

Uniform Audit & Accounting Guide

For Audits of Transportation Consultants'
Indirect Cost Rates



Prepared by the American Association of State
Highway and Transportation Officials,
Audit Subcommittee
December 2001

American Association of State Highway and Transportation Officials
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Assistance and consultation provided by:

Southern Resource Center of the Federal Highway
Administration (FHWA)

and

American Council of Engineering Companies (ACEC)
Transportation Committee

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Uniform Audit & Accounting Guide

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Chapter One - Introduction, About This Guide

This guide has been developed by the American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee with assistance from the American Council of Engineering Companies (ACEC) Transportation Committee and the Southern Resource Center of the Federal Highway Administration (FHWA). The AASHTO Audit Subcommittee is comprised of the chief of audits for each state's transportation or highway department. This guide was approved by AASHTO at the organization's 2001 annual meeting and has been endorsed by the ACEC Transportation Committee.

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The purpose of the audit guide is to provide a tool that can be used by individual state auditors, consulting firms and public accounting firms that perform audits of consulting firms. The primary focus of the guide is auditing and reporting on the indirect costs and resultant overhead rates of consultants who perform engineering and engineering-related work for state Highway Agencies.

This guide is not intended to be an auditing procedures manual but rather a guide that will assist individuals in understanding terminology, policies, audit techniques and sources for regulations and specific procedures.

Note: Individual acknowledgements are included in Appendix A.

Chapter Two - Background

Most **State Highway Agencies (SHAs)** award contracts for engineering and related services using Qualifications Based Selection (QBS) procedures. Under QBS, consultant selections are based solely on elements of qualification without consideration of price. Consultants do not submit bids or priced proposals to be used as a basis for selection. Once the SHA has made a selection based on the consultant's qualifications, prices are negotiated based on the consultant's actual cost and must be a reasonable price for the work to be performed.

Federal law [23 USC Sec. 112 (b) (2) (C)] requires that contracts for engineering services be performed and audited in compliance with costs principles contained in the **Federal Acquisition Regulations (FARs)**. Because most SHAs construct highway improvements using both state and federal funds, most have state rules for selection and pricing of state-funded consultant contracts that incorporate or are similar to federal rules.

The timing and types of audits performed to meet federal requirements may vary between states and contracts depending on state procedures and other circumstances. The audits are performed to ensure that consultant contract pricing is based on actual costs incurred in compliance with the Federal Acquisition Regulations as well as specific contract provisions.

Contract Audits generally fall within the following categories.

Audit Types

INDIRECT COST RATE (COST INCURRED) AUDIT

This type of audit is performed to render an opinion on the consultant's indirect cost rate(s) for a specified period (usually a fiscal year). In addition to making sure that **unallowable** costs have been removed from overhead, the auditor must also make sure that **allowable** costs have been correctly measured and properly allocated. Rates audited are used to retroactively adjust costs previously invoiced at provisional rates to actual cost. Many SHAs also use audited indirect cost rates of the most recently completed fiscal year as a provisional rate to be used for estimating and invoicing costs on new contracts. Audit risk and materiality for this type audit would be

measured with consideration given to all contracts that may be priced using the indirect cost rate.

INDIRECT COST RATE (FORWARD PRICING) AUDIT

This type of audit is performed to render an opinion on the consultant's forward pricing indirect cost rate(s) used to prepare estimates of costs that will be incurred in future periods. Forward pricing rates are similar to cost incurred rates in that they have a **basis in historical costs**. However, forward pricing rates are adjusted to reflect estimates of future costs and activity levels to project indirect cost rates for future periods. Audits of forward pricing rates must evaluate the reasonableness of future projections as well as the accuracy of historical cost information used as the starting point for the rate development. While most contracts negotiated directly with the federal government utilize forward pricing rates, **many SHAs will only negotiate contracts using indirect cost rates based on historical information**. Audit risk and materiality for this type audit should be determined with consideration given to all contracts which may be priced using the indirect cost rate

CONTRACT PRE-AWARD REVIEW

Contract pre-award reviews are performed to evaluate the reasonableness and accuracy of a cost proposal for a specific contract. The auditor may examine the reasonableness of estimates used as well as the accuracy of estimate components that are based on current or historical costs. When conducting pre-award reviews, auditors often rely on work done in indirect cost rate audits. If other audits don't exist, auditors performing the pre-award review may examine items like indirect cost rates. Audit risk and materiality should be determined with consideration only to the contract being covered by the pre-award. Additional audit work may be necessary for very large contracts.

CONTRACT COST AUDIT

Cost audits are performed to render an opinion on cost incurred under actual cost contracts. The auditor may examine both direct and indirect costs to determine whether costs invoiced were **allowable** under applicable cost principles and treated consistently with cost accounting practices used to develop the consultant's indirect cost rate(s). When conducting "final" cost audits, auditors often rely on work done in indirect cost rate audits. In addition to using the indirect cost rate, the auditor may be able to rely on

evaluation and testing of accounting systems that were performed during indirect cost rate audits.

If other audits don't exist, auditors may consider work performed during the pre-award review. Audit risk and materiality for this type of audit should be determined with consideration only to the contract(s) being covered under the contract cost audit.

Auditing Standards

Government Auditing Standards ("Yellow Book") published by the Comptroller General of the United States of America apply to audits of government entities and government assistance paid to contractors, non-profit organizations and other non-governmental organizations. These standards are often referred to as "generally accepted government auditing standards" (GAGAS). Consultant indirect cost rate audits fall within the category of "financial related audits" under GAGAS. The audit of a consultant's indirect cost rate is an audit of a special purpose financial presentation to comply with a contractual requirement.

Chapter Three - Cost Principles

Federal Acquisition Regulations (FARs)

State Highway Agencies (SHAs) rely on the Federal Acquisition Regulations (FARs), Title 48, Chapter 1, Part 31 -- Contract Cost Principles and Procedures for guidance when negotiating costs and reviewing project proposals with consultants. The FARs contain cost principles and procedures for pricing contracts, subcontracts, and modifications to contracts. In addition, the FARs may also be used in the determination, negotiation or allowance of costs when required by a contract clause.

The following is a general discussion of applicable cost principles described in Part 31 of the FARs. This discussion is on a summary level only and is not intended to be a complete rendition of all cost principles contained in the FARs.

The provisions apply to commercial organizations, educational institutions, state, local and federally recognized Indian tribal governments and nonprofit organizations. Subpart 31.105, dealing with construction and architect-engineering contracts, states that the allowability of costs shall be determined in accordance with Subpart 31.2. For the purpose of our discussion, we will focus on Subpart 31.2 - Contracts with Commercial Organizations.

The total cost of a contract includes all costs properly allocable to the contract under the specific contract provisions. The **allowable** costs to the government are limited to those costs which are **allowable** pursuant to Part 31.

In some cases, the contracting state may enter into an advance agreement with a consultant to clarify the allocability and allowability of special or unusual costs. Subpart 31.109 provides further clarification of advance agreements, including examples of costs for which advance agreements may be important.

In the absence of any advance agreements, the auditor must determine the allowability of costs. To determine the **allowability**, the auditor should consider the following:

- 1. Any limitations set forth in Subpart 31.2 of the FARs.**

2. **Allocability;**
3. **Standards promulgated by the Cost Accounting Standards Board (CAS); if applicable, otherwise, Generally Accepted Accounting Principles and practices appropriate to the particular circumstances;**
4. **Terms of the contract; and**
5. **Reasonableness.**

A cost is **reasonable** if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. The reasonableness of specific costs is not always easy to determine since such a determination depends to some extent on judgment and interpretation of the FARs.

Reasonableness depends upon a variety of considerations and circumstances, including the following:

1. **Whether the cost is generally recognized as ordinary and necessary for the conduct of business or the contract performance;**
2. **Generally accepted sound business practices, arm's length bargaining, and federal and state laws and regulations;**
3. **The consultant's responsibilities to the government, other customers, the owners of the business, employees and the public at large; and**
4. **Any significant deviations from the firm's established practices.**

A cost is **allocable** if it is assignable or chargeable to one or more cost objectives or cost centers on the basis of relative benefits received or some other equitable relationship. A cost must be distributed in some reasonable proportion to the benefits derived. A cost is allocable to a government contract if it:

1. **Is incurred specifically for the contract;**
2. **Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or**
3. **Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.**

Costs that are expressly or mutually agreed to be **unallowable**, including directly associated costs, must be identified and excluded from any billing, claim, or proposal applicable to a government contract. A directly associated cost is any cost

which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an **unallowable** cost is incurred, its directly associated costs are also **unallowable**. The practices to account for and present **unallowable** costs are described in 48 CFR 9904.405, Accounting for **Unallowable** Costs.

