-133** | All | All | None |
| **SAO** | All | All | None |
| **UFR and other non A-133** | M<br>(IM - recommended) | R and MW<br>(NR - recommended) | None |

**Financial Statement Audits for Periods Ending On *or* After 12/15/2006 use:**

| Types of Audits | Audit Findings Which Require Resolution | | |
|---|---|---|---|
| | **Compliance Report** | **Internal Control Report** | **Management Letter** |
| | *M = Material Non-compliance*<br>*IM = Immaterial Non-compliance* | *SD = Significant Deficiency*<br>*MW = Material Weakness*<br>*NM = Not Material* | *IM = Immaterial Non-compliance* |
| **A-133** | All | All | None |
| **SAO** | All | All | None |
| **UFR and other non A-133** | M<br>(IM - recommended) | SD and MW | None |

3. *Format*: Corrective action plans shall identify the findings, deficiencies, uncorrected prior audit findings and reference numbers utilized by the independent auditor to identify the findings. Corrective actions to be taken, along with specified action dates, must be identified in the corrective action plan and approved by the Contractor's board of directors.

<u>Department Management Decisions</u>

1. *Requirements:* Department management decisions and corrective actions must be consistent with law, regulations, contract terms and conditions and policies established by the Department, Secretariat, OSD, the federal government and other oversight entities as applicable. Written justification supported by sufficient, competent and relevant evidence must account for the legal basis for any decisions not agreeing with the independent auditor's findings and recommendations. Evidence that was not available for review by the independent auditor during the field work stage of the audit and which the auditor indicated may be relevant to the audit findings, may be reviewed and utilized for making management decisions. However, evidence that was available but not furnished to the auditor as requested by the auditor during the field work stage of the audit may not be reviewed or considered in making management decisions.
2. *Legal Review:* Management decisions not to collect funds in whole or in part related to non-reimbursable cost overpayments (Questioned Costs) and cost reimbursement contract overpayments must be reviewed by the legal counsel of the purchasing Department, the applicable Secretariat and OSD's audit and legal staff for appropriateness. Decisions not to collect these funds and to write them off as Commonwealth bad debts must be authorized by OSD, the applicable Secretariat, Office of the Comptroller, applicable federal cognizant and oversight agencies as appropriate.

3. *Corrective Action Plan:* The corrective action plan and purchasing Department management decisions must incorporate an agreement signed by the authorized signatory of the Contractor and the purchasing Department or the principal purchasing agency's representative, as applicable.
4. *Oversight Response:* Federal cognizant and oversight agencies, OSD and the appropriate Secretariat may review written corrective action plans and management decisions and issue additional management decisions that include further actions necessary to correct deficiencies and resolve audit findings.

Timelines

1. *Initiation of audit resolution:* The Department must require prompt resolution and corrective action on audit recommendations. The Department must issue a management decision on audit findings within six months after receipt of the Contractor's audit report and corrective action plan, and ensure that the Contractor takes appropriate and timely corrective action. Corrective action should proceed as rapidly as possible.
2. *Department process:* The purchasing Department must provide a means to ensure timely responses to the independent auditor's reports if Contractor responses have not been incorporated into the independent auditor's reports. The process must provide sufficient time to permit resolution to take place within the six-month period.
3. *Corrective Action:* Corrective actions should be accomplished within a reasonable period of time and generally prior to the termination of the contract and federal award related to the finding. Departments must take all actions necessary to ensure that corrective actions are accomplished, whenever possible, prior to the termination of all contracts and agreements or federal awards with the Contractor.

Purchasing Departments are expected to place a high priority on audit resolution and to complete the process quickly. Contractors are expected to cooperate with audit resolution efforts to initiate corrective actions. Independent auditors are responsible for follow-up on audit findings and corrective actions. Disagreements between Departments, Contractors and independent auditors are to be resolved by OSD. Questions concerning any aspect of the OSD Audit Resolution policy may be directed to the Director of Audit at 617-720-3373.

## AUDIT RESOLUTION STANDARDS

A. Non-Performance

Non-performance under contracts means services were not delivered or the services that were delivered did not meet standards established by the purchasing Department in the contract. In the event of non-performance, recovery of funds is appropriate. Depending on the circumstances and severity of the problem, Departments may also need to consider reduction or termination of contracts, debarment or other legal remedies. Once a determination of non-performance is made, the focus should be on the manner of resolution which is most appropriate under the circumstances and, if not already determined, the value of services which were not rendered.

