

Maryland Department of Health and Mental Hygiene Audit Division

Standards for Audit of Human Services Sub-Vendors

I. Executive Summary

This document sets forth standards to obtain consistency and uniformity among DHMH human services vendors for audits of their sub-vendors and to delineate the responsibilities of the DHMH Audit Division and the vendors in overseeing and performing these audits. It is issued under the authority of COMAR 10.04.03 and 21.06.05.02 and of State Finance and Procurement 15-110 and 7-404.

II. Background

A. **Purpose:** The Human Services Agreements Manual and the Local Health Department Funding System Manual dictate that human services vendors perform sub-vendor audits in compliance with directions from the Chief of the Audit Division. These audits are important monitoring tools, considering the significant amounts of funding awarded to sub-vendors. The purpose of these standards is to provide the audit guidelines required by HSAM (Section 2210.04) and LHDFSM (Section 2180.04).

B. Scope:

1. These standards apply to all DHMH vendors that award funds to sub-vendors through contracts, Memoranda of Understanding (MOUs), grants, or any other written agreements to deliver human services to third parties.
2. These standards apply to all sub-vendors that receive funds from DHMH vendors through contracts, Memoranda of Understanding (MOUs), grants, or any other written agreements to deliver human services to third parties.

C. Note on other audits:

- A sub-vendor audit performed in accordance with these standards shall not substitute for the Single Audit, which is a federal requirement. Conversely, the Single Audit shall not substitute for a sub-vendor audit that is required by these standards.
- If a sub-vendor receives funding from another organization that requires an additional audit (performance audit, evaluation, inspection, or review), these standards place no limit upon such an audit.
- Occasionally a vendor may operate under a contract or MOU, issued by DHMH or another entity, containing audit requirements that are more stringent than the ones described here. In such a case, the vendor must perform an audit that meets these more stringent requirements as well as the standards in this policy.

III. Policy Statements

A. Definitions

1. **Audit**, for the purposes of this document, means 1) an examination of the sub-vendor's records and controls to obtain reasonable assurance that those items

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reported on the 440 Form are reasonable and properly supported by documentation and 2) an examination of the sub-vendor's compliance with its contract and with the DHMH Human Services Agreements Manual or the Local Health Department Funding System Manual.

2. **Auditee** means any entity that expends funds awarded by DHMH that is required to be audited under these standards.
3. **Auditor** means an adequately trained and/or credentialed individual.
4. **Contract**, for the purposes of this document, means any written agreement between a vendor and a sub-vendor to conduct a program or perform specified services for a consideration. This could be in the form of a standard procurement contract covered by COMAR Title 21, a Memorandum of Understanding (MOU), a grant, a purchase order, or any other written evidence of an agreement between the two parties.
5. **Cost reimbursement contract** means a funding agreement between a vendor and a sub-vendor that relates the award to a detailed line item budget, possible line item control, and detailed reporting requirements. These requirements may include year-end reports (DHMH 440), audits, and documentation of the vendor's review of the detailed line item budget.
6. **Unit-price, fixed-price, or fee for service contract** means a funding agreement between a vendor and a sub-vendor where the award is not related to a budget. This type of funding agreement includes a rate of payment for the services stipulated in the agreement. Payment is made only for services actually delivered.
7. **HSAM** means the DHMH Human Services Agreements Manual, which specifies administrative and fiscal policies for grants and contracts with any entity that is not a Local Health Department. These contracts are funded by DHMH and processed through the Division of Program Cost and Analysis.
8. **LHDFSM** means the Local Health Department Funding System Manual, which specifies administrative and fiscal policies for grants and contracts with Local Health Departments funded by DHMH and processed through the Division of Program Cost and Analysis.
9. **Sub-vendor** means any organization with whom a DHMH vendor engages to deliver health-related services to third party clients, using funds awarded to the vendor by DHMH. It may also mean the sub-vendor of a sub-vendor. Sub-vendors may include a wide variety of entities, such as non-profit or for-profit organizations, community groups, churches, or public school systems. For purposes of this policy, sub-vendors may also include group medical practices or other health care organizations, or physicians, psychologists, or other health care professionals who provide services as individuals.
10. **Vendor** means any organization, public or private, including a local health department, which delivers or provides for the deliverance of health-related

services to third party clients under a funding arrangement governed by HSAM or LHDFSM.

