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**INDEPENDENT STATE AUDITOR'S REPORT ON
CERTAIN ACTIVITIES OF THE
MASSACHUSETTS SCHOOL BUILDING
AUTHORITY
JULY 1, 2004 TO DECEMBER 31, 2007**

**OFFICIAL AUDIT
REPORT
AUGUST 7, 2008**

TABLE OF CONTENTS/EXECUTIVE SUMMARY

INTRODUCTION

1

The former School Building Assistance Program (SBA), within the Massachusetts Department of Education, was eliminated by Chapters 208 and 210 of the Acts of 2004, together with Section 35BB of Chapter 10 and Chapter 70B of the Massachusetts General Laws (collectively referred to as the “Act”), and was replaced in July 2004 by the Massachusetts School Building Authority (MSBA). The MSBA was established as an independent public authority to administer and fund a new program for grants to cities, towns, and regional school districts for school construction and renovation projects. At the time the MSBA was created, there had been 1156 projects approved by the DOE, of which 728 had received grant payments and 428 were on a waiting list to receive grant payments. In addition, final audits had not been conducted for 803 of the 1156 approved projects. The Act, in combination with new regulations promulgated by the MSBA, resulted in major changes in the administration and financing of grants to cities, towns and regional school districts for school construction and renovation projects.

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor (OSA) has conducted an audit of MSBA’s administration and oversight of the new School Building Assistance Program (SBA) for the period July 1, 2004 through December 31, 2007. The objectives of our audit were to (1) determine whether appropriate corrective action had been taken regarding issues identified in our prior audit report (No. 2004-0157-3S); (2) review MSBA’s internal controls over its financial operations, including the operations of the Massachusetts School Modernization and Reconstruction Trust; (3) determine whether the MSBA’s audit functions and oversight practices are comprehensive, therefore ensuring that municipalities adhere to regulations regarding bond refinancing, interest costs, and the maintenance of adequate documentation and project records in support of local school construction projects; and (4) review the MSBA’s most recent Independent Public Accountants’ report and management letter to determine whether the audit identified any issues needing further review.

Based on our review, we have concluded that the MSBA has taken appropriate corrective action regarding all of the issues noted in our prior audit and has implemented internal controls and audit oversight activities to ensure that adequate documentation and project records exist in support of construction costs incurred by local authorities under the new Massachusetts School Building Authority.

AUDIT RESULTS

7

PRIOR AUDIT RESULTS - RESOLVED

7

Our prior audit consisted of a review of certain activities of the DOE’s SBA, the results of which were directed to MSBA and are discussed as follows:

a. Improvements Made Regarding Community Compliance with Final Project Cost Regulations

Our prior audit revealed that the former SBA did not require communities receiving grant payments to comply with regulations regarding the timely filing of final project cost documentation. In addition, the former SBA had not suspended any payments for projects that were delinquent in submitting documentation. Our follow-up audit revealed that the MSBA has implemented a new progress payment system whereby grant payments are not made unless the community submits cost documentation and an audit is conducted to identify the eligible final project costs, as stipulated by regulation. In addition, the MSBA is in the process of either suspending or recouping grant payments to two communities that have not submitted cost documentation.

b. Changes Made to Ensure that Communities Adhere to MSBA Program Regulations Regarding Bond Refinancing and Interest Costs

8

Our prior audit revealed that communities were not in compliance with Chapter 70B, Section 19, of the Massachusetts General Laws (MGL), which required that they notify the former SBA within 30 days of refinancing any bond for which the community will receive state reimbursement. Without proper notification of refinancing that resulted in a lower interest rate, future grant payments would not be reduced to reflect the lower interest costs. Our follow-up audit revealed that Section 19 has been amended to require communities to notify the MSBA no later than 14 days before refinancing any bond for which the community will receive reimbursement for interest costs. In addition to new projects and projects which have not yet been funded, the MSBA has either paid in a lump sum or modified its grant payment system in accordance with a progress payment system, which results in the elimination of the need for communities to borrow funds in anticipation of the receipt of the MSBA's portion of project cost, thereby eliminating interest as a component of total cost.

c. Changes Made Regarding Approval Process and Regulations to Include all Areas of Project Income

