Program Income Manual

CDBG Economic Development Program

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Table of Contents

Introduction

This manual has been prepared to assist local governments who manage Community Development Block Grant Revolving Loan Funds. The manual is intended to serve each local government grantee as an instructional guide and provide Commerce with a means for tracking program income activities.

The U.S. Department of Housing and Urban Development requires Commerce to ensure that CDBG Program income is used to meet a national CDBG objective of benefit to low- and moderate-income persons and, where applicable, comply with the requirements of Title 1 of the Community Development Act of 1974. In turn, Commerce requires that grantees permitted to retain program income meet these same requirements.

Program Income

Definition of Program Income

Program Income is any income generated by a grantee from a CDBG-supported activity. These funds are often received after a project has been completed and closed out and may be retained at the local level, if authorized by Commerce. When program income is generated by an activity that is only partially assisted with CDBG funds, the income shall be prorated to reflect the percentage of CDBG funds used.

Program income **includes**, but is not limited to, the following:

- Payments of principal and interest on loans made using CDBG funds, the primary source of program income.
- Interest earned on funds held in a revolving loan account.
- Proceeds from the sale of loans or obligations secured by loans made with CDBG funds.
- Proceeds from the disposition of sale or long-term lease of real property or equipment purchased or improved with CDBG funds.

Program income **does not include**, but is not limited to, the following:

- Interest earned on grant advances from the U.S. Treasury. Any interest earned on grant advances is required to be returned to the U.S. Treasury.
- Proceeds from fund-raising activities carried out by sub-recipients that are receiving CDBG assistance to implement eligible activities.
- Funds collected through special assessments that have been made to recover the non-CDBG portion of a public improvement.
- Proceeds from the disposition of real property that has been acquired or improved with CDBG funds, where the disposition occurs within a five-year period after expiration of the agreement between the grantee and sub-recipient.

- Proceeds from CDBG economic development loans that are used for economic development activities through a qualified nonprofit.

Retaining Program Income

Under the Housing and Community Development Act of 1974, a state may require a local government to return program income to the state to fund additional CDBG activities, except when the local government uses the program income to continue the activity from which the income was derived. Commerce's decision to permit the retention of program income by a local government will be based upon the adequacy of the proposed plan to expend program income in a manner which coincides with HUD requirements, while meeting community needs.

It is pertinent that the local government demonstrate that it has the capacity to set up and manage a revolving loan fund, or a program income plan for eligible activities with the approval of the Commerce.

Program Income Plan

An applicant requesting to retain program income must submit a plan for the ongoing use and administration of any program income, at the time of project closeout. For economic development projects, the program income plan or RLF plan must be submitted before loan repayments are made. Commerce's decision to permit a grantee to retain program income will be based on the adequacy of the proposed program income plan submitted.

The proposed program income plan must provide the following information:

1. Describe how the proposed use of program income will serve to address identified community needs, assist LMI persons and be in compliance with requirements of Title I and other federal and state regulations, when applicable.

2. Describe the primary elements that will make-up the Revolving Loan Program, including:
   a. Goals and objectives.
   b. Eligibility requirements.
   c. Loan review, selection and approval process.
   d. How the loans will be secured and serviced.
3. Describe the related accounting and reporting procedures which are to be used when reporting on program income and revolving loan activity.

The grantee must demonstrate that it could efficiently establish and manage a RLF.

If Commerce determines that the proposed program income plan has an inadequate level of support and time from commitment, Commerce will recover the program income and commit it to other CDBG-eligible activities.

Program Income Contractual Requirements

When Commerce determines that program income is to be retained by a grantee, the grantee should specify in their agreement with Commerce that all activities undertaken with such income will follow the provisions of the written agreement. Specific requirements are:

1. Include a statement that the financial accounting system will comply with federal and/or state guidelines.
2. Provide assurance that all unexpended funds and collectible accounts will be returned to Commerce in the event they find evidence of fraud, waste, mismanagement and/or substantial non-compliance with the program income plan.
3. Include evidence that the governing body has approved the program income plan in a manner that will legally bind the community to follow its guidelines.

4. Specific requirements may be inserted that relate to the project based on the application, other open or closed CDBG projects, current Commerce policy and the purpose of the RLF.