B. Fraudulent Billing

All reimbursements to a Contractor which have been determined to be supported by fraudulent documentation will be disallowed. Funds fraudulently acquired must be promptly recovered in full and returned to the Commonwealth. All such cases will be referred to the offices of the State Auditor, the Attorney General, and the Inspector General and, if federal funds are involved, to the appropriate federal Inspector General and U.S. Attorney.

C. Undocumented Reimbursement

Under all contracts (regardless of the reimbursement mechanism), Contractors must maintain appropriate documentation of actual reimbursable operating costs, revenues, service provision and performance attained in accordance with the requirements established by federal and state regulations and laws, terms of the contract, Center for Health Information and Analysis regulations (if applicable), and the policies of the purchasing Department. When there is a determination that there was a failure to maintain adequate and appropriate documentation, depending upon the circumstances, resolution may occur through recovery of funds or a rate adjustment. For instance, undocumented costs are considered non-reimbursable costs pursuant to 808 CMR 1.05 (26), Undocumented Expenses, and they are normally subject to recoupment unless alternative evidence is produced to substantiate that the costs were actually incurred. In the case of non cost reimbursement contracts, other evidence, in the form of credible and convincing alternative documentation, that the services in question were actually provided and the type and amount of costs were actually incurred during the contract period will be considered. In such cases, however, in order to prevent re-occurrence of recordkeeping deficiencies in subsequent years, a satisfactory, written resolution of all such audit determinations must have been reached.

D. Non-Reimbursable Expenses

Under all contracts, reimbursement to Contractors is permitted only for actual reimbursable operating costs incurred (as defined in 808 CMR 1.02) for the contract, based on terms of the contract, Center for Health Information and Analysis requirements, and/or purchasing Department requirements. Non-reimbursable costs (as defined in 808 CMR 1.05) that are defrayed using Commonwealth funds and offsetting revenue (intended for use in defraying reimbursable costs), as designated in the contract or as required by 808 CMR 1.00 or OMB Circular A-110 (program income as applicable), are subject to recovery through recoupment, delivery of in-kind services or rate adjustment, in accordance with 808 CMR 1.05. In-kind services furnished by the Contractor in lieu of recoupment or rate adjustment must result in the Contractor incurring additional program costs equal to the value of the non-reimbursable costs. In addition, in-kind service costs must be defrayed with funds other than Commonwealth funds and offsetting revenue, as designated in the contract or as required by 808 CMR 1.00 or OMB Circular A-110 (program income as applicable). In-kind services may only be delivered to eligible clients of the Department.

E. Billing Errors

Errors in invoices submitted to the Commonwealth for reimbursement, which do not constitute fraud, will be referred to the purchasing Department to be rectified in the most appropriate manner possible under the circumstances.

F. Under-utilization of Staffing Resources

This provision is intended to be utilized when there are indications that staffing may not have been provided as agreed upon in the original contract or amendment documents as needed to carry out the program of services. For purposes of this section, emphasis should be placed upon the review of staff credentials and full-time equivalents (FTEs) provided. Review of the cost of staffing shall take into consideration payroll, the cost of relief staff and consultants, compensated overtime performed by existing staff, related taxes, related benefits, and the like. For purposes of resolving audit findings concerning reimbursement, a determination that any program or cost category for staff related spending was below 90 percent of the funds budgeted or allocated for staffing in the relevant contract, shall be referred to the purchasing Department for review of actual service delivery and quality levels. Purchasing Departments are responsible for resolving the deficiency by determining if service delivery requirements, performance standards and/or minimum staffing or program standards have been met or need to be revised.

G. Over-billing in Cost Reimbursement Contracts

The provisions of MGL c.29, s. 22 and other state finance laws limit payments from the Commonwealth in the year funds were appropriated to the amount necessary to meet expenses incurred in that year. Accordingly, all cost reimbursement contract payments from the Commonwealth that exceed expenses incurred by the Contractor in the year appropriated must be recovered. Current state finance law limits methods of recovering surplus funds in cost reimbursement contracts to the establishment of a reasonable schedule of Contractor repayments to the Commonwealth. In addition, when expenses are undocumented in cost reimbursement contracts, other evidence (in the form of alternate documentation) cannot be considered and recovery of funds is appropriate as a basis of resolution.