8

Our prior audit revealed that the former SBA regulations did not include provisions that clearly define and include all areas of income that must be used to offset project costs. In addition, the audits of final project costs did not include a review of income, resulting in an overpayment to one community in excess of \$1.5 million. Our follow-up audit revealed that 963 CMR 2.00, Section 2.16(1)(C), the Authority's established Audit Guidelines, and the scope of the audit of final project costs have been enhanced to define project income and include a review which identifies all types of income to be used to offset project costs.

d. Programmatic and Financial Oversight over Billions of Dollars in School Construction Projects has Significantly Improved

9

Our prior audit revealed that audits of final project costs were not being conducted on a timely basis. The follow-up audit disclosed that the MSBA has made significant progress in addressing the audit backlog and has developed and documented policies and procedures for the conduct of project audits. In addition, Chapter 208 of the Acts of 2004 requires the MSBA to complete a final audit on all projects previously

authorized by the DOE for which a final audit had not been completed. At the time the MSBA was created, there were 803 projects pending a final audit; as of April 2, 2008, 653 final audits had been completed and 61 were in progress.

e. Automated Project Tracking and Planning has been Initiated in Order to Efficiently and Effectively Manage the MSBA Grant Program **10**

Our prior audit revealed that the former SBA was not maintaining a comprehensive database on school construction projects, as well as information on all school buildings in the Commonwealth, as required by MGL Chapter 70B, Section 3. Our follow-up audit revealed that MSBA has established and is maintaining a database on school construction projects and has obtained information on the condition of all school buildings within the Commonwealth.

f. Policies and Procedures have been Documented **11**

Our prior audit revealed that the former SBA had not documented its policies and procedures regarding its financial and programmatic operations. Our follow-up audit revealed that corrective action has been taken: the MSBA has documented policies and procedures regarding its cash/fund/investment management activities, disbursement controls, audit process controls, audit programs, audit guidelines, and new grant application process.

INTRODUCTION

Background

The School Building Assistance Program (SBA) was established by Chapter 645 of the Acts of 1948 and placed within the Department of Education (DOE) in 1965, under the control of the Board of Education (Board). At the time of its enactment, the SBA was directly linked to regionalization efforts, and was limited specifically to new school construction costs. The SBA was established as a temporary program for the purpose of aiding communities with state grants to defray a portion of the costs associated with school construction, until Chapter 159, Section 140, of the Acts of 2000 incorporated it into the Massachusetts General Laws as MGL Chapter 70B. The SBA provided state grants to cities, towns, regional school districts, and independent agricultural and technical schools, and included grants for new capital construction, renovation, reconstruction, and repair projects. Grant payments were typically paid in annual installments over 20 years. The initial payments were based on estimated project costs and were adjusted when final cost documentation was submitted and an audit was conducted to identify the eligible final project costs.

Chapters 208 and 210 of the Acts of 2004, together with Section 35BB of Chapter 10 and Chapter 70B of the Massachusetts General Laws (collectively referred to as the “Act”), eliminated the SBA under the DOE and created the Massachusetts School Building Authority (MSBA) in July 2004 as an independent public authority responsible for administering and funding a new program for grants to cities, towns, and regional school districts for school construction and renovation projects. At the time MSBA was created, there had been 1156 projects approved by the DOE, of which 728 had received grant payments and 428 were on a waiting list to receive grant payments. In addition, final audits had not been conducted for 803 of the 1156 approved projects. The Act, in combination with new regulations promulgated by MSBA, resulted in major changes in the administration and financing of grants to cities, towns and regional school districts for school construction and renovation projects. The Act and new regulations mandate the following:

- The MSBA shall achieve effective management, planning, and financial sustainability for a new program for grants to cities, towns, and regional school districts for school construction and renovation projects.

- Starting in state fiscal year (FY) 2005, the sole source of state funding of the SBA is a “dedicated sales tax revenue amount” of 1% of the statewide 5% sales tax. The 1% is phased-in through FY 2011 with a guaranteed minimum amount through FY 2009, as follows:

<u>Fiscal Year</u>	<u>% Phased In</u>	<u>Guaranteed Minimum (Millions)</u>
2006	70%	\$488.7
2007	78%	\$557.4
2008	85%	\$634.7
2009	90%	\$702.3

The former program was operated without a defined funding limit, and consequently was reliant upon annual appropriations in the state budget. Projects that did not fit within that appropriation were placed on a “waiting list.” Once funding became available, projects began receiving reimbursements based on estimated costs over a 20-year payment schedule.