In evaluating a consultant's overhead, an auditor must consider direct as well as indirect costs. A **direct cost** is any cost that can be identified specifically with a particular contract or project. Costs identified specifically with a contract or project are direct costs and are to be charged directly to the contract or project. All costs specifically identified with a project are direct costs of that project and cannot be charged to another project, either directly or indirectly. Finally, a cost cannot be charged as direct and also be included in any indirect cost pool. For reasons of practicality, any small dollar direct cost may be treated as an indirect cost if the accounting treatment is consistently applied to all projects and produces substantially the same results as treating the cost as a direct cost.

Indirect costs should be accumulated by **logical cost groupings** with due consideration of the reasons for incurring such costs. Commonly, manufacturing overhead, selling expenses and general and administrative (G&A) expenses are separately grouped. The consultant's method of allocating overhead costs should be in accordance with generally accepted accounting principles, which are consistently applied.

Some contracts may be subject to Cost Accounting Standards (CAS), which are promulgated by the Cost Accounting Standards Board (GASB), an agency of the Federal Government within the Office of Management and Budget (OMB).

A **distribution base** common to all cost objectives or projects is selected for allocation of an overhead or indirect cost pool. Typically, consultants use direct labor as the base for developing overhead rates. Once a base has been established, it should not be adjusted by removing individual components.

The **base period** for most consultants' overheads will normally be the firm's fiscal year. When a contract is performed over an extended period, as many base periods shall be used as are required to represent the period of contract performance.

Chapter Four - Cost Accounting

Allocation Bases

An allocation base is the means by which certain overhead or indirect costs are distributed to final cost objectives. There are a variety of allocation bases which are commonly used in cost accounting systems for allocating indirect costs, however, for State Highway Agency (SHA) administered engineering contracts **direct labor cost** or **usage** are recommended.

Some of the common methods include:

Direct Labor Cost

Direct labor cost is the most common and accepted base used to allocate overhead costs on SHA contracts. Direct labor costs are generally all project hours multiplied by labor rates and summarized for all employees within the applicable allocation unit. Labor rates are based on actual employee wages paid or represent wages effectively paid.

Direct Labor Hours

The direct labor hour method is another way to allocate indirect costs based on total direct hours charged in an appropriate allocation unit.

Total Labor Hours (Total Hours Worked)

This method is similar to Direct Labor Hours allocation base, except that the base includes all hours incurred for direct and indirect activities. Use of this base assumes that costs incurred benefit both direct and indirect objectives and should be allocated to the appropriate pool receiving a benefit.

Total Costs

Generally, this is the base used to allocate G & A costs. The base consists of direct labor, fringe benefits, overhead costs, associated non-salary direct expenses (including other costs sometimes referred to as internal direct expenses) and subcontract costs.

Total Cost Value Added

This basis is similar to the Total Cost base shown above to allocate G & A costs. However, the value-added basis excludes materials (used primarily in

production only) and subcontract costs. Distortion in allocations may occur due to a disproportionate amount of subcontract costs or materials in the pool.

Usage

This method allocates costs to direct or indirect activities on a common unit, usually time or quantity used. For instance, an internal cost pool such as one for computer-aided drafting and design equipment (CADD) costs can be allocated specifically as a direct cost to a project or as an indirect cost based on the number of hours actually incurred.

Cost Centers

Cost centers are established to accumulate and segregate costs.

Functional Cost Centers

This method segregates costs unique to a business activity, typically for purposes of direct costing. Examples are CADD costs, vehicles and reproduction services.

Subsidiaries, Affiliates, Divisions & Geographic

Locations

Another method is focused on the corporate structure. Some examples of cost centers used for accumulating costs are groupings of regional offices, specific subsidiaries, affiliates, divisions, or field offices.

Allocated Costs:

Fringe Benefits

Fringe benefits are the costs associated with the business' portion of payroll taxes and benefits in employment. Such costs generally include, but are not limited to: payroll taxes, pension plan contributions, medical insurance costs, life insurance and employee welfare expenses.

Overhead

Overhead costs are costs that may benefit or are associated with two or more business activities, but are not specifically allocated to an activity for reasons of practicality. Overhead differs from general and administrative costs (below) in that these costs can be associated with a unit based on benefit. Some examples of overhead costs are rent, depreciation, employee recruitment and training, and general or professional insurance policy costs.

General and Administrative

This expense generally is all costs associated with the entire business' operation, which cannot be specifically identified with a smaller unit of

business activities. Example: certain management or administration costs that are incurred for an entire business unit may be considered G & A, but other accounting or legal costs benefiting a segment of the business may be considered part of the overhead pool of that specific segment.

Computer/CADD Costs

Generally, this pool includes costs such as equipment depreciation or rental; software including license costs; employee training costs on new software; equipment maintenance; cost of special facilities or locations; and systems development labor or support costs.

Fleet or Company Vehicles

For the most part, these costs are company vehicles such as cars, survey trucks, and vans that may be used for a direct or indirect cost objective. Pooled costs may include depreciation, lease costs, maintenance, insurance and operation costs such as fuel.

Equipment

Costs accumulated to this pool are similar to both computer and company vehicle pools. Company equipment can be a wide variety of items from small to large that are used in various activities.

Printing/Copying/Plan Reproduction

Costs in this pool are generally associated with reproduction from a single page copied to multiple prints of large specialized drawings or blue prints. The pool in most cases includes equipment, labor, ink or toner, and paper supplies.

Direct Labor

Labor costs are usually the most significant costs incurred in the performance of Government contracts. Incurred labor costs form the basis for estimating labor for future contracts. It is, therefore, imperative that consultants establish and maintain a sound system of internal control over the labor charging function.

Unlike other items of cost, labor is not supported by external documentation or physical evidence to provide an independent check or balance. The key link in any sound labor charging system is the individual employee. It is critical to labor charging internal control systems that management fully indoctrinate employees on their independent responsibility for accurately recording time charges. This is the single most important feature management can emphasize in recognizing its responsibility to owners, creditors, and customers to guard against fraud, waste, and significant errors in the labor charging functions.

An adequate labor accounting system, manual or electronic, will create an audit trail whenever an employee creates a timesheet entry. A system that

allows an audit trail to be destroyed is inadequate because the integrity of the system can be easily compromised. Access to timesheets should be controlled and preprinted, if possible, with the employee's name, number and fiscal week. An inadequate system would allow employees to erase prior entries without recording the adjustment; adjustments should be maintained as part of the audit trail.

The consultant should have policies and procedures for training employees to reasonably assure that all employees are aware of the importance of proper time charging.

Uncompensated Overtime

Companies may not be required to pay overtime to salaried employees for hours worked in excess of 40 hours per week. Any hours worked by salaried employees in excess of the normal 40 hours per week are commonly called uncompensated overtime.

The consultant should have procedures to ensure that all hours worked are recorded, whether they are paid or not, to assure the proper distribution of labor costs. This is necessary because labor rates and labor overhead costs can be affected by total hours worked, not just paid hours worked.

Acceptable accounting methods for uncompensated overtime:

1. Compute a separate average labor rate for each pay period based on the salary paid and the total hours worked. Apply this rate to all cost objectives worked on during the period, including paid absences and indirect activities, to distribute the salary costs.
2. Determine a pro rata allocation of total hours worked during the period and distribute the salary cost using the pro rata allocation. If an employee worked 25 hours on one cost objective and 25 hours on another, each cost objective would be charged with one-half of the employee's salary.
3. Compute a standard hourly rate for each employee for the entire year based on the total hours the employee is expected to work during the year and distribute salary costs to all cost objectives worked on at the standard hourly rate. Any immaterial variance between actual salary costs and the amount distributed would be charged/credited to overhead. Material variances would be charged to the cost objective. Billings should be adjusted for material variances.

Any other methods would require further review to determine acceptability.

