

UNITED STATES DEPARTMENT OF AGRICULTURE
Rural Utilities Service

STAFF INSTRUCTION 1780-4

SUBJECT: Borrower Accounting Records, Management Reports, and Audited Financial Statements for Water Programs Borrowers

TO: State Directors, Rural Development
Program Directors for Water and Wastewater Loans and Grants

EFFECTIVE DATE: Date of Approval.

OFFICE OF PRIMARY INTEREST: Portfolio Management Branch, Water Programs Division, Water and Environmental Programs.

INSTRUCTIONS: This staff instruction (S.I.) supersedes S.I. 1780-4, Borrower Accounting Records, Management Reports, and Audited Financial Statements for Water Program Borrower, dated April 22, 2000.

PURPOSE: This staff instruction provides guidance on RUS audit and management reports requirements for Water Programs loans and grants.

This revision includes an increased audit threshold from \$300,000 to \$500,000, as prescribed by OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations, which became effective January 1, 2004.

/s/

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Date

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(1) Borrower Accounting Records.

(i) Method of accounting and preparation of financial statements. Annual financial statements of Water Programs borrowers must be prepared on the accrual basis of accounting, in accordance with generally accepted accounting principles (GAAP), unless State statutes or other funding agencies require otherwise. Borrowers may maintain accounting records on a cash basis provided that the year-end audit report reflects accrual basis accounting. Borrowers with both water and sewer facilities should maintain accounting records in such a manner that will allow the operations of each to be reported separately.

(ii) Review of accounting records. Prior to each loan closing or the start of construction, whichever is first, the servicing official should review the borrowers accounting records and financial reporting procedures to determine that an acceptable system is in place. The servicing official should verify that the borrower has established records such as a chart of accounts, general ledger, check register, receipts and disbursement journals, billings journal, and accounts receivable ledger. The RUS Accountant may be utilized to review the accounting records of new borrowers or borrowers experiencing financial problems. The servicing official should concur in the borrower's audit agreement and maintain a copy in the case file.

(iii) Retention of records. The borrower should retain all records, books, and supporting materials for a period of 3 years after the issuance date of the audit report or management report, as applicable. These records must be made available, upon request, to Agency or its designated representatives.

(2) Management Reports.

When a borrower has revenues from multiple sources and all revenues are pledged as security for a RUS loan, two management reports are required; one for the project being financed by RUS and one combining the borrower's total operations. In cases where an RUS loan is secured by general obligation bonds or assessments and the borrower maintains one revenue fund, one management report combining all revenues is acceptable. The following information containing the signature of an appropriate official of the organization shall be submitted to the servicing office:

(i) Prior to the beginning of each fiscal year, the servicing office should request the borrower to submit two copies of Form RD 442-2, Statement of Budget, Income and Equity, Schedule 1, page 1; and Schedule 2, Projected Cash Flow. This information should be received in the servicing office thirty days prior to the beginning of each fiscal year. The only data required at this time is Schedule 1, page 1, Column 3, Annual Budget, and all of Schedule 2, Projected Cash Flow;

(ii) For a borrower who has received its first loan from RUS, the servicing office should request two copies of Form RD 442-2, Schedule 1, page 1, columns 4-6, as appropriate, and page 2. This information should be received in the servicing office thirty days after the end of each of the first three quarters of the fiscal year. The servicing office may request a borrower experiencing financial or management problems to submit quarterly copies of Form RD 442-2, Schedule 1, pages 1 and 2;

(iii) At the end of the fiscal year, the servicing office should request the borrower to submit two copies of Form RD 442-2, Schedule 1 and Form RD 442-3, Balance Sheet. This information should be received in the servicing office sixty days after the end of the fiscal year. Borrowers may submit financial data on forms other than Forms RD 442-2 and 442-3, if the information is provided in a similar format. An annual audit report may be submitted in lieu of Forms RD 442-2 and 442-3. The audit must be submitted no later than 150 days after the end of the borrower's fiscal year; and

(iv) With the submission of the year-end management report or audit, the servicing office should request the borrower to provide a rate schedule in effect at the time of submission.

(3) Audited Financial Statements.