- The creation of a School Building Advisory Board to assist the Authority in the development of general policy regarding school building construction, renovation, reconstruction, cost management, and to provide technical advice and input to the Authority. The Advisory Board consists of 17 members: the State Auditor or his designee, the Inspector General or his designee, and the Executive Director of the Authority, who shall serve as the secretary to the Advisory Board and shall be a non-voting member of the Board, and 14 members to represent and be appointed by the following non-governmental organizations: the Massachusetts Municipal Association, the Massachusetts Association of School Committees, the Massachusetts Association of Regional Schools, the Massachusetts Building Trades Council, the Massachusetts Chapter of the Associated Builders and Contractors, the Massachusetts Alliance of Small Contractors, the American Council of Engineering Companies of Massachusetts, the Associated Subcontractors of Massachusetts, the American Institute of Architects - Massachusetts, the Massachusetts Smart Growth Alliance, the Massachusetts Taxpayers Foundation, Associated General Contractors of Massachusetts, and, acting jointly, the Massachusetts Teachers Association and Massachusetts Federation of Teachers.
- The MSBA may issue bonds with an aggregate limit of \$10,000,000,000 outstanding at any time. (NOTE: the Authority has issued a total of \$4 billion in Dedicated Sales Tax Bonds - \$2.5 billion in 2005 and \$1.5 billion in 2007).
- The estimated amount of new grants approved by the MSBA will be limited during a fiscal year. For FY 2008, the limit was \$500,000,000. For each fiscal year thereafter the limit shall be the limit for the previous fiscal year plus the lower of the rate of growth in the dedicated sales tax revenue amount, as defined in subsection (a) of Section 35BB of Chapter 10, or 4.5%.

- The grant rate for school construction projects was changed from 50% - 90% to 40% - 80% of eligible project costs. (No grant percentage shall be less than 40% or greater than 80%, based upon a calculation which considers (1) community income, (2) community property wealth, (3) community poverty, and (4) an incentive percentage.)
- A moratorium was established on accepting school project applications for the new SBA program until July 1, 2007.
- The MSBA shall administer and fund its share for the 1156 projects authorized by the DOE under the former SBA. (NOTE: Specifically, the Commonwealth had committed to \$5.1 billion in grant payments from 2005 to 2023 for the 728 projects that were receiving grant payments and approximately \$5.5 billion for the Commonwealth's share of construction costs for the 428 projects on the waiting list.)
- The existing grant payment system of 20 annual installments was replaced with a "pay as you build" payment system (Progress Payment).
- The MSBA shall complete a final audit on all projects authorized by the DOE for which a final audit had not been completed (803 of 1156 projects) and adjust future grant payments in accordance with the result of the audits.
- Communities and school districts are required to notify the MSBA within 30 days of refinancing any bond for which the community or district will receive state reimbursement. The MSBA shall reimburse communities or districts at the actual interest rate obtained. (NOTE: This was amended in Chapter 122 of the Acts of 2006 by replacing "within 30 days" with "no later than 14 days before.")
- On or before June 30 of each year, the MSBA shall submit a report to the Governor and Legislature that includes pertinent data on all school buildings in the Commonwealth.

The Authority's Board of Directors consists of seven members: the State Treasurer (Chairperson), Commissioner of Education or his/her designee, the Secretary of Administration and Finance or his/her designee, and four members appointed by the State Treasurer, two of whom shall be persons in the field of education with demonstrated knowledge of Massachusetts curriculum frameworks and other relevant federal and state educational standards. The chairperson of the Authority shall appoint an Executive Director who shall supervise the administrative affairs and general management and operations of the Authority and who shall also serve as secretary of the Authority, ex officio. The Executive Director may appoint other officers of the Authority necessary to the functioning of the Authority.