Distribution of Program Income

1. Distribution of program income before project closeout

All program income received prior to a CDBG project closeout must be returned to the corresponding open project fund as additional funding, and used for the same activities, before a grantee can request an additional drawdown of funds from the project account. The program income will be accounted for and reported on as an integral part of the financial transactions of the CDBG project.

2. Distribution of program income after project closeout

If there are no other open CDBG projects, all program income received after closeout of a project must be distributed to an appropriate RLF or program income account, subject to approval of a grantee's program income plan, and used to support CDBG eligible activities. The program income activity will be accounted for and reported on as a part of the financial transactions of the respective RLF.

Commerce has developed the following policies for expenditure of program income after closeout, which will meet the federal national objective of benefit to LMI persons and allow local governments some flexibility with their program income.

Eligible Uses of Program Income

1. After project closeout for the years of 1992 and prior:
   - Commerce encourages the use of program income for CDBG-eligible activities that assist a minimum of 51% LMI persons.
   - Program income should be expended on activities as specified in the local government’s program income plan and/or closeout agreement.

2. Before project closeout for the years of 1993 and later and applying only to program income managed by local governments:
   - Program income received by a grantee before closeout must be used in accordance with the provisions of Title I. As such, all the regulations and requirements that applied during the term of the project will apply to the program income received before closeout. Program income must be used for eligible CDBG activities, and a minimum of 51% of the funds must be used for activities that are clearly designated to meet identified needs of LMI persons.
3. After project closeout for the years of 1993 and later and applying only to program income managed by local governments:

Commerce has developed the following policies for expenditure of program income after close-out which will meet the federal national objective of benefiting LMI persons and allow local governments some flexibility with their program income:

- As program income is received, the following applies:
  - For CDBG housing and public facilities activities: a maximum of 15% would be allocated to an administration fund and a minimum of 85% allocated to an activity fund for each state fiscal year.
  - For CDBG economic development activities: a maximum of 18% would be allocated to an administration fund and a minimum of 82% allocated to an activity fund for each state fiscal year.
- CDBG activity funds must be used on CDBG-eligible activities that principally benefit at least 51% LMI persons. The RLF never loses its federal identity. When loans are repaid, all CDBG regulations and requirements that applied during the term of the original project(s) will apply to the RLF. Some of these requirements include meeting a national objective, public benefit standards, citizen participation and an environmental review and Davis-Bacon prevailing wage.

An important exception is that federal Title I requirements do not apply to funds which are less than $25,000 received and retained in a single year by a grantee. A grantee may use this amount for any eligible CDBG activity that benefits at least 51% LMI persons.

4. Please see “Non-Grantee Administration” below for program income managed by a qualified nonprofit rather than the local government.

Revolving Loan Fund Program

Required RLF Plan

Commerce will require a grantee that operates an RLF Program to develop a written plan for the administration of its program.

RLF Purpose

An RLF is a separate fund, with a set of accounts independent of other CDBG project accounts, established to carry out eligible housing and/or economic development activities which in turn generate program income to the fund. An RLF is the administrative umbrella for the reuse of program income in the making of low interest community loans.

Commerce will require a grantee to establish RLFs, subject to approval of the grantee's program income plan, to continue eligible CDBG activities.

A RLF may not be funded or capitalized with grant funds. However, it may be recapitalized, at the discretion of the governing body, with borrowings from commercial financial institutions or others.

RLF Guidelines

To assist a grantee in this undertaking, Commerce has developed guidelines for a loan program plan.

1. Goals and objectives

Develop a clear set of goals and objectives, which articulate in quantifiable terms the purpose of and reason for the Revolving Loan Program. The purpose of the RLF would reflect the economic conditions and opportunities in the community that the RLF is expected to address. The goals and objectives established should serve as a basis for an organizational strategy and operating plan for the reuse of program income.

2. Eligible applicants

Establish criteria for identifying eligible applicants for the Revolving Loan Program. Limited revolving loan resources may necessitate targeting of loans. Targeting of loans is a process that identifies areas of need. Needs might include targeting a specific geographic area of discrimination in lending; targeting existing businesses versus startup businesses; addressing specific industries affected by lending patterns; and addressing discrimination against women and minorities in lending.

3. Eligible and ineligible activities

Develop standards for funding eligible activities and show how they relate to the community's problems or needs and to the goals and objectives of the Revolving Loan Program. Eligible activities must meet all tests for CDBG eligibility and a national CDBG objective.