B. Audit Costs

1. **Allowable:** The costs of audits of sub-vendors performed in accordance with these standards are allowable contract costs either to the vendor or sub-vendor (see HSAM 2150.08.01 or LHDFSM 2110.08.01).
2. **Classification:** The charges may be considered a direct or an indirect cost. If they are considered an indirect cost, they must be included within the limit on administrative/indirect costs that applies to the vendor's particular funding. For example, Cigarette Restitution Fund Program contracts have a limit of seven percent on administrative/indirect costs.

C. Responsibilities for sub-vendor audits

1. **Vendor responsibilities:** The standards set forth in this document shall apply to all DHMH human services vendors that award all or a portion of their funds received from DHMH to sub-vendors to provide services. Vendors are to comply with these requirements and to communicate them to their sub-vendors. These standards shall also apply when a sub-vendor contracts with its own sub-vendor. For example, if sub-vendor A contracts with sub-vendor B, sub-vendor A has the same responsibilities toward sub-vendor B as a vendor. When the standards refer to the vendor, they also apply to sub-vendor A's responsibilities to its sub-vendor B.
 - a. **Audits of sub-vendors:** Each vendor is responsible for conducting or contracting for regular audits of sub-vendors as set forth in sections D. (2) and E. (1 through 4) and consistent with the requirements of these standards.
 - b. **Controls over sub-vendors:** Each vendor is responsible for having adequate controls and monitoring procedures over its sub-vendors. These controls should include, but not be limited to, properly executed sub-vendor contracts, periodic progress and fiscal reports, review of audit reports, and site visits to sub-vendors. If a vendor suspects that the sub-vendor has fiscal problems or questionable costs, the vendor shall have an audit of the sub-vendor performed as soon as possible. (If this is necessary, the vendor shall follow the audit requirements in Subpart C for cost reimbursement contracts totaling over \$100,000.) The vendor shall inform the Chief of the DHMH Audit Division about any special audit and send him or her a copy of the special audit report.
 - c. **Review of other audits:** The vendor shall document annually that it has determined whether the sub-vendor has had an audit performed. (Even if DHMH does not require an audit, a sub-vendor may have had an audit performed to meet the requirements of another funding source.) If a vendor determines that a sub-vendor has had an audit performed, they shall document that they have requested and reviewed the audit report and any

management letter prepared in conjunction with it. The vendor should review the audit findings to determine if conditions exist that might prevent the sub-vendor from delivering services or fulfilling the terms and conditions of its contract with the vendor.

- d. **Follow-up on audit findings:** Each vendor is responsible for following up audit findings within six months to ensure that the sub-vendor has taken corrective action. Additional follow-ups may be necessary. The vendor should retain written documentation of follow-up results for review by the Audit Division.

2. **DHMH Audit Division responsibilities**

- a. The DHMH Audit Division will oversee and review the human services vendors' implementation of the standards in this document. The Audit Division will also provide interpretations of the policies and procedures and provide technical assistance to ensure their effective and efficient implementation.
- b. The DHMH Audit Division will consider vendor audit activities as part of its regular vendor audits. In particular, the Audit Division will review a vendor's activities to determine if the vendor has:
 - i. followed the sub-vendors' audit standards
 - ii. adequate controls and monitoring procedures over its human services sub-vendors
 - iii. performed audits in accordance with these standards. If the vendor has not done so, the Audit Division may take the following actions, or others deemed appropriate:
 - instruct the vendor to have these audits performed immediately
 - disallow amounts budgeted for sub-vendor audits
 - refer the problem to the Division of Program Cost and Analysis and the funding administration for appropriate sanctions. These sanctions might include, but are not limited to, withholding a percentage of the funding until the audits are satisfactorily completed, withholding or disallowing overhead costs, suspending funding until the audits are conducted, or terminating the funding.
 - Conduct or have an audit conducted and bill the vendor for the cost of the audit.
- c. Special situations:
 - i. At any time the Chief of the Audit Division may audit or request the vendor to audit a sub-vendor if he or she determines that it is in the best interest of the State to do so. (HSAM 2210.04 or LHDFSM 2180.04)
 - ii. The Chief of the Audit Division may, in consultation with the Director of the Fiscal Services Administration, exempt a vendor from auditing its sub-vendors (as described in this policy) if a special situation exists. For example, the vendor may have particularly rigorous controls over sub-vendor financial activities. Each fiscal year the Audit Division will confirm that the vendor's controls are still in place.

D. Sub-vendor audit criteria (by type of contract)

1. Unit price, fixed price, or fee for service contracts

Under these standards, vendors are not required to have audits performed of unit price, fixed price, or fee for service contracts.