*07revisedauditresolution*

# COMMONWEALTH OF MASSACHUSETTS

Issued 1/24/2001

## *STANDARD CONTRACT FORM AND INSTRUCTIONS*

This form is jointly issued and published by the Executive Office for Administration and Finance (ANF), the Office of the Comptroller (CTR) and the Operational Services Division (OSD) for use by all Commonwealth Departments. **Any changes to the official printed language of this form shall be void. This shall not prohibit the addition of non-conflicting Contract terms.** By executing this Contract, the Contractor under the pains and penalties of perjury, makes all certifications required by law and certifies that it shall comply with the following requirements: that the Contractor is qualified and shall at all times remain qualified to perform this Contract; that performance shall be timely and meet or exceed industry standards, including obtaining requisite licenses, permits and resources for performance; that the Contractor and its subcontractors are not currently debarred; that the Contractor is responsible for reviewing the Standard Contract Form Instructions available at www.comm-pass.com/comm-pass/forms.asp; that the terms of this Contract shall survive its termination for the purpose of resolving any claim, dispute or other Contract action, or for effectuating any negotiated representations and warranties; and that the Contractor agrees that all terms governing performance of this Contract and doing business in Massachusetts are attached to this Contract or incorporated by reference herein, including the following requirements: all relevant Massachusetts state and federal laws, regulations, Executive Orders, treaties, requirements for access to Contractor records, the terms of the applicable Commonwealth Terms and Conditions , the terms of this Standard Contract Form and Instructions including the Contractor Certifications and Legal References, the Request for Response (RFR) or solicitation (if applicable), the Contractor's response to the RFR or solicitation (if applicable), and any additional negotiated provisions.

**[THE CONTRACTOR MUST COMPLETE ONLY THOSE SECTIONS PRECEDED BY AN "→".]**

| | |
|---|---|
| **→VENDOR CODE:** | ***mmars document id:*** __ __ __ __ __ __ __ __ __ __ __ __ __ __ __<br>**CONTRACT ID:** |
| **→CONTRACTOR NAME:** | **DEPARTMENT NAME:** |
| **→CONTRACT MANAGER:** | **CONTRACT MANAGER:** |
| **→PHONE:**<br>**→FAX:**<br>**→E-MAIL ADDRESS:** | **PHONE:**<br>**FAX:**<br>**E-MAIL ADDRESS:** |
| **→BUSINESS MAILING ADDRESS:** | **BUSINESS MAILING ADDRESS:** |

**THE FOLLOWING COMMONWEALTH TERMS AND CONDITIONS FOR THIS CONTRACT HAS BEEN EXECUTED AND FILED WITH CTR:** (*Check only one*)
___ COMMONWEALTH TERMS AND CONDITIONS _X_ COMMONWEALTH TERMS AND CONDITIONS FOR HUMAN AND SOCIAL SERVICES

| | |
|---|---|
| **COMPENSATION:** (*Check one option only*)<br>__X__ Maximum Obligation of this Contract: $_____<br>____ No Maximum Obligation has been set for this Contract: (Check one)<br>___ Rate Contract with a Rate of: $_____ Per:_____<br>___ Rate Contract with Multiple/Negotiated Rates: (Attach listing of multiple rates or description of negotiation process) | **PAYMENT TYPE:** *(Check one option only)*<br>__X_Payment Voucher (PV)<br>____Ready Payment (RP) (Schedule:_____Initial Base Amt:$_____)<br>____Contractor Payroll (CP) (Required for Contract Employees)<br>____Recurring Payment (Required for Leases and TELPs) |

**→PAYMENT METHOD:** The Contractor agrees to be paid by Electronic Funds Transfer (EFT is the Commonwealth's Preferred Payment Method): _ Yes _ No

**BRIEF DESCRIPTION OF CONTRACT PERFORMANCE:** *(Reference to attachments without a narrative description of performance is insufficient.)*