Some consultants' accounting systems may not assign costs to those hours worked by salaried employees in excess of 8 hours per day or 40 hours per week. Because there is a serious risk of mischarging costs to government contracts under these circumstances, the following methods of distributing these salary costs are **unacceptable**:

1. Distribute labor costs to only those cost objectives worked on during the first 8 hours of the day.
2. Allow employees to select the cost objectives to be charged when more than 8 hours per day are worked or the consultant has an informal policy as to how employees are to select the objectives to be charged.

Contracting state SHAs should be consulted to determine individual state interpretations where material amounts are involved.

Premium Overtime

Consultants should have the capability of maintaining records that segregate overtime premium amounts as direct or indirect costs. An acceptable method is to charge premium overtime as a direct charge when it is the consultant's regularly established policy and when appropriate tests demonstrate that this policy results in equitable cost allocations. Premium overtime should be excluded from the direct labor base.

When employees normally work on multiple contracts it is often difficult to determine which contract "caused" the overtime. In this case the overtime premium may be charged to overhead.

Other Considerations

The consultant should have procedures assuring that labor hours are accurately recorded and that any corrections to time keeping records are documented, including appropriate authorizations and approvals.

The consultant should have procedures requiring that the total labor dollars reflected in labor distribution summaries agree with the total labor charges as entered in the time-keeping and payroll systems. This reconciliation ensures the labor charges to contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records.

The consultant should have procedures requiring that direct and indirect labor costs directly associated with **unallowable** costs are identified and segregated.

Areas of Potential Risk

1. **Overrun Contracts.** When contract costs have exceeded or are projected to exceed contract value, these excess costs should not be diverted to other cost objectives such as indirect labor, overhead accounts or other contracts.
2. **Significant Increases in Direct/Indirect Labor Accounts.** Trend analyses may disclose instances where charges to direct or indirect labor accounts have increased significantly. Sufficient review should be performed to determine the nature of the increase.
3. **Reorganization/Reclassification of Employees.** The organizational structure of the consultant should be analyzed to determine if it permits inconsistent treatment of similar labor. For example, a program manager should not charge direct on cost-type contracts and indirect on fixed-price/commercial contracts.
4. **Adjusting Journal Entries/Exception Reports (Labor Transfers).** Adequate rationale and supporting documentation should be available for all significant labor transfers.
5. **Budgetary Control.** Consultants may operate management systems that require strict adherence to budgetary controls. If the system is inflexible, labor charges may have a tendency to follow the identical route of the budgeted amounts. Rigid budgetary control systems can result in predetermined labor charges.
6. **Mix of Contracts.** Costs should be identified and charged consistently in the accounting system regardless of type of contract.

Sole Proprietors' and Partners' Salaries

The compensation of owners or partners must be charged as direct labor when they are personally engaged in performing under contracts. Salaries must be determined by advance agreements or negotiation. Please refer to each individual state policy for more specific requirements regarding treatment of this compensation.

Contract Labor

In some cases firms contract for services provided by engineers, technicians, etc. rather than hire individuals as employees. This is commonly referred to as "Purchased Labor". The accounting treatment varies, depending on the circumstances under which the purchased

labor costs are incurred.

CAS 418 requires that pooled costs be allocated to cost objectives in reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where such a relationship exists and the allocation method must be consistent with the consultant's disclosed accounting practices. A separate allocation base for purchased labor may be necessary to allocate significant costs to purchased labor, such as supervision and occupancy costs, or to eliminate other costs, such as fringe benefits, that do not benefit purchased labor.

Other Direct Costs-Outside Vendors/Employee Expense Reports

Other Direct Costs typically include subcontracts, travel, long distance phone calls, and outside printing. Costs based on charge-out rates developed by the company, typically mileage and copying, are addressed elsewhere. In order to be treated as a direct cost, the item must have been needed for and used on that job, the "but-for" principle. But for this job, the cost would not have been incurred. All similar costs must also be treated as direct costs.

Field Office Rates

Field offices may exist in several forms. Regardless of the consultant's organization, consistency in allocating costs to cost objectives is critical.

A consultant's employees may work for a period of time in an on-site office maintained by the SHA. Since the consultant's employees are not working out of their own offices and are not receiving office support in their day to day activities, the hours billed for them do not qualify for the consultant's full overhead rate.

The purpose of the field rate is to pay the consultant for the fringe benefits and home office support they do provide to their field employees.

Approved costs directly identified with the project and consistently treated as direct costs in the consultant's accounting records will be allowed as direct project costs. If a cost is not specifically incurred for a project and identified with that project, it may not be claimed as a direct cost. However, it may be allowed as part of the indirect costs allocated to the field office indirect cost pool.

Field Office Indirect Costs

As a general rule, SHAs do not require extensive staffing of

consultants' field offices. Most administrative and management functions will be performed in the home or branch office. Therefore, an equitable portion of these offices' indirect costs should be allocated to the field office. The costs that are allocated and the basis for the allocation depends largely on the consultant's customary accounting practices. Some SHAs require separate cost centers for accumulation of field office costs.

Fringe Benefits. The fringe benefits applicable to the field office direct labor costs should be allocated to the field office overhead pool. If the consultant's accounting records do not maintain separate accounts for field office fringe benefits, the fringe benefits should be allocated on a direct labor basis (e.g., field office direct labor divided by total direct labor).

Indirect Labor. Indirect salaries (accounting, legal, purchasing, personnel, management, etc.) are allocated to the field office overhead pool on a direct labor basis:

$$\text{Direct Field Labor} / \text{Total Direct Labor} = \text{Allocation A}$$

This percentage is applied to expenses common to both field and home office direct labor in equal proportions. The accounts typically allocated by this percentage include indirect salaries, payroll taxes, group insurance, paid leaves, etc.

Indirect Expenses. As a general rule, home or branch office indirect expenses are allocated to the field office overhead pool on a percentage basis that is determined by dividing the allocated indirect labor by the total home or branch labor:

$$\frac{\text{Indirect Salaries} \times \text{Allocation A}}{\text{Home Office Direct Labor} + \text{Indirect Salaries}} = \text{Allocation B}$$

After the calculations are made, the allocations are applied to the various line item accounts identified in a firm's overhead schedule.

Note: An example of a Schedule of Indirect Costs including Field Office rates is included in Appendix D.

Chapter Five - Selected Items of Cost

The purpose of this chapter is to provide guidance for **selected items of cost**. It is organized by FAR Part 31.2 sub-sections in ascending order, numerically. It is not meant to be authoritative or to supersede the FARs. The entire text of the FARs should be consulted when determining proper accounting treatment (see Appendix C for sources Advertising & Public Relations (FAR 31.205-1)

Advertising Costs

The only advertising costs **allowable** are costs for:

- recruiting personnel required for performing contractual obligations;
- acquiring scarce items for contract performance;
- disposing of scrap items for contract performance;
- costs of activities to promote sales of products normally sold to the U.S. government, including trade shows, which contain a significant effort to promote exports from the United States, or
- employee recruitment costs in accordance with FAR 31.205-34.

Even those advertising costs that are **allowable** must be reasonable, allocable, and properly assigned to cost objectives.

Allowable advertising can recruit direct as well as indirect labor. Costs of recruiting employees with skills needed only for commercial contracts are **unallowable**, however. Costs are considered **unallowable** when no specific vacancies are to be filled or if the advertising done is out of proportion to the number or importance of the positions to be filled.

Trade Show Expenses and Labor

Expenses and labor pertaining to trade shows and other special events are generally **unallowable** except as described above under advertising costs to promote export sales.

Public Relations Costs

Public relations include functions and activities dedicated to enhancing an organization's image or products and maintaining or promoting favorable relations with the public.

Specifically, costs of promotional material, motion pictures, videotapes, brochures, handouts, and magazines that are designed to elicit favorable attention to the contractor are **unallowable** unless used primarily for employee training and orientation. Costs of memberships in civic and community organizations and costs of souvenirs, models, imprinted clothing, buttons and other mementos provided to customers or the public are also **unallowable**.

Allowable public relations costs include costs incurred for (a) responding to inquiries on company policies and activities; (b) communicating with the public, press, stockholders, creditors, and customers; and (c) conducting general liaison with news media and government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, and financial information.

Bad Debts & Collection (FAR 31.205-3)

Bad debts, including actual or estimated losses arising from uncollectible accounts receivable due from customers and other claims, and any directly associated costs such as collection and legal costs are **unallowable**.

Compensation (FAR 31.205-6)

Reasonableness

Costs must be reasonable in amount considering what is normal for a comparable business, the established compensation plan or practice of a given contractor, or restraints imposed by business circumstances.