Audited financial statements shall be submitted on an annual basis, in accordance with Generally Accepted Government Auditing Standards, (GAGAS) and the requirements of the Governmental Accounting Standards Board (GASB). The audit shall also comply with the requirements of Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments and Non-Profit Organizations, and Water Programs audit requirements as published in the RUS Instruction 7 CFR Part 1780, Section 1780.47.

(i) Definition of an audit. As defined by this part, an audit means an examination of an organization's financial statements by an independent certified public accountant (CPA), for the purpose of expressing an opinion on the fairness with which the statements present the financial position, results of operations, and changes in cash flows in conformity with GAAP and for determining whether the borrower has complied with the applicable laws, regulations, and contracts for those events reflected in the financial statements.

(ii) Cognizant agency. "Cognizant agency" means the Federal agency assigned by OMB to carry out the responsibilities described in OMB Circular A-133. Within the Department of Agriculture, the Office of Inspector General (OIG) has cognizant agency responsibility for USDA audits.

(iii) Audits based upon the amount of Federal financial assistance expended. As outlined in the OMB Circular, Federal financial assistance is defined, in part, to include loans, loan guarantees, and grants.

The requirements for submitting an audit report are based upon the total amount of Federal financial assistance expended during a borrower's fiscal year from all Federal sources. Therefore, the borrower's Federal funds expended from all sources must be totaled to determine the Federal financial assistance "expended" for the fiscal year. A borrower is considered to have "expended" Federal financial assistance when: (a) Federal funds have been disbursed, either directly or as a subrecipient from a pass-thru entity; or (b) when the organization has incurred expenditures that will be reimbursed with Federal funds.

(4) Requirements For Submission of Audit Reports.

(i) Borrowers expending \$500,000 or more in Federal assistance per fiscal year must submit an audit in accordance with the requirements of OMB Circular A-133.

(ii) Borrowers expending less than \$500,000 in Federal assistance per fiscal year are exempt from OMB Circular A-133 requirements. However, a Water Programs audit (i.e., a GAGAS audit) or management report will be required as follows:

(a) A Water Programs audit is required if RUS debt is \$1,000,000 or more.

(b) A management report may be submitted in lieu of a Water Programs audit if RUS debt is less than \$1,000,000 and the servicing official determines that:

(1) the borrower is not experiencing significant financial or managerial problems.

(2) the borrower's accounting system is adequate.

(3) the borrower has fidelity bond coverage in accordance with RUS requirements.

(4) the borrower has submitted acceptable management reports in previous years.

(iii) On an annual basis, the servicing official should review the borrower's financial condition and management practices when making the determination whether to require a management report or Water Programs audit. If the servicing official determines that an audit report is warranted, the borrower shall be advised of the submission requirements. If the borrower has an audit for any reason, the servicing official should request a copy of the audit report for review.

(5) Review of CPA Audit Reports.

The servicing official is responsible for obtaining and reviewing the audited financial statements of Water Programs borrowers. RUS Bulletins 1780-16 and 1780-17 should be used to document reviews of OMB Circular A-133 and Water Programs audits, respectively. The servicing official should forward all audits with RUS debt of \$1,000,000 or more to the State Office for a final review. State Office personnel should perform the final review on audits with RUS debt of \$1,000,000 or more.

(6) Borrower and Auditor Responsibilities For Audit Reports.

The financial statements are the responsibility of the borrower's governing body. This responsibility includes, in part, ensuring that audits are completed and submitted to the Agency when due, and corrective action is taken on all audit findings. Unless State statutes or other funding agencies require otherwise, these financial statements should be presented on a 12-month comparative basis for the current and preceding year, in accordance with GAAP. A borrower that is submitting its first audit report to Rural Development may submit single year financial statements.

(i) Selection of a CPA. The borrower is responsible for the selection of an independent, licensed CPA to conduct the audit. When permitted by State statutes or with the approval of the Agency, a state or Federal auditor may perform the audit in lieu of a CPA. The CPA does not have to be

licensed by the state in which the borrower is located; however, the CPA must abide by the rules and regulations of professional conduct promulgated by the accountancy board of the state in which the borrower is located. A CPA will be considered independent if the CPA:

- (a) Meets the standards for independence contained in the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct in effect at the time the CPA's independence is under review;
- (b) Does not have any direct financial interest or any material indirect financial interest in the borrower during the period covered by the audit; and
- (c) Is not, during the period of the audit, connected with the borrower as a promoter, underwriter, trustee, director, officer, or employee.