**Program Code:**

**PROCUREMENT OR EXCEPTION TYPE:** (*Check one option only*)
___ Single Department Procurement/Single Department User Contract; ____ Single Department Procurement/Multiple Department User Contract;
___ Multiple Department Procurement/Limited Department User Contract; ___ Statewide Contract (Only for use by OSD or an OSD-designated Department);
___ Grant (as defined by 815 CMR 2.00); __ Emergency Contract (attach justification); __ Interim Contract (attach justification); __ Contract Employee;
___ Collective Purchase (attach OSD approval) _X_ Legislative/Legal Exemption Salary Reserve 1599-6900___ (attach proof); ___ Other (Specify):
**RFR REFERENCE NUMBER:** (or "N/A" if not applicable)

**ANTICIPATED CONTRACT EFFECTIVE START DATE:** Performance shall begin on ___12/1/01_____, which shall be no earlier than the latest date this Contract is signed by authorized signatories of the Department and Contractor and approved under Section 1 of the applicable Commonwealth Terms and Conditions.

**TERMINATION DATE OF THIS CONTRACT:** This Contract shall terminate on _____6/30/02_____ unless terminated or amended by mutual written agreement by the parties prior to this date under Section 4 of the applicable Commonwealth Terms and Conditions.

| | |
|---|---|
| **→AUTHORIZING SIGNATURE FOR THE CONTRACTOR:**<br>**→X:**_____<br>**(Signature of Contractor's Authorized Signatory)**<br>**→DATE:**_____<br>**(Date must be handwritten at time of signature)**<br>**→NAME:** _____<br>**→TITLE:**_____ | **AUTHORIZING SIGNATURE FOR THE DEPARTMENT:**<br>**X:** _____<br>**(Signature of Department's Authorized Signatory)**<br>**DATE:** _____<br>**(Date must be handwritten at time of signature)**<br>**NAME:** _____<br>**TITLE:** _____ |

# OSD Update Capital Items Procurement Policy

**99-17**

The Operational Services Division
One Ashburton Place, Room 1017
Boston, MA 02108

| | |
|---|---|
| TO: | Chief Financial Officers, Department Heads, MMARS Liaisons and Procurement Management Team Members |
| FROM: | Philmore Anderson III, State Purchasing Agent |
| DATE: | October 6, 1998 |
| **RE:** | ***+ For POS Only:*** **NEW Purchase of Service (POS) Capital Items Procurement Policy (Also included in Handbook Update #1 of the *Procurement Policies and Procedures Handbook)*** |

**Summary**
This OSD Update presents the "Purchase-of-Service (POS) Capital Items Procurement Policy", which is effective September 1, 1998. The policy was developed to provide flexibility in assuring POS (i.e., human and social service) contractors can acquire needed capital items of furnishings and equipment, particularly for start-up programs.. The text of the new policy, related regulatory changes and contract forms are contained in this OSD Update. Questions regarding the Purchase of Service (POS) Capital Items Procurement Policy may be directed to the Operational Services Division, Bureau of Audit at (617) 727-7500.

**Changes to Handbook**
The *Procurement Policies and Procedures Handbook* has also been revised to reflect implementation of this new policy. As a result, the following Handbook pages have been replaced: 70, 87, 92, 119, 144 -155, and 168. The following Handbook pages have been added: 170A, 234-235. See Handbook Update #1, available at http://www.magnet.state.ma.us/osd/phand/index.htm for a complete package

## Purchase of Service (POS) Capital Items Procurement Policy

### Effective: September 1, 1998

This policy was developed to provide flexibility in assuring POS contractors can acquire needed capital items of furnishings and equipment, particularly for start-up programs. The policy recognizes that the Commonwealth typically should not own capital items and then lend them to human and social service contractors, but rather, when necessary, these contractors should receive funding from the Commonwealth to procure necessary capital items of furnishings and equipment to serve the Commonwealth's clients.

The policy has been adopted in conjunction with modifications to regulation 808 CMR 1.00: *Compliance, Reporting and Auditing for Human and Social Services,* which has been issued on an emergency basis, effective September 1, 1998. In addition, certain contract forms have been modified to accommodate the new policy. Copies of the relevant regulatory and contract provisions are attached to this document.

This policy consists of three options. A Commonwealth department may choose to use any one or all of the options, as it deems appropriate.