The government can challenge either the reasonableness of individual components of employee compensation or the reasonableness of total compensation costs.

Incentive Compensation (Bonuses)

The following types of bonuses and incentive compensation are usually **allowable**: incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance. To be **allowable**, business or incentive compensation must be:

1. granted under an agreement entered into in good faith between the employer and the employee, before the services are rendered; **or**
2. granted pursuant to an established plan or policy followed consistently (to the point of implying an agreement).

The government sometimes challenges bonus plans that are not based strictly on production, cost reduction, or efficient performance.

Bonuses for officers of closely held corporations should be reviewed carefully to ensure they are not dividends that would be considered distribution of profits. Distributions of profits are **unallowable** for inclusion in either direct or indirect labor costs.

Compensation Limits (Executive Compensation Benchmarks)

In addition to reasonableness, executive compensation is specifically limited by the FARs and the limits can be found at the DCAA web site, **www.dcaa.mil** (see Appendix C). The Office of Management and Budget Administrator, pursuant to Section 808 of Public Law 105-85, determine these limits periodically. The term compensation includes wages, salary, bonuses, deferred compensation, and employer contributions to defined pension plans. The cost rule is applied to the senior executives at corporate offices and business segments. **Maximum limits** for contract costs incurred after the following effective dates are as follows:

Compensation Maximum Limits:

July 1, 1996	\$200,000
January 1, 1997	\$250,000
January 1, 1998	\$340,650
January 1, 1999	\$342,986
January 1, 2000	\$353,010
January 1, 2001	\$374,228

Pension Plans

Pension plan expenses are complicated so that FARs, IRS regulations and CAS regulations must be carefully reviewed in order to determine allowability of costs. Generally, a pension plan is a deferred compensation plan that provides for systematic payment of benefits that are paid for life, or gives employees the option for benefit payments for life. **Qualified pension plans** are definite written programs that meet the criteria as set forth by the Internal Revenue Code. All other pension plans are considered **unqualified pension plans**. Costs for either types of plans may be allowable depending on the specific circumstances.

One of the critical FARs requirements is that, for pension costs to be **allowable** in the current year, they must be funded by the due date for filing the federal income tax return. Pension costs assigned to the current year but not funded on time are **unallowable** in any subsequent year.

The amount contributed to qualified pension or profit sharing plans on behalf of principals and employees is **allowable**. However, the payments must be reasonable in amount and be paid pursuant to an agreement entered into in good faith between the contractor and employees, before the work or services are performed and pursuant to the terms and conditions of the established plan.

Costs of changes that are discriminatory to the government or that are not intended to be applied consistently in the future are **unallowable**. One-time-only pension supplements not available to all plan participants are generally **unallowable**, unless the supplemental benefits represent a separate pension plan and the benefits are payable for life at the employee's option. Increased payments to retired participants for cost-of-living adjustments are **allowable** if paid in accordance with a consistent policy or practice.

Employee Stock Ownership Plans

Employee stock ownership plans (ESOPs) are an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. The contractor's contributions to an employee stock ownership trust (ESOT) can be in the form of cash, stock, or property. The purpose of an ESOP may be for deferred compensation or for a supplementary pension plan; each would be covered by different regulations.

Severance Plans

Severance pay or dismissal wages are extra payments made to employees whose employment is involuntarily terminated. Severance pay does not include payments under early-retirement incentive plans.

Severance pay is **allowable** only when payment is required by (1) law, (2) employer-employee agreement, (3) established policy that is, in effect, an implied agreement on the contractor's part, or (4) circumstance of the particular employment. Normal severance pay relates to recurring, partial layoffs, cutbacks, and involuntary separations and is an **allowable** cost when properly allocated.

“Normal severance” refers to routine employee terminations. **“Abnormal severance”** refers to any mass termination of employees, which is usually unpredictable. Actual costs of normal severance pay must be allocated to all work performed at the contractor's facility. Accruals of normal severance pay are acceptable (1) if the amount is reasonable in light of prior experience, and (2) if it is allocated to both government and nongovernment work. Abnormal severance, however, is **unallowable** as an accrued cost because of the conjectural nature of the cost.

Special compensation to terminated employees after a change in management control is **unallowable** to the extent that it exceeds normal severance pay (“golden parachute”). Special compensation contingent on the employee remaining with the organization after a change in management control is also **unallowable** (“golden handcuff”).

Personal Use of Company Vehicles

This cost is **unallowable**, including the portion of cost related to transportation to and from work.

Contributions or Donations (FAR 31.205-8)

Contributions in the form of cash, property and services are **unallowable** except for costs of participation in community services such as blood bank drives, charity drives, disaster assistance, etc..

Cost of Money (FAR 31.205-10)

This is an imputed cost related to investment in facilities used in contract performance whether the source of the investment is equity or borrowed capital. The resulting cost of money is not a form of interest on borrowing.

The costs of the capital investment must be determined, measured and allocated to contracts in accordance with CAS 414.

The estimated facilities capital cost of money **must** be specifically identified in the cost proposals relating to the contract under which the cost is to be claimed.

Accounting for the facilities cost of money is generally through a memorandum entry of the cost. The contractor must maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry fully.

The cost of money rate is the arithmetic mean of the interest rates specified by the Secretary of the Treasury. These are published in the Federal Register around January 1 and July 1. For a fiscal year ending December 31, the arithmetic mean would be the simple average of the rates for the January 1 through June 30 period and the July 1 through December 31 period.

The average book value of the investment base is multiplied by the cost of money rate. The resultant value is divided by the allocation base units (such as direct labor hours, or dollars of total cost input) for the corresponding indirect cost pool.

Appendix A to CAS 414 contains the form for Facilities Capital Cost of Money and Appendix B to CAS 414 contains a detailed example in which the total cost of money on facilities capital is computed on a step-by-step basis.

Employee Morale, Health & Welfare (FAR 31.205-13)

Employee welfare and morale expenses incurred on activities to improve working conditions, employer-employee relations, employee morale, and employee performance are **allowable**. Expenses and income generated by employee welfare and morale activities should be in compliance with FARs 31.205-13. Note that employee morale type expenses are often covered by the entertainment cost principle, 31.205-14. FAC 90-31, effective October 1, 1995 clarified that entertainment costs are **unallowable** under any cost principle, without exception. Consequently, the entertainment cost principle at FARs 31.205-14 takes precedence over any other cost principle.

Although gifts are an expressly **unallowable** expense, the cost principle **specifically excludes two categories** of awards from the **unallowable** gift definition:

1. Awards covered by the compensation cost principle FAR 31.205-6; and
2. Awards made pursuant to an established plan or policy for recognition of employee achievements.

Recreation expenses are an expressly **unallowable** expense unless the cost claimed meets the following criteria:

1. The cost is for employee participation in a sports team or employee organization.
2. The team or organization is company sponsored.
3. The team's or organization's activity is designed to improve company loyalty, team work, or physical fitness.

Costs incurred for employee welfare and morale, less credits for income generated by these activities, are **allowable** to the extent that the net amount is reasonable. Reasonableness is considered in nature and amount both for the contractor as a whole and for the employee(s) benefited by the expenditure.

Whether or not the IRS has recognized certain costs as deductible business expenses for Federal income tax purposes is not necessarily determinative of their allowability under government cost-reimbursement type contracts where such costs fail to satisfy allowability or reasonableness criteria.

Types of activities that fall under this subsection are very restrictive and limited. Examples of **allowable** activities are house publications, health clinics, wellness/fitness, employee counseling services, and food and dormitory services.

Entertainment (FAR 31.205-14)

Costs of amusement, diversions, social activities and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation,

and gratuities are **unallowable**. Costs of membership in social, dining, country clubs or other organizations having the same purposes are also **unallowable**, regardless of whether the cost is reported as taxable income to the employees.

Fines & Penalties (FAR 31.205-15)

Costs of fines and penalties resulting from violations of, or noncompliance with, Federal, State, local or foreign laws and regulations, are **unallowable** except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.

Bid & Proposal (FAR 31.205-18)

The composition of bid and proposal costs is often a key issue. Although marketing costs are very similar to bid & proposal costs, basic bid & proposal costs are incurred in preparing specific documents, whereas selling and marketing costs are more general in nature. Therefore, a contractor should establish procedures for segregating bid & proposal costs from selling and marketing costs.