The MSBA's overall funding consists of the dedicated sales tax, investment income, bond proceeds, and proceeds from the sale of commercial paper. These funds are used for grant payments for

projects previously approved by the DOE, operations of the MSBA, bond debt service, and grant payments for new projects approved by the MSBA. The independent auditor's report for fiscal year ending June 30, 2007 reported the following:

Bond Proceeds (including premium)	\$1, 576,688,000
Dedicated Sales Tax Revenue	\$ 557,400,000
Proceeds from the Sale of Commercial Paper	\$ 455,000,000
Investment Income	\$ 68,407,000
Grant Payments	\$ 1,411,351,000
Operating Expenses	\$ 6,706,000
Bond Debt Service and Issuance Costs	\$ 186,316,000

The MSBA has made significant progress in addressing the Legislature's mandate to achieve effective planning, management, and financial sustainability for a new SBA. In addition to the appropriate corrective actions taken to address the prior audit issues, the MSBA has accomplished the following:

- Completion of a comprehensive revision of program regulations. The new regulations add more rigor, due diligence, and planning in the initial phases of a project and require collaboration between the community and the MSBA during all phases of a project. The goal is to identify the optimum solution (affordable, equitable, and educationally sound) to the community's school facility problem.
- Replacement of the previous grant payment system of 20 annual installments with a "pay as you build" payment system (Progress Payment) for new projects, which is one of the more significant changes in the new regulations. In addition, for projects on the waitlist, if construction has not started or is in the early stages, the community is required to follow the Progress Payment Plan. In general, on a monthly basis, the community submits to the MSBA incurred project cost documentation that has been approved by the community and Project Manager and certified by the architect, when applicable. After the Authority performs an audit, the community is reimbursed for the MSBA's share of eligible project costs up to 95% of the Authority's grant. The final 5% will be reimbursed once the project is substantially completed and the MSBA has performed a close-out audit. The Progress Payment system provides communities with much needed cash flow and eliminates the need for communities to borrow money related to the MSBA's portion of project costs, thereby effectively eliminating interest as a component of total cost.
- An Audit Advisory Council has been established consisting of representatives from the Office of the State Auditor, the Office of the Inspector General, the State Comptroller's Office, the Department of Revenue, a Massachusetts Town Treasurer, and a Massachusetts school official. The primary purpose of the Council was to develop an audit program that

would efficiently and effectively eliminate the audit backlog and address concerns highlighted in our prior audit report (No. 2004-0157-3S). The MSBA worked with the Council to dedicate appropriate resources to institute an effective audit function. In addition, the MSBA and the Council developed a written audit program, which included:

- Interviewing Town and school personnel.
 - Reviewing 100% of the final construction costs through a detailed document review (invoices, purchase orders, contracts, school building committee minutes).
 - Requiring maintenance and enrollment certifications signed by community officials.
 - Reviewing bond/interest calculations.
 - Sending draft audit reports to communities and then requiring multiple parties within the community (e.g. Mayor, selectmen, treasurer, superintendents) to sign an acceptance form.
 - Site visits for most projects.
- Final audits have identified excessive and/or non-reimbursable costs resulting in over \$701 million in savings to Massachusetts taxpayers.
 - Since the moratorium on school building project applications was lifted, 423 Statements of Interest from 162 school districts have been reviewed and analyzed. Over 400 visits have been made to more than 140 school districts as part of the MSBA's review and due diligence process, and the first projects under the new program have been approved.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor (OSA) conducted an audit of MSBA's administration and oversight of the new program for grants for school construction and renovation projects for the period July 1, 2004 through December 31, 2007. The objectives of our audit were to (1) determine whether appropriate corrective action had been taken regarding issues identified in our prior audit report (No. 2004-0157-3S); (2) review MSBA's internal controls over its financial operations, including the operation of the Massachusetts School Modernization and Reconstruction Trust; (3) determine whether the MSBA's audit functions and oversight practices are comprehensive, therefore ensuring that municipalities adhere to regulations regarding bond refinancing, interest costs, and the maintenance of adequate documentation and project records in support of local school construction projects; and

(4) review the MSBA's most recent Independent Public Accountants' report and management letter to determine whether the audit identified any issues needing further review.

Based on our review, we have concluded that MSBA has taken appropriate corrective action regarding all of our prior audit issues and has implemented internal controls and audit oversight activities adequate to ensure that documentation and project records exist in support of construction costs incurred by local authorities under the new Massachusetts School Building Authority.