(ii) Quality review requirement. As required by GAGAS, the auditor must belong to and participate in an external quality review program and provide the borrower with a copy of the most recent quality review report. These reviews are performed every 3 years by an independent organization to determine if the auditor is following established audit procedures and applicable auditing standards.

(iii) Audit agreement. The borrower must enter into a written audit agreement with the auditor. The audit agreement may include terms and conditions that the borrower and auditor deem appropriate; however, the agreement should include the following:

- (a) A statement that the auditor will perform and document the audit work in accordance with GAGAS and the professional standards of the AICPA;
- (b) A statement that the auditor will submit the completed audit and accompanying letters to the borrower's governing body 30 days prior to the date the audit is due to the Agency;
- (c) A statement that the auditor will make all audit-related documents, including workpapers, available to the Agency or its representatives, upon request; and
- (d) A statement that the auditor will immediately report, in writing, all irregularities and illegal acts to the borrower's governing body and the Agency, as outlined in Section 6(ix) of this part.

(iv) Reporting requirements for OMB Circular A-133 audit reports. In addition to the audit report and accompanying audit letters, the following items should be prepared when performing an audit in accordance with OMB Circular A-133 audit requirements:

- (a) Data Collection Form. The Data Collection Form provides information about the borrower, its Federal programs, and the results of the audit. The form is available from the Federal Audit Clearinghouse and should include the signature of an appropriate official of the organization and the auditor. The Data Collection Form should be submitted to the Federal Audit Clearinghouse along with the audit reporting package.
- (b) Schedule of expenditures of Federal awards. The borrower must prepare a schedule of expenditures of Federal awards for the period covered by the audit. This schedule should list the expenditures, by Federal program, the Catalog of Federal Domestic Assistance

(CFDA) number, identify major programs, and include notes on significant accounting policies used in preparing the schedule.

(c) Corrective action plan. The borrower must prepare a corrective action plan in response to each audit finding included in the current year audit. This schedule should include the contact person responsible for the corrective action, the corrective action planned, and the anticipated completion date. If the borrower does not agree with the audit finding or believes that corrective action is not warranted, the corrective action plan should include an explanation of the borrower's position.

(d) Summary of prior audit findings. The borrower must prepare a summary schedule of prior audit findings to report on the status of all audit findings included in the prior audit's schedule of findings and questioned costs.

The audit report, accompanying audit letters, and items (b) through (d), are referred to as the "reporting package". The borrower is responsible for submitting the reporting package to the Agency and the Federal Audit Clearinghouse in accordance with the requirements of the OMB Circular.

(v) Submission of audit reports to Rural Development. OMB Circular A-133 audits with fiscal years ending prior to June 30, 1999, shall be submitted no later than 13 months after the end of the fiscal year. OMB Circular A-133 audits with fiscal years ending on or after June 30, 1999, shall be submitted no later than 9 months after the end of the fiscal year.

Water Programs audit reports (i.e., a GAGAS audit) shall be submitted no later than 150 days after the end of the fiscal year.

(vi) Submission of audit reports to the Federal Audit Clearinghouse. In addition to submitting audit reports to the Agency, the borrower is also required to submit copies of OMB Circular A-133 audits and Data Collection Form to the Federal Audit Clearinghouse as designated by OMB. To comply with this requirement, the borrower shall: (a) submit one copy of the reporting package to the Federal Audit Clearinghouse to retain as an archival copy; and (b) submit one copy of the reporting package for each Federal agency that has a related audit finding or questioned cost. The auditor is responsible for determining the number of reporting packages to be forwarded to the clearinghouse. The clearinghouse address is: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, Indiana 47132. An audit performed in accordance with Water Programs audit requirements (i.e., a GAGAS audit) should not be submitted to the Federal Audit Clearinghouse.