Bid & proposal costs are **allowable** and should be treated as indirect costs unless the contract requires submission of a proposal for subsequent work and authorizes the costs to be charged directly to that contract.

Pre-contract costs are those costs that are considered as part of the **direct costs** of the contract, but are incurred prior to execution of the contract. These costs are **unallowable** as indirect costs.

Insurance, Key-Man Life & Re-Work (FAR 31.205-19)

“Key-man life insurance” is insurance on the lives of officers, partners or proprietors and it is considered an **unallowable** expense unless the insurance is included as additional compensation.

“Re-work insurance” is casualty insurance to protect the contractor against the costs of correcting its own defects, and is considered **unallowable**.

Interest Costs (FAR 31.205-20)

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, costs of preparing and issuing stock rights, and directly associated costs are **unallowable** except for interest assessed by state or local taxing authorities under the conditions specified in 31.205-41.

Lobbying Costs (FAR 31.205-22)

Lobbying and political activity costs are generally **unallowable**. Some examples of these types of costs are activities that attempt to influence the outcomes of Federal, state or local elections, contribute to political parties or organizations,

influence Federal, state or local legislation, influence legislative liaison activities or influence employees of the executive branch of government.

Certain activities **may be allowable** if detailed records are maintained. They may include activities such as testifying at hearings, providing technical information on topics directly related to contracts, or lobbying activities that may directly reduce contract cost.

Losses on Other Contracts (FAR 31.205-23)

Any excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts) is **unallowable**.

Organization & Reorganization (FAR 31.205-27)

All expenditures in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, or raising capital are **unallowable**. The exception to this is under (b), the cost of activities primarily intended to provide compensation. These costs will not be considered organizational costs but are governed by FAR 31.205-6.

The rationale for disallowing these costs is that the government entered into a contract with a specific entity considered competent to perform the work and should not reimburse the costs of corporate changes not incident to contract performance.

Patent Costs (FAR 31.205-30)

Patent costs not required by the government contract are **unallowable**.

Certain costs **may be allowable** if they are incurred as a requirement of a government contract. They include costs such as preparing disclosures, filing documentation, searching records and counseling related to general patent matters.

Retainer Agreements (FAR 31.205-33)

Work performed by professionals and consultants with special skills are **allowable** but must be supported by detailed evidence of the nature and scope of the work performed. However, retainer agreements which are not based on specific statements of work performed are **unallowable**.

Relocation Costs (FAR 31.205-35)

Certain costs of relocating permanent employees are **allowable** if numerous requirements are met. **Some examples** of the conditions which would cause the costs to be **unallowable** are:

- mortgage-related costs if employees were not homeowners prior to the move
- if the move was for a period of time less than 12 months

- the move does not benefit the employer
- employer does not have a consistent relocation policy for all employees
- costs represent loss on sale of a home
- continuing mortgage principal payments on sold residence

Rent/Lease (FAR 31.205-36)

The most common form of renting or leasing real or personal property is via an **operating lease** where the consultant pays rent to a third party at prevailing market rates. These costs are generally **allowable**.

However, in some cases, property is considered a “purchased asset” and must be accounted for as a **capital lease**. In the case of a capital lease the capitalized value of the assets must be distributed over their useful life as depreciation charges, or over the term of the lease as amortization charges. Criteria were established by FAS-13 in paragraph .007, which classifies leases. If a lease meets one or more of the following four criteria, the lease shall be classified as a **capital lease**. Otherwise, it shall be classified as an **operating lease**.

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease is equal to 75% or more of the estimated economic life of the leased property.
4. The present value at the beginning of the lease term of the minimum lease payment (with certain exclusions) equals or exceeds 90% of the fair value of the leased property to the lessor at the inception of the lease over any related investment tax credit retained by the lessor and expected to be realized by him.

Common control is another important issue when considering the allowability of rental costs. Charges in the nature of rent for property between any divisions, subsidiaries, or organizations under common control, are **allowable** to the extent that they **do not exceed the normal costs of ownership**, such as depreciation, taxes, insurance, facilities capital cost of money, and maintenance, provided that no part of such costs shall duplicate any other allowed cost.

Selling Costs (FAR 31.205-38)

Selling costs are **allowable** if reasonable.

Selling and marketing costs cannot be adequately identified by mere reference to account titles. Such a shallow analysis is not sufficient to assess the allocability and allowability of costs within an account. The actual composition of the account or the activities it represents must be known and analyzed.

Any selling and marketing costs are subject to government challenge if the costs can be considered unnecessary for government contracts. In determining the reasonableness of selling costs, the government considers the nature and amount of the expense in light of the expenses that a prudent individual would incur in a competitive business, the proportionate amounts expended as between government and commercial business, the trend and comparability of current costs with historical costs, the general level of selling costs in the industry, and the nature and extent of the selling and marketing efforts in relation to the contract value.

Some states have more specific policies regarding selling costs and state that “general sales promotion” costs shall include/encompass any activity conducted by a company that is meant to call attention to or enhance the image of the company, its products and/or services. Any cost associated with such activity shall be **unallowable**.

Travel Expenses (FAR 31.205.46)

Travel expenses, based on their nature and purpose may be **allowable** as either indirect or direct. Travel costs incurred in the normal course of overall administration of the business are **allowable** and shall be treated as indirect costs. Travel costs attributable to specific contract performance are **allowable** and may be charged to the contract. Costs for transportation may be based on mileage rates, actual costs incurred, or on a combination thereof; costs of lodging, meals and incidental expenses may be based on per diem, actual expenses, or a combination thereof, provided the method used results in a reasonable charge as provided in **the Federal Travel Regulation (FTR)**.

Costs shall be **allowable** only if the following information is documented:

- Date and Place
- Purpose of Trip
- Name of personnel or relationship to the contractor
- For transportation costs a log must be maintained

Legal Costs (FAR 31-205-47)

Costs incurred in connection with any proceeding brought by a Federal, state or local government for violation by the consultant of a law or regulation are often **unallowable**. The FARs provide specific criteria. Costs of legal, accounting, etc. that arise as a result of a dispute between consultants that are partners in a joint venture, or similar shared interest arrangement, are **unallowable**. This FARs section also requires that these costs, including directly associated costs, which may be unallowable, be segregated in the accounting system.

Business Combination Costs (FAR 31.205-49 &-52)

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. These combinations are classified as mergers or consolidations and are accounted

for as purchases or pooling of interests. The purchase method accounts for a business combination as the acquisition of one company by another (merger). Any difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill.

Costs for amortization, expensing, write-off, or write-down of goodwill (however represented) are **unallowable**.

When the purchase method is used, **allowable** costs for amortization, cost of money and depreciation are limited to the amounts that would have been allowed had the combination not taken place. Consultants must maintain detailed records which identify and track elements of costs for future reporting periods.

Alcoholic Beverages (FAR 31-205-51)

Costs of alcoholic beverages are **unallowable** and consultant's records should clearly segregate these costs and exclude them from the indirect cost schedule.

Chapter Six - Management's Responsibility for Accounting Records

It is the responsibility of management of companies involved in government contracts to prepare timely, accurate financial statements. In most cases special schedules and disclosures will be required in addition to normal annual financial statements, prepared for stockholders, for lending institutions or for internal management.

Schedule of Indirect Cost

This schedule is the primary financial statement for determining the indirect cost overhead rate. It will be developed from financial statement and/or general ledger amounts as well as from amounts in the contractor's cost accounting system. This schedule must be in agreement with or reconciled to financial statement and/or general ledger amounts.

The schedule should clearly display the **unallowable** amounts that have been removed from the indirect expense accounts, or state that the amounts are "net of **unallowable** costs."

Direct labor should be included as a separate line item and must be in agreement with general ledger and/or project accounting records.

Other items, such as Facilities Capital Cost of Money, may be shown as required by individual states.

The Schedule of Indirect Costs or accompanying notes should show the calculation of the overhead rate. In some cases multiple overhead rates will be shown such as functional rates for segments of the business, or rates for separate subsidiaries.

It should be emphasized the consultant is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles. Examples of supporting documentation include time sheets and usage logs. Costs which are not adequately supported may be disallowed all or in part by the auditor. When accounting practices are inconsistent with the FARs, costs resulting from such practices shall

not be allowed in excess of the amount that would have resulted from those consistent with the FARs.