AUDIT RESULTS

1. PRIOR AUDIT RESULTS - RESOLVED

Our prior audit consisted of a review of certain activities of the Department of Education's (DOE) School Building Assistance Program (SBA), the results of which were directed to the Massachusetts School Building Authority (MSBA). Our follow-up review revealed that MSBA has taken the following corrective actions:

a. Improvements Made Regarding Community Compliance with Final Project Cost Regulations

Our prior audit revealed that the former SBA did not require communities receiving grant payments to comply with regulations regarding the timely filing of final project cost documentation. Specifically, we found that final cost documentation for 169 projects was not filed with the former SBA as required by regulations. Because initial grant payments were based on the estimated cost of a project, the actual grant payment amount could not be determined, and appropriate adjustments made to future payments could not be made, until final cost documentation was submitted and an audit was conducted to identify the eligible final project costs, as stipulated by DOE regulations. In addition, although regulations permitted the suspension of grant payments if a community failed to file final project costs on a timely basis, the former SBA had not suspended any payments for any of the 169 delinquent projects.

Our follow-up audit revealed that the Authority has received either final cost documentation or documentation for costs incurred to date (Progress Payment System) for 774 of the 803 backlogged projects transferred from the DOE. The following represents the status of the remaining 29 projects:

- 11 projects have been withdrawn by the community.
- 15 projects have not submitted final project costs; however, the communities have not received any grant payments.
- Three projects have not submitted final project costs but have received grant payments. In two cases the Authority has advised the community that future grant payments will be suspended until the materials are submitted. In one case the Authority will recoup all grant payments to date by reducing grant payments for other projects within the same community.

b. Changes Made to Ensure that Communities Adhere to MSBA Program Regulations Regarding Bond Refinancing and Interest Costs

Our prior audit revealed that communities and the former SBA were not in compliance with Chapter 70B, Section 19, of the Massachusetts General Laws (MGL), which required the community to notify the SBA of the actual interest rate obtained for any bond issuance by the community within 30 days of initial bonding. Since initial grant payments were based on estimated interest costs, the lack of proper oversight and timely submission of actual interest costs resulted in grant overpayments to communities that refinanced and received a lower interest rate. Furthermore, without proper notification of refinancing that resulted in a lower interest rate, future grant payments would not be reduced to reflect the lower interest costs. Grant payments were adjusted only when the final costs were submitted and an audit conducted.

Our follow-up audit revealed that corrective action has been taken, as follows:

- For projects receiving annual grant payment installments, the Act requires that communities notify the MSBA no later than 14 days before refinancing.
- One of the changes made in the new regulations (963 CMR 2.00, Section 2.15) was to replace the existing grant payment system of 20 annual installments with a “pay as you build” payment system (Progress Payment). Since the MSBA is making grant payments on a monthly basis for its share of costs incurred, communities do not need to borrow to pay for the MSBA’s share of the project costs. As a result, once a community begins to receive grant payments under the Progress Payment system, it no longer has to borrow in anticipation of the MSBA’s portion of project costs, thereby eliminating interest as a reimbursable project cost.
- Another change in the new regulations (963 CMR 2.00, Section 2.16(5)(b)) categorizes interest as an ineligible cost for reimbursement.

c. Changes Made Regarding Approval Process and Regulations to Include all Areas of Project Income

Our prior audit revealed that the former SBA regulations did not include provisions that clearly defined and included all of the areas of income that must be used to offset project costs. In addition, the audit of final project costs did not include a review of income. Specifically, we found that one community received \$2,018,113 from insurance as a result of a fire at the school and used a portion of this settlement to finance the project. However, the former SBA calculated the grant amount on the basis of total project costs, without taking into consideration the insurance proceeds, resulting in an overpayment to the community in excess of \$1.5 million.