**Option 1 - Reimbursement**: The department may reimburse the contractor for incurred depreciation and interest expense related to capital items owned by the contractor and used in the delivery of services to Commonwealth clients. Departments should ascertain the contractor's capitalization level when the contract is negotiated (see revised Attachment 3: Fiscal Year Program Budget). The contractor holds title to the capital items procured under Option 1.

**Option 2 - Commonwealth Purchase**: The department may purchase, in accordance with 801 CMR 21.00, and retain title of furnishings and equipment using the M-11 object code. The furnishings and equipment are then made available to the contractor as free-use items in the delivery of services to Commonwealth clients. Option 2 must be carried out consistent with the provisions of the Office of the State Comptroller MMARS Memo #281 (available on the Internet at http://www.magnet.state.ma.us/osc/memos/281.htm.). The following requirements apply:

- Contractors must maintain and inventory Commonwealth-owned, free-use equipment and furnishings in accordance with 808 CMR 1.04(5). Said inventory shall contain the number and description of assets, source of funding, acquisition cost and location of each item.
- Depreciation expense associated with capital items of furnishings and equipment provided under Option 2 is to be carried on the Uniform Financial Statements and Independent Auditor's Report (UFR) statements and schedules and in contract budgets as a nonreimbursable expense. Departments should also exclude such expenses when establishing a non-negotiated rate.
- Upon termination of the contractor's contracts with the department, any capital items of furnishings and equipment owned by the Commonwealth must be returned to the Commonwealth or transferred to another contractor, as directed by the department.

- Federal grant funds may be used by departments for Commonwealth purchases of capital items of furnishings and equipment only if the benefit received by the contractor from the use of the capital items (monetary value) is disclosed in the budget and the UFR as free-use items.

**Option 3 - Contractor Purchase**: The department may provide the contractor with funds for the procurement of capital items of furnishings and equipment that have been identified in a capital budget page of a multiyear or renewable contract with a term of three or more years remaining. Under Option 3, furnishings and equipment are procured by the contractor in accordance with 808 CMR 1.03(8) and are owned by the contractor (with certain restrictions). In addition, Option 3 must be carried out consistent with the provisions of the Office of the State Comptroller MMARS Memo #281. The following conditions apply to Option 3:

- Capital items of furnishings and equipment that are contained and certified as capital items in the contractor's capital budget page must meet the new definition of a capital item in 808 CMR 1.05(4)(a). In addition, the contractor must inventory capital items in accordance with 808 CMR 1.04(5) and said inventory shall contain the number and description of assets, source of funding, acquisition cost and location of each item.

- Upon termination of the contractor's contracts with the department, any capital item procured under Option 3 that is not fully depreciated is subject to the following disposition options, as directed by the department: the item and its title may be returned to the department, or transferred to another contractor, or the item may be retained or sold by the contractor after paying the Commonwealth for the remaining value of the item not fully depreciated or the proceeds of the sale. The Department should provide written authorization to the contractor of which option is to be used, based on financial and programmatic considerations that give best value to the Commonwealth.

- Depreciation expense associated with capital items of furnishings and equipment provided under Option 3 is to be carried on the UFR statements and schedules and in contract budgets as a non-reimbursable expense. Departments should also exclude such expenses when establishing a non-negotiated rate.

- Capital Purchase with Federal Funds: Pursuant to the provisions of newly revised OMB Circular A-122, a capital budget and federal grant funds may <u>not</u> be used to furnish federally defined capital items to be owned by the contractor for use in programs unless the department receives prior written approval from the federal awarding agency(ies). Federally defined capital items to be owned by the contractor not receiving prior written approval from the federal awarding agency(ies) may only be furnished and reimbursed through depreciation or a federally approved use allowance. The federal government defines capital items of equipment as an article of nonexpendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals or exceeds the lesser of (a) the capitalization level established by the organization (contractor) for the financial statement purposes, or (b) $5000.

- Capital items of furnishings and equipment purchased with Commonwealth funds rather than federal funds, that are to be owned by the contractor and used in programs receiving federal grant funds may only be acquired using a capital budget if the revenue and expense associated with the capital items are budgeted and disclosed in the UFR as a separate revenue and cost category of the program. In addition, capital expenditures must be separately billed for by the contractor and the department must utilize a separate MMARS accounting line.