4. Eligible type of loans

Determine which type of loans are to be funded, e.g., amortized loans, deferred loans, 100% financing versus public or private partnerships, permanent versus construction loans, direct versus guaranteed, etc., and whether they will be made for the fixed-asset family and/or for working capital.

5. Financing policies

Establish the minimum and maximum dollar amount of loans; include their terms and rates of interest for repayment. Include policies for restructuring loans or modifying terms, along with any other financing policies required. Quantify acceptable levels of risk. Matching sources and uses of funds is key to the ability to revolve funds.

6. Loan review committee

Establish a loan review committee whose purpose is to make recommendations to the governing body. Ideally, its membership would also include private sector finance professionals. The committee's membership, role and responsibilities should be specified.

7. Loan review, selection and approval

Create a process for advertising the Revolving Loan Program. Establish criteria and procedures for review and approval of loan applications. This should include the following:

a. Provide justification of applicant’s need.
b. Define beneficiaries.
c. Describe what will be used for necessary or appropriate documentation, such as certifications, etc.
d. Describe the type of credit and financial analyses that will be performed on loan requests.
e. Describe the manner and time frame for disbursement of loan proceeds.
f. Indicate which loan review and/or approval functions will be delegated to staff and/or the loan review committee; describe which functions will be retained by the governing body.

8. Loan security

Secure each amortized real property loan by trust indenture, and secure each deferred real property loan that provides a contingency for repayment by lien.

Collateralize each business loan to the extent practical. The amount and quality of the collateral should be a matter of policy. The pledged collateral should be confirmed and documented as to type, quality, location, ownership and existing encumbrances.

Require each borrower, where appropriate, to protect the grantee against insurable risks. A copy of each policy underwritten should be filed with the grantee.

9. Loan servicing

Establish policies and procedures for loan repayments, loan delinquencies, loan defaults and loan monitoring, and designate who will be responsible for carrying out each of these vital functions.

10. Recapitalization strategy

Develop a recapitalization strategy and identify which other financial resources are intended to be used.

11. Title I compliance certifications

Describe the process that will be used to assure that all loan recipients will comply with the appropriate Title I compliance requirements.

General Accounting Requirements

1. Accounting standards

A grantee must demonstrate that the program income received is used solely for authorized purposes, a requirement that is best met through fund accounting. The required accounting system is the Montana BARS system for counties, cities and towns. BARS is a fund accounting system that meets all fund accounting requirements, including generally accepted accounting principles.

Fund accounting is a control device that segregates resources and ensures that the segregated resources are used only for their intended purposes.

2. Fund type to be utilized

There are a number of funds and account groups that are required to be utilized in a fund accounting system, each depending on the financial situation. However, a CDBG grantee retaining program income need only be concerned with RLFs, a subcategory of special revenue funds.

A grantee is authorized to maintain a separate RLF for housing activities and a separate RLF for economic development activities, or a grantee may opt to utilize a single RLF for all such activities.

However, it is recommended that a grantee maintain separate RLFs for eligible CDBG activities covered under 1992 and prior contracts, and separate RLFs for eligible CDBG activities covered under 1993 and future contracts.

3. Basis of accounting

The basis of accounting is a term used to refer to when revenues and expenditures, and related assets and liabilities, are recognized in the accounts and reported in the financial statements.

There are three fundamental accounting bases used to account for transactions: the cash basis, the accrual basis and the modified accrual basis. The basis for RLFs is the modified accrual basis.

Under the modified accrual basis, revenues are recognized when they become susceptible to accrual, which is when they become both measurable and available to finance expenditures of the current period. Available means collectible in the current period or soon enough thereafter to be used to pay liabilities of the current period. Expenditures are recognized when the fund liability is incurred.

4. Fund and account structure

The chart of accounts is the framework around which the accounting system is built. A chart of accounts is merely a numerical coding system that permits identification of individual accounts. It also simplifies the referencing of entries on documents and records and helps reflect account relationships.

The coding system that follows is consistent with RLF needs and is made up of fund identifiers and balance sheet, revenue and expenditure accounts.

1. Fund code identifiers

Fund code identifiers are the numerical indicators assigned to identify independent fiscal and accounting entities with self-balancing sets of accounts, consisting of assets, liabilities and fund equities.