2. Cost reimbursement contracts

Sub-vendors with cost-reimbursement contracts of any amount must submit the DHMH 440 (Annual Report) to the vendor and must certify that the reported expenditures and revenues are true and correct. The vendor shall carefully review the sub-vendor's DHMH 440 to determine that it is correct and reasonable, and that the sub-vendor stayed within budgetary limits.

Audit requirements for cost reimbursement contracts depend upon the funding level:

a. cost reimbursement contracts totaling \$100,000 or less do not need to be audited unless there are allegations of abuse of funds or suspicions of mismanagement.

b. cost reimbursement contracts totaling over \$100,000 must be audited by the vendor as set forth in paragraph E below.

E. Audit requirements for contracts totaling over \$100,000

1. Frequency of audits

a. Sub-vendor contracts that have been terminated for cause or contracts with sub-vendors that have gone out of business must have audits performed and the reports completed within three months of the end of the contract period or the termination of the contract.

b. Sub-vendor contracts that have not been continued (i.e., they have simply expired) must have audits performed and the reports completed within 12 months of the end of the contract period.

c. Sub-vendor contracts that are continuing from year to year shall be audited every other fiscal year and the audit shall encompass the last two completed fiscal years. If a vendor believes that a sub-vendor may be having fiscal or other problems, the vendor shall have an audit performed as soon as possible.

2. Audit report due date for continuing contracts

The audit report is due 12 months after the end of the last fiscal year covered by the audit. Vendors must maintain copies of all sub-vendors' audit reports.

3. Vendor responsibilities for sub-vendor audits

a. Selection of auditors: Auditors may be chosen from one of three sources: vendor's in-house staff, independent auditors under contract with the vendor, or independent auditors under contract with the sub-vendor.

i. A vendor or sub-vendor should make positive efforts, whenever possible, to utilize minority-owned business enterprises in procuring audit services.

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- ii. A vendor should consider several factors when evaluating proposals for audit services: responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, results of external quality control reviews, and price.
- b. Audit preparation, performance, and reporting: A vendor is responsible for assuring that an audit is conducted according to the following standards:
 - i. Risk analysis: The vendor must assure that before an auditor begins an audit of a sub-vendor, the auditor performs a risk analysis. He or she shall use auditor judgment and shall consider, but not be limited to, the following criteria:
 - nature of the control environment
 - competence and experience of the personnel administering the program
 - prior audit findings
 - length of time since the sub-vendor was last audited
 - sub-vendor's phase in the funding life cycle, i.e., if the program is in its first or last year, the risk may be higher due to start-up or closeout activities.
 - ii. Scope of audit: Each audit of a sub-vendor should include the following areas:
 - verification of the information reported on the DHMH 440
 - review and analysis of internal control procedures
 - determination of compliance with laws, regulations, and the terms and conditions of the sub-vendor's contract with the vendor
 - determination of compliance with the terms and conditions of HSAM or LHDFSM
 - follow up on prior audit findings
 - determination of findings and questionable costs

Note: Compliance testing should include tests of transactions and other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance.

- iii. Content of audit report.
 - 1) General:
 - Each report issued for a sub-vendor audit should provide sufficient schedules, forms, analysis, etc., to allow the reader to evaluate the results of the subcontracted service during each of the contract fiscal years (ending June 30) separately and isolated from the sub-vendor's total operations.
 - The audit report must provide a statement of revenues and expenditures that details total revenues and allowable expenditures and the amount due to the vendor for each contract that the sub-vendor has with the vendor.
 - The report also shall include all notes prepared by the auditor and any management letter that may have been generated as part of the audit.

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- 2) Specific: each audit report should contain the following parts, though they need not be organized in this manner:
 - an opinion (or disclaimer of opinion) as to whether the DHMH 440 is presented fairly in all material respects in conformity with generally accepted accounting principles. This opinion or disclaimer would be included in a report prepared by independent auditors, but not by a vendor's in-house staff.
 - a report on internal control describing the scope of internal control testing and the results of the tests
 - a report on compliance with laws, regulations, and the provisions of the contract or agreement that the sub-vendor has with the vendor
 - a report on compliance with the terms and conditions of HSAM or LHDFSM
 - a report on the status of prior audit findings
 - a list of funds due either to the vendor or to the sub-vendor
 - a schedule of findings and questionable costs

- iv. Audit findings
 - 1) Subject matter of audit findings: Auditors should report the following as audit findings in a schedule of findings and questionable costs.
 - Reportable conditions in internal control. These reportable conditions should include all weaknesses detected, if any.
 - All noncompliance detected, if any, with laws, regulations, contracts, or grant agreements.
 - Known questionable costs (those specifically identified by the auditor) that are \$500 or greater. In addition, when reporting the finding the auditor should include information to give a perspective on the prevalence and possible consequences of the questionable costs.
 - Non-allowable costs.
 - Known or suspected fraud affecting DHMH funds.