- In certain circumstances, a department may wish to permit procurement of capital items by the contractor for contracts or procurements with less than three years remaining. This may occur only with the prior written approval of the department head or chief financial officer.

# Purchase of Service (POS) Capital Items Procurement Policy Relevant Provisions of 808 CMR 1.00

**808 CMR 1.03(8) (New Provision)**
**Procurement of Contractor Furnishings, Equipment and Other Goods.** All procurements of furnishings, equipment and other goods by or on behalf of a Contractor shall be conducted in a manner to provide, to the maximum extent practical, open and free competition. Capital items, as defined in 808 CMR 1.05(4)(a), shall be acquired through solicitation of bids and proposals consistent with generally accepted accounting principles.

**808 CMR 1.04(5) (Revised)**

**Inventory of Equipment and Furnishings and Other Goods.** Any Contractor in possession of capital items, as defined in 808 CMR 1.05(4)(a) shall label, maintain and keep on file a written inventory of the property in accordance with generally accepted accounting principles. The Department may specify additional inventory requirements for capital items acquired with funds from the Commonwealth. Upon termination of the Contractor's contracts with the Department, capital items acquired with Commonwealth funds under a capital budget shall be subject to the following disposition standards:

(a) if the Department holds title, the item shall be returned to the Department or transferred to another Contractor, as directed by the Department;
(b) if the Contractor holds title and the item has been fully depreciated it shall be retained by the Contractor, or;
(c) if the Contractor holds title and the item has not been fully depreciated, the item and its title shall be returned to the Department, or transferred to another Contractor, or the item may be retained or sold by the Contractor after paying the Commonwealth for the remaining value of the item not fully depreciated or the proceeds of the sale, as determined by the Department.

**808 CMR 1.05(2)(d) (Revised)**
**Certain Depreciation**.

(d) Depreciation on assets acquired under a capital budget approved by a Department and held in trust for the Commonwealth of Massachusetts or depreciation on assets acquired under a capital budget approved by a Department to which the Contractor holds title under the terms of the contract.

**808 CMR 1.05(4)(a) (Revised)**
**Current Expensing of Capital Items**. All costs attributable to the current expensing of a capital item.

**808 CMR 1.02 Capital Item (Revised)**
A capital item is:

(a) an asset or group of assets of nonexpendable personal property having a useful life of more than one year; or
(b) a repair, betterment or improvement or a group of repairs, betterments or improvements of non-movable assets which adds to the permanent value of an asset or prolongs its useful life for more than one year and which costs the lesser of: (a) the capitalization level established and certified by the Contractor in accordance with generally accepted accounting principles for financial statement purposes, or (b) the dollar amount authorized by the Federal Office of Management and Budget Circular A-122 or A-21.

**FY:** **Contractor Name:** **Amendment #,if Applicable:** **If Federal Funds, CFDA #:**

**PURCHASE OF SERVICE - ATTACHMENT 3: FISCAL YEAR PROGRAM BUDGET**

| Program Name: | Document ID#: | MMARS Activity Code: | Program Type: | UFR Prog. #: |
|---|---|---|---|---|
| | | | | |