Applicable Fund Code Identifiers	Fund Number
For the years 1992 and prior:	
Combined RLF	2392
Housing RLF	2394
Economic development RLF	2395
For the years of 1993 and future:	

Combined RLF	2396
Housing RLF	2397
Economic development RLF	2398

2. Balance sheet accounts

Balance sheet accounts are those accounts that remain open after the books have been closed at year-end, the balances of which are carried forward into the succeeding year. When properly classified, these accounts form the basis for the balance sheet. Simply, the balance sheet purports to exhibit what a fund owns in the form of assets and what a fund owes in the form of liabilities. The net result of assets minus liabilities is equity.

Applicable general ledger balance sheet accounts:

Account Number	Account Name
101000	Cash
125000	Loans receivable
172000	Revenue control
201100	Warrants payable
202100	Accounts payable
204000	Contracts/loans payable (short term)
235100	Contracts/loans payable (long term)
223800	Deferred revenue
242000	Expenditure control
271000	Fund balance

3. Revenue accounts

Revenue accounts should be classified by source. The primary function of revenue accounts is to provide a means for verifying the receipt of revenues and to furnish information for preparing financial reports. Revenue accounts are closed out at year-end.

Applicable revenue accounts:

Account Number	Account Name
362000	Miscellaneous
371XXX	Investment earnings
373010	Interest on loans
373020	Principal on loans
381XXX	Other financing sources

4. Expenditure accounts

Expenditures should be classified by function, activity and object. The function classification provides information on the overall purposes or objectives of expenditures. The activity classification provides information according to the specific types of work performed by the organizational unit. The object of expenditure relates to the article purchased or service obtained. The primary functions of expenditure accounts are to provide proper control and furnish information for preparing financial reports. Expenditure accounts are closed out at year-end.

Applicable housing expenditure accounts:

Account Number	Account Name
470200	Housing rehabilitation
470210	Administration

	100 Personal services 200 Supplies 320 Printing/duplicating 330 Advertising/publications 800 Other
470220-86X	Acquisition of property
470240-86X	Rehabilitation loans
470260-86X	Planning and management
470270-86X	Clearing and demolition
470280-86	Code enforcement

Applicable economic development expenditure accounts:

Account Number	Account Name
470300	Economic development
470310	Administration 100 Personal services 200 Supplies 320 Printing/duplicating 330 Advertising/publications 800 Other
470320-86X	Economic development loans
470330-86X	Other

5. Basic accounting records

The books of accounts maintained are assumed to be on the double-entry system. A double-entry system is defined as a system which requires that for every entry made to the debit side of an account, an entry for a corresponding amount be made to the credit side of another account.

The records required to account for program income funds are of two types: the books of original entry and the books of final entry. The books of original entry are those records in which transactions are recorded for the first time, e.g., the cash receipts journal, the cash disbursement journal and the general journal voucher. The books of final entry are the summary records in which accounting information is accumulated for financial reporting, e.g., the general ledger. In an automated environment; however, a single transaction may be recorded simultaneously in the books of original entry and the books of final entry.

The books of original and final entry are described below:

- Cash receipts journal: All cash received is recorded in this book of original entry.
- Cash disbursement journal: all cash disbursed is recorded in this book of original entry.
- General journal voucher: All transactions in place of, or supplemental to, the regular journals are recorded in this book of original entry. The voucher is a substitute for maintaining a formal general journal.
- General ledger: The general ledger is the book of final entry, where all summarized journal transactions are posted. It contains the accounts necessary to present after closing, the financial representations of the organizational unit.

It is virtually impossible to discuss the books of original entry without discussing their relationship to source documents. Specifically, source documents are documents upon which evidence of accounting transactions are initially recorded. They may be internally or externally created and are used as the source entry and support to the various books of original entry. Examples of source documents are general receipts, purchase orders, invoices, claims, payroll time records, contracts, etc.

6. Special accounting provisions

Treatment of Revolving Loans

One common approach to accounting for revolving loans is to report revenues and expenditures in a special revenue fund. The repayments of loan principal are reported as revenue. Similarly, the disbursement of loan proceeds is reported as expenditures. This approach produces a continuing cycle of revenue and expenditure as the loan revolves. For financial purposes, receivables are reported on the balance sheet with a corresponding amount of deferred revenue. Governments often favor this approach because it allows them to report cash flows related to loans in the operating statement of the same fund. Unfortunately, it is questionable whether it is appropriate to report a loan as expenditures and the repayment of principal as revenues.