The consultant is responsible for maintaining consistency in estimating, accumulating and reporting costs. All projects should benefit from the same accounting procedures and processes.

Unallowable Costs

FARs 31.201-6 requires that **unallowable** costs and any directly associated cost be identified and excluded from billings, claims or proposals for government contracts. In addition, **unallowable** costs must participate in indirect cost allocations just as they would if they were **allowable**. See **Appendix D** for a list of **common unallowable costs**.

Consultants are to maintain adequate records to establish and maintain the visibility of identified **unallowable** costs including directly associated costs. If a directly associated cost is included in a cost pool that is allocated over a base that includes the **unallowable** cost with which it is associated, the directly associated cost should remain in the cost pool. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as **unallowable** costs.

Salary expenses for the time employees participate in activities that generate **unallowable** costs should be treated as directly associated costs provided the costs are material. Time spent by employees outside the normal working hours would not be considered unless the employee engaged in those company activities so frequently outside the normal working hours that it would indicate that the activities are a part of the employee's regular duties.

Financial Statements

Financial statements will vary depending on the company ownership, organization, size, etc.. Publicly-held companies will generally have audited financial statements which includes the opinion of the CPA firm. Other entities may also have audited financial statements to serve the needs of lending institutions, owners, government agencies, etc.

Many smaller firms will have financial statements which are compiled by accounting firms. In many cases, the accounting firms will also assist in preparing the Schedule of Indirect Costs.

In some cases, the financial statements will be prepared by internal accounting or management personnel.

In all cases the financial statements should include representations from management that the amounts are timely, accurate and in compliance with regulations that apply to their individual circumstances.

Disclosures

Disclosures are generally included with financial statements. They would include explanatory information about the financial data. Disclosures may describe the types of accounting systems and methods. They may describe the types of operations or contracts. A schedule of principal owners is often included.

The disclosures should describe if the statements are, or, are not, in compliance with authoritative pronouncements such as GAAP, FARs, etc.

Extraordinary events that may have a material impact on the financial statement amounts should be disclosed.

Management Representations

In working with consultants it is important for auditors to obtain written representations from management personnel. Specific representations will vary depending on the circumstances as well as other available information, such as audited financial statements. For indirect cost overhead audits, auditors should request representations such as:

- the financial information is **accurate**
- the financial information is **complete**
- the information is in **compliance** with government regulations (i.e. FARs)
- estimates are based on **sound** financial data and **consistent** assumptions

In some contract audit environments, a management-certified cost proposal may be the starting point for the audit and serves as management's representation. The auditor should consider obtaining additional representations on matters that arise during the course of the audit.

Chapter Seven - Audit Considerations

Audits of consultant indirect cost rates present unique and significant issues that auditors must consider when planning and performing audits. For detailed information and guidance, the reader should refer to the following publications:

- Government Auditing Standards (GAO “Yellow Book”) and Generally Accepted Auditing Standards
- Audits of Federal Government Contractors (AICPA)
- Consideration of the Internal Control Structure in a Financial Statement Audit (AICPA)

It must be emphasized that auditors **must exercise significant judgment** in planning and performing audits and take into consideration the unique circumstances involved with each government contractor and associated accounting systems. A wide variety of tools and publications may be helpful in determining the appropriate audit procedures, testing methods and reporting formats.

Auditors must consider specific government regulations and individual contract provisions when designing and performing audit procedures.

Internal Controls

Management is responsible for maintaining an **effective internal control structure**. The unique requirements of cost-based government contracting require cycles and elements of internal control which must be evaluated as part of an audit. The following important elements must be considered in the auditor’s evaluation of internal control on a consulting firm:

- Systems for monitoring compliance with government procurement regulations
- Estimating systems and proposal preparation practices
- Contract cost accounting practices
 - Systems for tracking and allocating labor cost
 - Systems for allocating non-labor direct costs

- Systems for allocating costs through cost centers
- Billing procedures and controls
- Miscellaneous Revenues/Credits
- Change order identification, pricing, and reporting
- Cost aspects of related-party and interorganizational transactions

Compliance with government procurement regulations is an important aspect for government contractors. Examples include compliance with Cost Accounting Standards (CAS) and Federal Acquisition Regulations (FARs). Controls must be in place that are designed to provide reasonable assurance of compliance with applicable regulations. Management must ensure that employees are made aware of compliance policies and that procedures are carried out and updated as regulations change.

Controls over estimating systems and preparation of proposals are important so that management's risk of loss when signing a contract is minimized. The controls ensure that reliable cost estimates support contract proposals, that the cost data are accurate, current and complete, that the source of cost data is well documented. The estimating process should be consistent and written policies and procedures should be maintained.

Contract cost accounting practices and systems are critical for government contracting. Well-controlled systems ensure that costs are distributed to cost objectives accurately and form a basis for comparing actual costs with estimated costs. Maintaining adequate controls provides reasonable assurance that:

- Costs are accurately distributed to cost objectives
- Costs are reasonable and in accordance with contract provisions
- **Unallowable** costs are segregated
- Cost-allocation practices are reasonable and in conformity with applicable CAS/GAAP
- Costs incurred on all projects are periodically reconciled to financial statements

Accounting for labor accurately is paramount to accurate cost-based accounting. Detailed records must be maintained, accumulated and controlled to ensure that both the **direct labor** and **indirect labor** amounts are accurate. Procedures must be in place to ensure that direct labor charges are distributed to respective contracts. Indirect labor must be captured and assigned to appropriate indirect labor categories. The total of direct labor plus the indirect labor displayed in the general ledger must reconcile to the overall labor recorded in the payroll system for the period.

Other areas where management must devote significant attention include:

Disbursements/Expenditures, Allocations of Other Direct Costs, Billing

Procedures, Related Party Transactions and Interorganizational Transfers.

Systems must be in place to ensure accurate recording of transactions. Controls must exist to insure that entries are reviewed and approved and that errors are promptly corrected. Management must maintain records to support the transactions and provide for an audit trail. Where integrated accounting systems are in place, management must have procedures to ensure that transactions are accurately recorded, summarized and transferred through the systems.

Understanding the Consultant's Business

The auditor should obtain an understanding of the consultant's business. The following are examples of categories of information that may be obtained, as appropriate, and considered by the auditor in planning the engagement:

- The consultant's products and services, including the relationship of those products and services to cost-based government contracts
- The nature, size, and location of the consultant's operations
- Mix of government and commercial business
- Competition in the industry
- Types of contracts (lump sum, cost plus fixed fee, time & materials)
- The consultant's accounting policies and procedures
- Key data for significant contracts including the following:
 - Government Agency or Department
 - Type of Contract
 - Contract Price
 - Revenues, costs and profit/loss recognized to date
 - Incentive, escalation, or other relevant contract provisions
- Government Regulations affecting contract accounting such as state cost principles
- Key changes in operations, systems or segments of the business
- CAS Disclosure Statement and Revisions if applicable
- Key information-processing systems
- Related party and interorganizational transactions
- Litigation, claims and disputes
- Prior audited indirect cost rates
- Prior filings with the SEC such as Form 10-K
- Minutes of the meetings of the board of directors
- Federal & State income tax returns
-

Consideration of Other Financial and Contract Audits

Information may be obtained from the contractor pertaining to other audits. These may include Audited Financial Statements (by CPA firm), audits by other SHAs, audits by local government agencies, audits by federal government agencies (i. e.

Defense Contract Audit Agency), or financial statement compilations/reviews by CPA firms.

Electronic Data Processing

The use of computers in the business environment is commonplace and is dynamic and rapidly changing. Therefore, the auditor must carefully assess the impact on the control environment. Accounting records may be maintained on a wide range of equipment including large host-based systems, networked environments, stand-alone PC applications and in some cases outside vendors (i.e. payroll services). The use of the Internet is now common for transmitting data or for accessing regulations and other information involved in government contracting.

The auditor must apply the same standards for controls in highly automated or manual systems. However, the audit tests may vary significantly depending on the level of automation and integration of the systems. In certain instances auditors may need to employ experts to properly assess the internal controls. Particular attention should be focused on the contractor's internal controls as new automated accounting systems are implemented or significant upgrades are performed on old systems. Contractor personnel must be adequately trained on new systems and be knowledgeable of the impact of control procedures.