Note: Auditors shall refer to the appropriate sections of HSAM or LHDFSM concerning allowable costs, non-allowable costs, and budget modifications and shall use this material for guidance in determining whether certain costs should be allowable.
 - 2) Detail of audit findings: The auditor should present audit findings in sufficient detail to allow the auditee to prepare a corrective action plan and to implement it. The auditor should include, but not be limited to, the following information:
 - The grant or contract number, the source of funding, and the fiscal year.
 - The criteria upon which the audit finding is based, citing a statute, regulation, etc.
 - The condition that the auditor found.

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- The questionable costs, how they were computed, how prevalent they are (i.e., whether they represent an isolated instance or a systemic problem), and what their likely consequences are.
- Recommendations to prevent future occurrence of the problem.

4. **Vendor's post-audit responsibilities**

- a. Vendor's review of sub-vendor audit: The vendor is responsible for reviewing the audit report and management letter after each sub-vendor audit is completed. (This applies to all audits – regular or special circumstances – required by these standards.) The vendor should determine if:
- i. the sub-vendor utilized DHMH funds in the appropriate manner as detailed in the approved budget
 - ii. the sub-vendor is in compliance with HSAM or LHDFSM
 - iii. any funds are due to or from the sub-vendor
 - iv. conditions exist that may prevent the sub-vendor from delivering services and/or fulfilling the terms and conditions of its contract with the vendor
 - v. the sub-vendor appears to be financially viable

Note: the vendor should retain audit reports and written documentation of follow-up results for five years after the due dates.

- b. Vendor's referral to Audit Division: If a vendor reviews a sub-vendor audit and finds allegations of abuse or suspicions of mismanagement, the vendor shall immediately send a copy of the audit report to the Chief of the DHMH Audit Division, along with a cover letter describing the problems. The Chief, in conjunction with the DHMH Office of Inspector General, may then decide to investigate further. They also may decide to audit funds granted to this sub-vendor by other vendors, even if the amounts do not meet the audit threshold.
- c. Vendor's requirement to submit a revised 440: If a sub-vendor audit reveals that adjustment to the financial information reported on the DHMH 440 is necessary, it is the vendor's responsibility to submit a revision of its own Form 440 to the Division of Program Cost and Analysis (DPCA) within 60 days of the issuance of the final report. (This period includes time for the vendor and sub-vendor to resolve any problems with the results of the report.)
- i. If funds are due back to DHMH, the vendor shall return the funds along with the revised 440 and an explanatory letter.
 - ii. If funds are due to the sub-vendor, the revised 440 will serve as a request to DPCA for these funds.
- d. Audit working papers: The vendor must assure the following:
- i. Retention of working papers: The working papers should be retained for a minimum of five years after the date that the audit report was

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due to the vendor and until audit requirements are met. However, DHMH may extend the retention period.

- ii. Access to working papers. The vendor shall ensure that audit working papers are available upon request to DHMH or its representative to resolve audit findings or for any other purpose consistent with DHMH's oversight responsibilities. A provision to this effect should be included in the vendor's contract with the sub-vendor or the sub-vendor's contract with the auditor.

5. **DHMH Audit Division responsibilities for sub-vendor audits**

In addition to the Audit Division's general responsibilities to audit vendors (see III.C.2.), the Audit Division will also determine:

- a. if the vendor has reviewed and followed up any audit findings
- b. if a sub-vendor owes funds to the vendor or vice versa, and if there has been settlement of this issue

IV. **References**

- COMAR 10.04.03 and 21.06.05.02
- State Finance and Procurement (SFP) 15-110 and 7-404
- DHMH Human Services Agreements Manual, section 2210.04
- Local Health Department Funding System Manual, section 2180.04

V. **Effective Date**

These standards are effective January 1, 2004. The standards govern the audit of sub-vendor contracts awarded in FY 2002 and thereafter, unless the audit was completed, commenced, or contracted for prior to January 1, 2004.