An alternative approach would be to report the disbursement of loan proceeds and the repayments of loan principal as balance sheet transactions, i.e., the exchange of one type of asset such as cash for another such as receivables. Accordingly, a grantee may wish to use an enterprise fund to account for revolving loans. Because they are balance sheet transactions, the disbursement of loan proceeds and the collection of principal repayments would not be reflected in the operations of an enterprise fund. Unlike a special revenue fund, an enterprise fund is required to present a statement of cash flows.

Until authoritative literature on accounting for revolving loans is more definitive, the use of a special revenue fund, because of its simplicity, is favored over the use of an enterprise fund.

Loan Subsidiary Records

Each loan amortization schedule will serve as the individual loan receivable record. When an amortization schedule is not generated, an individual subsidiary account must be maintained for each loan.

Uncollectible Loans

- Real property loans

  Given that all real property loans will be secured by trust indentures, it would seem unnecessary to make any allowance for doubtful loans. However, any such decision will need to be based on current loan-loss experience and/or existing market conditions.
- Business loans

  Some business loans, on the other hand, will invariably become uncollectible, whether collateralized or uncollateralized. If it is probable that a loan has been impaired, then the estimated loss should be expensed as a bad debt.

  If a loan was collateralized and some recovery made, then this recovered amount should be netted against the loan loss.

There are two methods in use for dealing with losses from uncollectible loans receivable: the direct write-off method and the allowance method. Either method is acceptable, but the allowance method preferred.

7. Financial reporting requirements

The annual financial statements prepared by a grantee must present fairly its financial position and results of operations in accordance with generally accepted accounting principles, and they must include all RLFs in the following type of statements:

- The combined and combining balance sheets: all fund types;

- The combined statements of revenues, expenditures and changes in fund balances: all governmental fund types;
- The combined and combining statement of revenues, expenditures and changes in fund balances, budget and actual: all governmental fund types.

Internal Control

Internal control is recognized as fundamental and indispensable to all types of organizations. It can be defined in terms of two elements: administrative controls and accounting controls. Administrative controls are designed to encourage adherence to prescribed policies and accounting controls, which deal with safeguarding assets.

Both administrative and accounting controls are implemented primarily through:

- Developing specific written procedures that specify how activities and functions will be conducted.
- Segregating key control duties and responsibilities among different employees.
- Monitoring these procedures, duties and responsibilities to ensure conformance over time.

A grantee is responsible for establishing and maintaining an internal control structure. The objectives of internal control are to provide a grantee with reasonable, but not absolute, assurance that assets are safeguarded against loss and that transactions are executed in accordance with a grantee's authorization.

In the financial operation of RLFs, it is presumed that, as a minimum, a grantee will see that the work is properly segregated so that no one person is allowed to perform a complete cycle of operations. Where segregation of duties is not always possible because of staffing limitations, management should function in an oversight capacity.

Records Retention

The type of documents, records and reports that follow must be retained for five years. However, in the event of litigation, claims, audit or other action, such documents, records and reports must be retained until completion of the action or regular time period, whichever is later.

1. Documents
   a. Receipts
   b. Purchase orders
   c. Invoices/statements
   d. Claims
   e. Checks
   f. Warrants
   g. Budgets
   h. Contracts/agreements
2. Records
   a. Accounting
   b. Budgetary
   c. Payroll
   d. Time sheets
   e. Bank statements
   f. Minutes, loan review committee
3. Reports
   a. Financial statements, monthly and annual
   b. Budgetary, monthly and annual
   c. Payroll
   d. Annual program income activity reports
   e. Annual statistical loan reports
   f. Semi-annual loan portfolio data reports, economic development activity only

5. Other
    a. Loan applications
    b. Loan review and selection documentation
    c. Title I compliance certifications

These documents, records and reports are subject to all applicable laws and requirements relating to public access, privacy and confidentiality.