| | | | Current | | Amend. Change | | New | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | FTE | Amount | FTE | Amount | FTE | Amount | COST REIMBURSEMENT ONLY | | |
| | | Program Component | | | | | | | Offset | Source | Reimbursable Cost |
| | UFR Title # | Direct Care/Program Support Staff/Overtime/ Shift Differential & Relief (Titles 101-141) | | | | | | | | | |
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| | | SUBTOTAL STAFF | | | | | | | | | |
| | 150 | Payroll Taxes | | | | | | | | | |
| | 151 | Fringe Benefits | | | | | | | | | |
| | T 100 | Total Direct Care/Program Staff | | | | | | | | | |
| | Title | Occupancy | | | | | | | | | |
| | 301 | Program Facilities | | | | | | | | | |
| * | 390 | Fac. Oper/Main/Furn | | | | | | | | | |
| | T 300 | Total Occupancy | | | | | | | | | |
| | UFR Title | Other Direct Care/Program Support | | | | | | | | | |
| | 201 | Direct Care Consultant | | | | | | | | | |
| | 202 | Temporary Help | | | | | | | | | |
| | 203 | Clients/Caregivers. Reimb/Stipends | | | | | | | | | |
| | 206 | Subcontract Dir.Care | | | | | | | | | |
| | 204 | Staff Training | | | | | | | | | |
| | 205 | Staff Mileage/Travel | | | | | | | | | |
| | 207 | Meals | | | | | | | | | |
| | 208 | Contracted Client Trans. | | | | | | | | | |
| * | 208 | Vehicle Expenses | | | | | | | | | |
| * | 208 | Vehicle Depreciation | | | | | | | | | |
| | 209 | Incid. Health/Med Care | | | | | | | | | |
| | 211 | Client Per. Allowances | | | | | | | | | |
| | 212 | Prov. of Material Good | | | | | | | | | |
| | 214 | Direct Client Wages | | | | | | | | | |
| | 214 | Other Commercial Prod. & Svs. | | | | | | | | | |
| * | 215 | Program Supplies/Mat | | | | | | | | | |
| | T 200 | Total Other Direct Care/Program | | | | | | | | | |
| | Title | Direct Admin Expenses | | | | | | | | | |
| | 216 | Program Support | | | | | | | | | |
| * | 510 (410 & 390) | Other Direct Administrative Expenses | | | | | | | | | |
| | T 500 | Total Direct Administrative Exp. | | | | | | | | | |
| | T | SUBTOTAL PROGRAM COSTS | | | | | | | | | |
| * | 410 | Agency Admin. Support Allocation | % $ | | | | | | | | |
| | | | | | | | | | | | |
| | T | PROGRAM TOTAL | | | | | | | | | |

**Commercial Fee, if applicable, for for-profit contractors only (for informational purposes only; not to be included in the price paid by the Commonwealth): %___$___: N/A for Cost Reimbursement**

**A. $ _____ Subtotal of offsets which are for non-reimbursable costs.**

**Non-reimbursable costs must be shown in detail on Attachment 5 when the program is subject to the provisions of Federal OMB Circular A-122 and/or 808 CMR 1.00.**

*** Contractor's Board approved capitalization level relative to any negotiated expense costs in lines 208, 215, 390 or 410 is $_____**

***Updated 6/19/07*** **Sensitivity level - low**

# POS ATTACHMENT 6: CAPITAL BUDGET INSTRUCTIONS

Attachment 6 is designed to document capital expenditures, purchased either by the department or the contractor, that are required to support the delivery of contracted human and social services. Furnishings and equipment (including computer hardware), meeting the definition of capital item in 808 CMR 1.05(4)(a), requested by the contractor and approved by the purchasing department, must be documented on Attachment 6. The following are not eligible to be procured through this capital budget: capital items defined under 808 CMR 1.05(4)(b), which includes capital items that are not moveable, an asset or group of assets that are below the contractor's capitalization level, or items not approved by the department. Items with a useful life less than one year or with a useful life of more than one year but costing less than the contractor's capitalization level for each item (or in aggregate) are not capital items and should be expensed. In this context, in aggregate means items of the same general type (e.g., office equipment such as chairs, tables and lamps) that are acquired together on a capital budget. In determining whether each item or items in aggregate exceed the contractor's capitalization level, the acquisition cost should include the cost of any modifications, attachments, accessories, or auxiliary apparatus necessary to make the item or items usable for the intended purpose.

The bidder or contractor should complete the chart for the capital items it is requesting and attest to its current capitalization level at the bottom of the form before submitting to the purchasing Department for consideration. **Upon approval of the capital items requested by the contractor, the purchasing department must determine whether it or the contractor shall procure the items, check the appropriate box on Attachment 6 and proceed accordingly:**

**a) For capital items to be purchased by the contractor:**

The Department will advise the contractor to proceed with the procurement of approved items in accordance with Operational Services Division's Purchase of Service (POS) Capital Items Procurement Policy and 808 CMR 1.00. The contractor shall acquire capital items through solicitation of bids and proposals, consistent with generally accepted accounting principles. Contractors eligible to participate in the POS State Purchase Program (see http://www.magnet.state.ma.us/osd/pos/dps.htm), may purchase items directly from statewide contracts without conducting a solicitation. The total amount on the capital budget page must match the capital budget amount (Line 14) on Attachment 4: Rate Calculation/Maximum Obligation Calculation Page (or on Attachment 1: Program Cover Page if no program budget is used). Title to all capital items purchased by the contractor through this capital budget shall vest with the contractor (with certain restrictions).