Our follow-up audit revealed that corrective action has been taken, as follows:

- The new regulations (963 CMR 2.00, Section 2.16(1)(c)) state that audits of approved projects shall be performed in accordance with the Authority's established Audit Guidelines.
- Authority Audit Guidelines include a section titled Grants, Insurance Settlements, and Rebates that states that funding from insurance settlements or rebates shall reduce eligible project costs.
- The scope of the audit of final project costs has been enhanced to include a review of all funding sources on the communities' accounting records and interviews with appropriate officials of the school district to identify any additional revenue sources.

d. Programmatic and Financial Oversight over Billions of Dollars in School Construction Projects has Significantly Improved

Our prior audit revealed that audits of final project costs were not being conducted by the former SBA on a timely basis. Specifically, we found a backlog of 298 projects; 169 for which SBA had not received final cost information, and 129 projects for which SBA had received final cost information but had not fully reviewed that information. In addition, the former SBA did not have documented policies and procedures for conducting audits, checklists to identify whether or not required documentation was received to conduct an audit, and instructions regarding the audit process on its website. Lastly, the former SBA had been unable to conduct site reviews to assess whether facilities are being built as planned and approved, and whether projects, when completed, meet the requirements of the authorized project.

Our follow-up audit revealed that corrective action has been taken, as follows:

- Chapters 208 and 210 of the Acts of 2004 required that the MSBA complete a final audit on all projects authorized by the DOE for which a final audit had not been completed.
- The MSBA established an Audit Advisory Council to develop an audit program that would efficiently and effectively eliminate the audit backlog and address concerns highlighted in our previous report (2004-0157-3S). The Council agreed to utilize independent CPA firms to perform specified agreed-upon procedures on selected school construction projects on behalf of the MSBA because the MSBA did not have the staffing resources to audit the backlog in a timely manner.
- At the time the MSBA was created to replace the former SBA, there were 803 approved projects for which a final audit had not been completed. As of December 31, 2007, the MSBA had completed 81% of the audits. Specifically, the audit status for the 803 projects was as follows:

- 714 project audits have been either completed (653) or are in progress (61).
 - 60 projects are in the new grant payment process (i.e. Progress Payment system.)
 - 15 projects have not submitted final project costs; however, the communities have not received any grant payments.
 - Three projects have not submitted final project costs but have received grant payments. In two cases the Authority has advised the community that future grant payments will be suspended until the materials are submitted. In one case the Authority will recoup all grant payments to date by reducing grant payments for other projects within the same community.
 - 11 projects have been withdrawn by the community.
- The MSBA created documented policies and procedures for conducting audits, including a checklist of required documentation.
 - The MSBA has included Audit Guidelines on its website.
 - The new regulations (963 CMR 2.00, Section 2.11) require a community to procure the services of a Project Manager, approved by the MSBA, if the project costs are estimated to be greater than \$1.5 million, or if required by the MSBA as a condition to qualify for grant funding. One of the requirements of the Project Manager is to submit a monthly project progress report to the MSBA.

e. Automated Project Tracking and Planning has been Initiated in Order to Efficiently and Effectively Manage the MSBA Grant Program

Our prior audit revealed that the former SBA was not maintaining a comprehensive database on school construction projects, as well as information on the condition of all school buildings in the Commonwealth, as required by MGL Chapter 70B, Section 3. The lack of an adequate system precluded the SBA from maintaining this information, which is necessary to perform adequate planning, analysis, and decision-making tasks to best manage the school construction program. Further, monitoring of school maintenance efforts is critical to ensure that the significant investment of public dollars in these buildings is not being wasted.

Our follow-up audit revealed that corrective action has been taken, as follows:

- The Progress Payment system implemented by the MSBA results in monthly reimbursement to communities of actual, eligible costs. The MSBA maintains an electronic accounting system to record and track grant payments for every school project and monitor payments made against the maximum allowed cost agreed upon by the MSBA and the community.

- The MSBA has conducted a data collection survey to establish standard, centralized data on all school buildings in the Commonwealth. The data was used to prepare a Needs Survey Report, as mandated by Chapters 208 and 210 of the Acts of 2004, together with Section 35BB of Chapter 10 and Chapter 70B of the General Laws (collectively referred to as the “Act”). The data is also used to prepare an annual report to the Governor and Legislature, also mandated by the Act.

f. Policies and Procedures have been Documented

Our prior audit revealed that the former SBA had not documented its policies and procedures regarding its financial and programmatic operation. Our follow-up audit revealed that corrective action has been taken, as follows:

- The MSBA has documented policies and procedures regarding its cash/fund/investment management activities, disbursement controls, audit process controls, audit programs, audit guidelines, and new grant application process.