Program Income Tracking

Because Commerce has ultimate responsibility for the program income retained and used at the local level, it is required to ensure that such program income is used in a manner consistent with CDBG requirements. Commerce will institute a grantee reporting process. This will require that each local government report the total program income fund's activity for the fiscal year, July 1-June 30. Reports are due August 15 of each year. This applies to projects funded that have been closed out and/or are receiving loan repayments on a project that is not open. HUD requires that states continue to report a local government's program income balance after a project has been closed out.

For local government grantees that have economic development CDBG projects, an additional report, the loan portfolio data report, must be submitted once a year as of December 31. This report compiles loan information for all primary and secondary loans derived from the use of CDBG funds.

Commerce Reporting Requirements

The loan portfolio data report will show the source and lending activity of all program income retained and used by a grantee.

For housing RLFs, please refer to the program income reporting form. Program income activity must be reported separately for the contract years of 1992 and prior and for the contract years of 1993 and later. The compliance certification for this report must be signed by the appropriate local official. In so doing, the grantee certifies that program income was expended for eligible CDBG activities and/or the requirements of Title I.

The loan portfolio data report or the annual program income report will provide Commerce with basic information on the condition of a grantee's revolving loan portfolio for analytical review.

Non-Grantee Administration

A grantee that has an approved program income plan may contract with a nonprofit organization or bank to administer its revolving loan funds, subject to Commerce approval. Administration means accepting and carrying out responsibility for the day-to-day functions of RLFs.

For CDBG Economic Development RLFs Managed by a Qualified Nonprofit

Grantees of CDBG-ED funds can sub-grant their award to a qualified nonprofit organization to carry out community economic development projects. This process is referred to as de-federalizing the funds. By doing so, the RLF is exempt from the CDBG requirements. The local government selects the nonprofit organization to carry out the activity.

Advantages of De-Federalization

- Decreases the administrative burden on local governments to comply with the onerous CDBG requirements
- Increased flexibility in the administration of CDBG-ED RLFs
- Maximizes the flexibility of use of CDBG-ED funds, including accommodating regional approaches to the administration of lending programs
- No annual reporting to Commerce on the use of the funds

Nonprofit Eligibility Requirements

The nonprofit must meet the requirements of 105(a)(15) of the Housing and Community Development Act. The local government and prospective nonprofit will be required to document that the following requirements related to eligibility have been met:

- The organization is organized as a nonprofit under the appropriate Internal Revenue Service code for nonprofits.
- The organization is organized under state or local law to serve the community/economic development needs of communities.
- The organization is independent of the local government.
- The nonprofit will be carrying out the specified activity. For loan repayments to become de-federalized, the nonprofit will be the beneficiary of the loan.
- The activity shall not be carried out until Commerce has approved the sub-recipient agreement.

Process

Commerce awards the CDBG-ED grant to the local unit of government who, after executing the sub-recipient agreement, grants the funds to the local nonprofit organization that meets the above definition. The nonprofit lends the funds to the business, and the loan repayments are returned to the nonprofit. This loan is subject to the CDBG-ED requirements; however, subsequent loans made by the nonprofit through the repayments of the original loan are not. The local government monitors the nonprofit for compliance. Commerce monitors the local government. When the project is complete, Commerce administratively closes the project file. Reporting to Commerce on the use of the RLF is not required. Though exempt from the CDBG requirements, the nonprofit must establish policies and procedures which further economic development in the community.

A local government that has an existing RLF capitalized with CDBG-ED funds can also provide some or all its RLF to a qualified nonprofit. The nonprofit's initial use of these funds must meet all CDBG requirements and will not be de-federalized until repaid to the nonprofit. The local government can still establish requirements for re-use of the funds and require some CDBG requirements to be followed through grant agreements between the local government and the nonprofit. An RLF plan must be executed that is agreeable to the local government. The local government must also execute a sub-recipient agreement with the community development organization for management of the RLF.

Commerce encourages community development organizations and nonprofits to continue to use loan proceeds for CDBG eligible activities that benefit 51% LMI persons and to follow activities specified in the RLF plan.

A written agreement must exist between a grantee and the RLF administrator. The agreement must remain in effect during any period that the administrator has responsibility for program income activity. The minimum provisions that must be included in the agreement are a statement of work to be performed; records and reports to be maintained; requirements for how program income is to be managed; applicability of federal circulars and other such requirements; provision for termination of the agreement; and a policy on reversion of assets at termination.

A grantee must receive an annual audit report or a single audit report from the administering organization.