**b) For capital items to be purchased by the Department:**

The Department shall procure the approved capital items through the state accounting system according to 801 CMR 21.00 and make arrangements to have the items delivered to the contractor's site. For capital items needed for human and social service procurements, the department will record the encumbrance under object code M11. The capital budget amount will <u>not</u> be included in the contractor's maximum obligation. Title to all capital items purchased by the Commonwealth through this capital budget and the M-11 object code shall vest with the Commonwealth.

Free use of capital items, facilities and other assets must be clearly disclosed on the contractor's annual financial statements, regardless of whether the department or the contractor holds title. Free use expenditures must be reported as non-reimbursable costs in the program budget and on the Uniform Financial Report (UFR). **Capital items are subject to inventory and disposal procedures specified in Attachment 6 and 808 CMR 1.00.**

FY _____ Contractor Name:_____ * If Federal Funds, CFDA #:_____

# PURCHASE OF SERVICE ATTACHMENT 6: CAPITAL BUDGET:

## For Purchase Of Capital Assets With Commonwealth Funds

| Program Name: | Document ID#: | MMARS Program Code: | Program Type | UFR Prog. # |
|---|---|---|---|---|

| Item to Be Purchased | Need For Item | Quantity | Estimated Unit Cost | Estimated Total Cost |
|---|---|---|---|---|
| | | | | |

DEPARTMENT USE ONLY: Check the appropriate box: **Total Cost: $**_____

Capital items purchased by the Contractor: ☐

Capital items purchased by the Commonwealth (object code M11): ☐

Only capital items, as defined in 808 CMR 1.05(4)(a), may be procured through a capital budget with Commonwealth funds. The following are not eligible to be procured through this capital budget: capital items defined under 808 CMR 1.05(4)(b) which includes capital items that are not moveable, an asset or group of assets that are below the Contractor's capitalization level, or items not approved by the Department. Title to all capital items purchased by the Contractor through this capital budget shall vest with the Contractor (with certain restrictions). Title to all capital items purchased by the Commonwealth through this capital budget and the M11 object code shall vest with the Commonwealth.

***** Pursuant to the provisions of OMB Circular A-122 a capital budget that utilizes federal grant funds to acquire capital items for use in programs receiving any federal grant funds may not be used unless the Department receives prior written approval from the Federal awarding agency(ies). Capital items of furnishings and equipment purchased with Commonwealth funds that are to be owned by the Contractor and used in programs receiving federal grant funds may only be acquired using a capital budget if the revenue and expense associated with the capital items are budgeted and disclosed in the UFR as a separate revenue and cost category of the program.

Use of assets acquired with Commonwealth funds should be clearly disclosed in the financial statements. The asset(s) should be disclosed on the UFR Balance Sheet in the plant fund if the Contractor holds title or in the Custodian fund if the Commonwealth holds title. The revenue derived from the capital budget when the asset is purchased should be disclosed in program services on the UFR Statement of Activities and in the appropriate program(s) on the Supplemental Revenue Schedule A. Capital assets, whether owned by the Contractor or the Commonwealth, should be depreciated and disclosed in Supplemental Expense Schedule B and Schedule B-1 as a non-reimbursable cost when incurred, using the schedule of service lives issued by the Operational Services Division. See also 808 CMR 1.05(2)(d).

The assets furnished through a capital budget must be labeled and kept on file in the Contractor's written inventory, which notes the number and description of assets, source of funding, acquisition cost and location of the assets, pursuant to 808 CMR 1.04(5). In addition, the Contractor must follow disposition standards in 808 CMR 1.04(5).

**I,_____, an authorized signatory for _____ (the Contractor), hereby certify that the Contractor's capitalization level established for financial statement purposes by the board of directors is: an asset or group of assets of non-expendable personal property having a useful life of more than one year and an acquisition cost of $_____**

_____

**_(Signature)**

_____

**_(Title)**

_____

**(Date)**

OSD 8/98