Audit Risk and Materiality

Audit risk involves the possibility that the auditor's testing and review may not detect material misstatements, mischargings or violations of government regulations. If the auditor's assessment of internal control risk is low, he/she may decide to accept a higher level of "detection risk" by limiting the audit procedures. When the internal control risk is considered to be high, the auditor will perform a greater amount of testing in order to reduce the detection risk.

When making risk assessments, auditors must consider materiality. This is a highly judgmental area but auditors are able to set reasonable levels of risk based on setting levels of materiality. GAGAS 4.8 states:

“Auditors’ consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements.”

Persons who rely on consultant indirect cost rates often expect a greater degree of accuracy than users of general purpose financial statements. GAGAS 4.9 points out that audits of entities receiving government assistance may require lower materiality levels than normally found in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.

Type and Volume of Contracts

The level of risk to a consultant varies depending on the type of contract (i.e. fixed-price-type or cost-type contracts). The audit emphasis changes depending on the

types of contracts or the mix of contract types. If the consultant has primarily fixed-price (lump sum) contracts, the auditor would place more emphasis on the contractor's estimating procedures as well as those controls which are designed to ensure that all direct costs are excluded from indirect costs. If the consultant has primarily cost-type contracts the emphasis would be on allowability and determination that costs recorded are not in excess of specific contract limitations. Consultants with a mix of fixed price and cost type contracts require special emphasis on consistent allocation of costs regardless of whether contract revenues are based on cost incurred.

The relationship of a consultant's cost based government contracts to total contracts may have several impacts on the audit. Not only does this relationship impact the auditor's assessment of audit risk through materiality, the level of cost based contracts may have a significant impact on the control environment and management's commitment to internal control aspects unique to government contracting.

Chapter Eight - Audit Procedures

General

The following guidelines should be considered when developing specific audit procedures for consultant overhead rate audits.

Labor Costs

In the majority of consultant contracts labor is the largest single component of cost. This component is made up of direct labor charges to the contract and indirect labor charges allocated to the contract through a factor or rate.

Verification of labor costs begins with the examination of the internal control structure and testing of those controls as discussed in Chapter 7. Once this assessment has been made the auditor can determine the size and depth of the audit sample for labor testing.

1. The labor sample should be tracked from employee time records to:
 - The payroll records to assure hours recorded are paid.
 - The cost system to assure hours are posted properly to jobs.
 - The general ledger to assure that the total posted is recorded in the financial accounting system.
2. The overall labor in general ledger accounts should be reconciled to:
 - The job cost system
 - The payroll reports submitted to the Internal Revenue Service (i.e. 941's).
3. Audit procedures should also determine if the labor accounts and individual time card entries sufficiently screen labor to:
 - Determine the allowability of payroll cost. (i.e. Do the records separate excess compensation and time spent on **unallowable** activities?)
 - Determine the proper allocation of labor. (i.e. Do the records charge all labor performed on similar tasks the same way?)
 - Determine if labor is posted in a manner from which the labor base can be computed. (i.e. If the base is direct labor

without premium overtime do the records accumulate direct labor and direct premium overtime?)

Allocated Costs

Cost centers are developed to capture costs associated with a single purpose. The costs are assigned to objectives based on unit charges. Examples of categories for individual cost centers are printing, computers and vehicles. The over/under allocation of costs is usually handled as an adjustment to the overhead pool, which is where the cost would have been charged if it had not been directed to the cost center. If the over/under allocation is significant, consideration should be given to adjusting the contract charges.

Some accounting systems will attempt to adjust the unit charge rate for the over/under allocation of the cost centers. The goal of any cost center is to minimize the over/under allocation by the application of a properly estimated unit charge.

Audit issues of particular concern are:

1. Costs posted to the center are properly **allocable**. *Do the costs belong to the function being priced?*
2. Costs posted to the center are **allowable**. *Do the costs exclude interest, profit or other costs excluded under the FARs?*
3. The unit charge records indicate the consistent assignment of all similar charges to projects.

Item three is the one most often overlooked by firms and can result in substantial adjustments.

Some firms do not choose to set up cost centers. These firms estimate the cost of providing certain services by pulling just certain elements from ledger accounts (i.e. automobile depreciation from a general ledger depreciation account). Once established, these unit charges are offset to overhead as they are utilized on projects. This type of costing is less precise and should not be utilized if the unit charges being accumulated are significant to the firm's overall operation.

Other Direct Costs

Invoices received from vendors or employees support these costs. They are processed through the cost accounting system and assigned directly to a project. The costs are not included in the overhead pool. Direct accounts should be established in the General Ledger and all similar costs should be posted to the accounts. Some examples are: project travel, vendor printing, employee mileage, rented vehicles and equipment, and subcontracts.

The audit procedures for these costs concentrate in two areas. The first area is the direct cost accounts themselves. The procedures are:

- Determine if costs are posted to the proper account and assigned to the correct projects.
- Determine if the costs are **allowable** in accordance with the contract and FARs.

The second area would concentrate on the overhead accounts. The accounts tested would be the ones similar in nature of cost to those charged to the direct accounts. The main audit efforts should be concentrated on:

- Determine if costs are consistently allocated to projects when they are incurred for similar purposes.
- Determine if costs are priced consistently to direct and indirect cost objectives.

Other Audit Procedures

Specific additional audit procedures are dependent upon the individual firm being audited. Certain audit steps that may be required for one firm are not necessary for another.

Several of these areas can be identified by a comprehensive preliminary review of the following information:

1. A detailed overhead rate schedule is needed to assure the auditee has separated **unallowable costs** as required by FARs.
2. An accounting and control survey is needed which will answer questions about possible areas of concern. Examples are:
 - Gains or losses on assets
 - Personal use of autos
 - Transactions with common control entities
 - Bonus plans
 - Direct costing policies
 - Acquisitions and re-structuring
 - Depreciation schedules
3. A tax return prepared for the fiscal year(s) being audited. Many areas addressed in the return are of concern to the Internal Revenue Service as well as for government contracting.
4. A disclosure statement (required by Cost Accounting Standards) when federal contracts exceed a given amount as follows:
 - \$25 million per single contract, or
 - \$25 million in CAS-covered contracts with at least one single award exceeding \$1 million

Chapter Nine - Reporting & Report Disclosures

Audit reports may take a variety of formats and styles. **When performing indirect cost audits, the auditor shall prepare a Report on the Statement of Indirect Costs and a Report on Internal Controls. The following represent samples of these reports we recommend for use by state transportation department auditors and public accounting firms when performing indirect cost audits of engineering consulting firms.**

The American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee and the American Council of Engineering Companies (ACEC) Transportation Committee have prepared and approved for use the following indirect cost rate audit report format for engineering consulting firms. The uniform use of this report format by state highway and transportation department auditors and public accounting firms will greatly enhance the understanding and utility of these reports when distributed to the consulting firms and the federal, state and local agencies who contract for their professional services.

It is important for the auditor to understand that each indirect cost audit must be conducted in accordance with Generally Accepted Auditing Standards and the financial audit standards contained in the Government Auditing Standards issued by the Comptroller General of the United States of America. Also, the schedule of indirect costs must be prepared in accordance with the accounting principles prescribed in Part 31 of the Federal Acquisition Regulations.

Report on Schedule of Indirect Costs

INDEPENDENT AUDITOR'S REPORT ON THE SCHEDULE OF INDIRECT COSTS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs for the fiscal year ended December 31, 1999. This statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the Government Auditing Standards issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Schedule of Indirect Costs. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying statement was prepared on a basis of accounting practices prescribed by Part 31 of the Federal Acquisition Regulations (FARs) and certain other federal and state regulations as discussed in Note 2, and is not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the statement referred to above presents fairly, in all material respects, the direct labor, fringe benefits and general overhead of the Company for the year ended December 31, 1999 on the basis of accounting described in Note 2.

In accordance with the Government Auditing Standards we have issued a report dated April 4, 2000 on our consideration of the Company's internal controls and its compliance with laws and regulations.

This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulations and should not be used for any other purpose.

Bob Brooks, CPA, Director
External Audit Branch

April 4, 2000

Report on Internal Control: No Reportable Conditions

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROLS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs of the Company for the fiscal year ended December 31, 199x, and have issued our report thereon dated April 4, 2000. We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the Government Auditing Standards issued by the Comptroller General of the United States of America.

Compliance

As part of obtaining reasonable assurance about whether the Company's schedule is free from material misstatement, we performed tests of the Company's compliance with certain provisions of laws, regulations and contracts, including the provisions of the applicable sections of Part 31 of the Federal Acquisition Regulations, noncompliance with which could have a direct and material effect on the determination of the schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the schedule and not to provide assurance on internal control over financial reporting.