(vii) Submission of corrective action plan. The borrower is responsible for follow up and corrective action on all audit findings. As part of this responsibility, the borrower shall provide the Agency with a written corrective action plan to address each recommendation included in the audit report. The corrective action plan must be submitted when the audit report is forwarded to the Agency. The borrower's corrective action plan must include a statement on action taken or planned in response to the auditor's audit findings for the current year and any unresolved audit findings from prior years. If the borrower does not agree with the audit finding or believes corrective action is not warranted, the corrective action plan should include an explanation of the borrower's position.

(viii) Management decision by Rural Development. The Agency shall prepare a written management decision in response to the borrower's corrective action plan for OMB Circular A-133

audit findings. This management decision shall be sent to the borrower within 6 months of receipt of the audit, and shall state whether or not the audit finding is sustained, discuss the borrower's action to repay disallowed costs, or approve the borrower's corrective action plan, as submitted. The management decision should also describe any appeal process available to the borrower. The Agency should only provide management decisions for OMB Circular A-133 audits. Management decisions are not required to be issued for Water Programs audits.

(ix) Disclosure of irregularities and illegal acts.

(a) In accordance with GAGAS, the CPA must design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, illegal acts, and material misstatements resulting from noncompliance with the provisions of regulations, contracts or grant agreements that could have a direct and material effect on financial statement amounts.

(b) If there is an indication that an irregularity may have occurred or evidence concerning the existence of a possible noncompliance that could have a material direct or indirect effect on the financial statements, the CPA must extend audit steps and procedures to obtain sufficient, competent evidential matter to determine whether, in fact, an irregularity has occurred and the effect on the borrower's financial statements.

(c) Pursuant to the terms of its audit agreement with the borrower, the CPA must immediately report, in writing, all irregularities and all indications or instances of illegal acts, whether material or not, to:

- (1) The borrower's governing body; and
- (2) the Agency.

(7) Borrowers Not Required To Submit Annual Audit Reports.

A borrower that is not required to submit an annual audit report due to the amount of Federal financial assistance expended shall, at a minimum, submit a management report to the Agency within 60 days after the end of the fiscal year. A year-end management report shall consist of:

- (i) Form RD 442-2, Statement of Budget, Income and Equity, and Form RD 442-3, Balance Sheet, or forms that provide the information in a similar format; and
- (ii) A copy of the rate schedule in effect at the time of submission.

(8) Compliance Supplements for OMB Circular A-133 and Water Programs Audit Reports.

Water Programs has developed compliance supplements to provide guidance to auditors when performing audits in accordance with OMB Circular A-133 and Water Programs audit requirements. These compliance supplements are available on the Water Programs website as RUS Bulletin 1780-31, for Circular A-133 audits, and RUS Bulletin 1780-30, for Water Programs audits. The compliance supplements should be provided to auditors upon request.

(9) OMB Circular A-133 Audit Reports.

The following reports should be included in an OMB Circular A-133 audit:

- (i) Independent Auditor's Report (the auditor's opinion).
- (ii) Financial statements (including notes to the financial statements).
- (iii) Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with GAGAS.
- (iv) Report on Compliance With Requirements Applicable To Each Major Program and Internal Control Over Compliance in Accordance With OMB Circular A-133.
- (v) Schedule of expenditures of Federal awards.
- (vi) Auditor's Report on Federal Awards (includes the auditor's opinion on internal control and compliance related to major Federal awards).
- (vii) Schedule of findings and questioned costs (if applicable).

The borrower is responsible for preparing Items (ii) and (v). The auditor is responsible for preparing items (i), (iii), (iv), (vi) and (vii).

In addition to the reports listed above, the OMB Circular requires the borrower to submit a corrective action plan and summary schedule of prior audit findings, if applicable, as outlined in Section 6(iv) of this part. RUS Bulletin 1780-16 should be used for reviewing OMB Circular A-133 audit reports.

(10) Water Programs Audit Reports.

The following reports should be included in a Water Programs audit (i.e., a GAGAS audit):

- (i) Independent Auditor's Report (the auditor's opinion).
- (ii) Financial statements (including notes to the financial statements).
- (iii) Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance with GAGAS.
- (iv) Schedule of audit findings (if applicable).

The Agency should request that borrowers provide a schedule of expenditures of Federal awards and, if applicable, a corrective action plan with each Water Programs audit report. RUS Bulletin 1780-17 should be used for reviewing Water Programs audit reports.