

BASIC ELEMENTS OF AN EFFECTIVE FINANCIAL MANAGEMENT SYSTEM

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Introduction

Agencies are required to have an effective financial management system as a condition of receiving federal funds. Federal and state rules and regulations establish several criteria that the financial systems of agencies receiving funds must meet. These criteria can be grouped in several different ways. However, we have chosen to rely heavily on the [Federal "Common Rule,"](#) which broadly establishes standards for financial management which are applicable to most grants, and we have identified seven essential elements to an effective financial management system. They are:

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| <ul style="list-style-type: none">• Financial Reporting• Accounting Records and Source Documentation• Internal Control | <ul style="list-style-type: none">• Budget Control• Allowable Cost• Cash Management• Compliance |
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1. Financial Reporting

Accurate, current, and complete disclosure of the financial results of financially assisted activities must be made in accordance with the financial reporting requirements of the grant or subgrant.

Financial reporting requirements stem from a variety of sources, and financial reports serve many purposes. For example, they serve as tools for use by managers to control their organizations and to monitor the extent to which management's objectives are being achieved. They also provide information to external parties on an organization's financial operations and compliance with a variety of requirements.

- Each agency may require its own system of financial reports designed to assist the agency and its governing board in controlling and monitoring its operations to insure that the objectives established for the agency by top management are being accomplished.
- The individual contracts under which an agency receives funding may impose additional financial reporting requirements upon the agency receiving funds.
- Federal regulations establishing the administrative requirements for grants require a variety of

expenditure reports which serve as a basis for reimbursement.

- d. Audit requirements imposed as a condition of funding require the organizations receiving funds to have audits. The audit reports reflect the financial condition of the organization and the results of operations and also include reports on the organization's internal control structure and compliance with applicable laws, rules, and regulations.

2. Accounting Records and Source Documentation

Grantees and sub-grantees must maintain records which adequately identify the source and application of funds provided for financially assisted activities. These records must contain information pertaining to grant or subgrant awards and authorizations, obligations, unobligated balances, assets, liabilities, outlays or expenditures, and income. Accounting records must be supported by such source documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subcontract award documents, etc.

In any financial management system, a variety of accounting and other records is required in order to adequately provide a picture of the financial condition and results of operations of the organization. Several issues related to accounting records and source documentation are discussed in [Chapter 2.2](#) (Accounting Records and Source Documentation) of this manual. These issues include criteria for documents and records, record retention requirements, and principles for accounting records related to the administration of financial assistance programs.

The independent auditor will examine and test accounting records and source documentation as a part of the audit in order to substantiate the information that appears in the financial statements. In an audit involving financial assistance, expenditures and other transactions that are not supported by adequate documentation may result in questioned and/or disallowed costs, which the grantee may have to pay back to the granting agency.

As a granting agency, DHSS reserves the right to examine/audit an agency's accounting records and source documentation.

3. Internal Control

Effective control and accountability must be maintained for all grant and subgrant cash, real and personal property, and other assets. Grantees and subgrantees must adequately safeguard all such property and must assure that it is used solely for authorized purposes.

Management is responsible for establishing and maintaining an effective system of internal control. An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. An internal control structure is comprised of three elements:

- a. The "control environment." Management philosophy and operating style, an entity's organizational structure, and the methods of assigning authority and responsibility can contribute to whether or not an agency has an effective system of internal controls. The combined effect of these and other factors constitute an entity's control environment.
- b. The accounting system. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.
- c. Control procedures. Control procedures are those policies and procedures, in addition to the control environment and accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved.

The topic of internal controls covers a wide area. Thus, a more in-depth treatment of internal controls is provided in [Chapter 2.4](#) (Internal Control) of this manual.

4. Budget Control

Actual expenditures or outlays must be compared with budgeted amounts for each grant or subgrant. Financial information must be related to performance or productivity data, including the development of unit cost information whenever appropriate or specifically required in the grant or subgrant agreement. If unit cost data are required, estimates based on available documentation will be accepted whenever possible.

The contract between the grantor agency and the provider establishes a budget for the grant. The budget provides a spending plan against which fiscal and program performance can be measured. The contract amount and any amendments shall be recorded in order to compare actual and budget amounts and comply with contractual and budget constraints.

The frequency and the level of detail with which budgetary performance information is generated from the accounting records depends on the needs of the users within an organization. For example, summary information presented monthly or quarterly may be sufficient for the top management of an organization, while detailed information available on-line may be required by those working in the accounting section processing payments.

The budget sets amounts and sources of revenue on one hand and amounts and purposes of expenditures on the other. The accounts, in summary and detail, should record both the planned revenues and expenditures and the actual transactions during the accounting cycle.

Governmental generally-accepted accounting principles require budgetary accounting control. Formal budgetary accounting control is essential to determine and demonstrate compliance with legal, and contractual provisions, such as the operating budget and federal and state compliance issues. Governmental organizations are also required to present financial statements on both the budgetary basis and GAAP basis.

5. Allowable Cost

Applicable cost principles, agency program regulations, and the terms of grant and subgrant agreements shall be followed in determining the reasonableness, allowability, and allocability of costs.

The Department of Health and Social Services bases its allowable cost principles on the various federal cost principles.

For each type of organization, there is a set of Federal principles for determining allowable costs, and allowable costs are determined in accordance with the cost principles applicable to the organization incurring the costs. For example, a local government agency, such as a county or tribe, would refer to [OMB Circular A-87](#), while a not-for-profit would refer to [OMB Circular A-122](#). [Chapter 2.3](#) (Allowable Costs) of this manual includes a chart showing the applicable federal guidelines for various types of agencies, the text of the allowable cost chapter from the Department's [Allowable Cost Policy Manual](#), and copies of [OMB Circulars A-87](#) and [A-122](#).

6. Cash Management

The cash management function of any organization is responsible for establishing and maintaining a set of policies and procedures with the dual purpose of ensuring that funds are available to cover payments made for program purposes, while also ensuring that neither state nor federal funds have been drawn unreasonably in advance of when they are needed to pay for program expenses.

In addition to providing adequate cash to meet operating needs while avoiding the build-up of excessive cash balances, some of the other major objectives of a sound system of cash management are:

- to provide adequate internal accounting controls over cash receipts from the time of receipt to deposit in the appropriate depository;
- to establish a set of internal controls and procedures for ensuring that disbursements are made only for approved purposes;
- to maintain adequate accounting records for cash receipts and disbursements; and
- to make use of proven technology for improving cash management, such as electronic fund transfers, and other non-check payment procedures.

7. Compliance

Agencies must comply with federal and state laws and regulations, local ordinances and other legal requirements.

All recipients of federal and state funds are required to comply with a variety of applicable federal and

state regulations. Major sources for compliance requirements are federal and state laws and administrative rules, contracts with the granting entity, and program manuals, administrative memos, and other information referenced in contracts.

Governmental generally accepted accounting principles require compliance with applicable laws and regulations. Specifically, the accounting system should be designed to determine and demonstrate compliance with finance-related legal and contractual provisions.

[Chapter 2-5](#) (Compliance) of this manual has been reserved for a more in-depth discussion of compliance.

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