The management of the Company is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control over financial reporting. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with the Federal Acquisition Regulations Part 31. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate. For the purpose of this report, we have classified the significant internal controls over financial reporting in the following categories: cash disbursements and payroll.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal controls over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulations, and should not be used for any other purpose.

Bob Brooks, CPA, Director
External Audit Branch

April 4, 2000

Report on Internal Control: With Reportable Conditions Which are Material Weaknesses

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROLS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs of the Company for the fiscal year ended December 31, 199x, and have issued our report thereon dated April 4, 2000. We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the Government Auditing Standards issued by the Comptroller General of the United States of America.

Compliance

As part of obtaining reasonable assurance about whether the Company's schedule is free from material misstatement, we performed tests of the Company's compliance with certain provisions of laws, regulations and contracts, including the provisions of the applicable sections of Part 31 of the Federal Acquisition Regulations, noncompliance with which could have a direct and material effect on the determination of the schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the schedule and not to provide assurance on internal control over financial reporting.

The management of the Company is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control over financial reporting. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with the Federal Acquisition Regulations Part 31. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate. For the purpose of this report, we have classified the significant internal controls over financial reporting in the following categories: cash disbursements and payroll.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our study and evaluation disclosed the following condition in the system of internal accounting control of the Company, which we consider to be a material weakness as defined above.

[Describe the condition]

This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulations.

Bob Brooks, CPA, Director
External Audit Branch

EXAMPLE : MATERIAL WEAKNESSES

Note: This page is added to the introductory page of the report to describe the conditions that lead to the material weaknesses.

Accounting Records and Financial Statements:

Accounting records are not closed out and reconciled on a regular basis. The Consultant's accounting package contains few Internal Controls. Record-keeping errors have gone undetected because of a lack of oversight reviews of accounting activities. Financial statements are not prepared on a periodic basis during the year and are generally not prepared by the outside accounting firm until September of the following year. The consultant does not prepare a Schedule of Indirect Costs in accordance with FARs part 31.

The result of these deficiencies is accounting records which may be inaccurate. They do not form a sound basis for timely preparation of the Schedule of Indirect Costs and the resultant overhead rate calculation.

Recording of Job Costs and Direct Labor:

Direct costs are posted manually to the Transaction Report, the Job Cost System, and the Billing Invoice. Differences, which went undetected, were noted between the three reports.

Labor is not distributed in the accounting system between direct and indirect classifications. The hours worked in excess of 40 hours per week by salaried employees are not recorded in the Transaction Report yet they are charged to the project. Therefore, the labor dollars per the job cost system do not agree with the financial records.

The above deficiencies relating to job costs and direct labor can lead to inaccurate invoicing. Incorrect direct labor and indirect labor amounts may be used in determining the overhead rate.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the schedule being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We believe the reportable conditions described above, taken in the aggregate, constitute a material weakness.

This report is intended solely for the use and information of government agencies as related to contracts employing the cost principles of the FARs, modified as required by applicable regulations.

Bob Brooks
Chief of Audit

December 1, 1998

Report on Internal Control: With Reportable Conditions Which are Not Material Weaknesses

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROLS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs of the Company for the fiscal year ended December 31, 199x, and have issued our report thereon dated April 4, 2000. We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the Government Auditing Standards issued by the Comptroller General of the United States of America.

Compliance

As part of obtaining reasonable assurance about whether the Company's schedule is free from material misstatement, we performed tests of the Company's compliance with certain provisions of laws, regulations and contracts, including the provisions of the applicable sections of Part 31 of the Federal Acquisition Regulations, noncompliance with which could have a direct and material effect on the determination of the schedule amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the schedule and not to provide assurance on internal control over financial reporting.

The management of the Company is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control over financial reporting. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with the Federal Acquisition Regulations Part 31. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate. For the purpose of this report, we have classified the significant internal controls over financial reporting in the following categories: cash disbursements and payroll.

We noted certain matters involving the internal control over financial reporting that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the organization's ability to record, process, summarize and report financial data in a manner that is consistent with the assertions of management in the statement.

Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe none of the reportable conditions described above are a material weakness.

[Describe the condition/s]

This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulations, and should not be used for any other purpose.

Bob Brooks, CPA, Director External Audit Branch

April 4, 2000

EXAMPLES: REPORTABLE CONDITIONS

We noted matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the schedule of indirect costs.

Segregating Costs

The Federal Acquisition Regulations (FARs) require that any cost that can be identified specifically with a final cost objective should be recorded as a direct cost of that cost objective. The FARs further state that an indirect cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives.

Sample Engineering, Inc. didn't identify, accumulate, and distribute direct and indirect expenses in accordance with the FARs. Direct costs weren't segregated from indirect costs. We recommend that the Company utilize an account structure to adequately segregate direct and indirect costs in order to be in compliance with the FARs.

Job Cost System & Managerial Commitment

The job cost system was not used in the preparation of invoices because the information in the system was not complete. Invoices were manually prepared because the system did not contain information on the drilling supplies or prices for the direct supplies.

The Company's management indicated that too much of the project manager's time was consumed in maintaining the accounting system. Therefore, the Company is in the process of converting to a new accounting system, with the belief that the new system will enable the Company to comply with the FARs.

Implementing the new system with appropriate controls and reports will require substantial effort. At the present time, it appears that sufficient resources and management support have not been dedicated to implementing the new system.

Overhead Rate Proposals

The Company has not prepared an overhead rate proposal in compliance with the FARs. At this time, the conditions mentioned above have contributed greatly to the inability to produce an accurate proposal report containing expense adjustments that comply with the FARs. Contracts with DOT require that a consultant maintain adequate financial information to properly invoice for actual costs. Without a proposal, the company can't attest to the validity of the invoiced costs.

REPORTING OF UNALLOWABLE COSTS:

A number of transactions, for types of costs considered to be unallowable for years, were found interspersed throughout the indirect expense accounts. This resulted in increased testing to determine if individual transactions in accounts contained unallowable transactions unrelated to the accounts in which they had been recorded. According to FAR 31.201-2 and 6, "...the company is responsible for identifying and excluding all unallowable costs from the proposal applicable to a Government Contract. The contractor is also responsible for accounting for costs appropriately and for maintaining records, including support documentation, adequate to demonstrate that costs claimed have been incurred and are allocable to the contract, and comply with applicable cost principles..."

RELATED PARTY TRANSACTIONS:

Until September of 1997, the firm had been leasing equipment from a related party (Ajax Leasing Company) which required a yearly adjustment be made reducing the amount charged to the actual cost for use of these assets. At the end of the lease, Sample Engineering, Inc. acquired these assets. Since the assets are already fully depreciated through past audit adjustments, further depreciation is not allowed. The firm needs to establish a policy for recognizing and recording capital versus operating leases.

Schedule of Indirect Costs

The following sample Schedule of Indirect Costs including the FAR references and descriptions on page 9-9 and the notes to the Schedule of Indirect Costs on page 9-10 are recommended for use by state transportation department auditors and public accounting firms when performing indirect cost audits of engineering consulting firms.

Example:

Sample Engineering, Inc. Schedule of Indirect Costs For the Year Ended December 31, 1999					
DESCRIPTION	PROPOSED	UNALLOWABLE COSTS	FAR REFERENCE	AUDITED	% DIRECT LABOR
DIRECT LABOR	\$ 1,039,290	\$ 3,245	(1) 31.202	\$ 1,042,535	
FRINGE BENEFITS					
Unemployment Taxes	\$ 13,328			\$ 13,328	
FICA Taxes	120,694			120,694	
Bonuses	30,209	(6,625)	(2) 31.202/31.205-6(f)	23,584	
Health & Dental Insurance	101,246			101,246	
401k Expense	28,702	-		28,702	
TOTAL FRINGE BENEFITS	\$ 294,179	\$ (6,625)		\$ 287,554	
GENERAL OVERHEAD					
Indirect Labor	\$ 676,825	\$ 1,179	(3) 31.202/31.203	\$ 678,004	
Utilities	52,836			52,836	
Vehicle Expenses	36,405			36,405	
Legal & Accounting	20,101	(7,762)	(4) 31.205-27(a)	12,339	
Office Supplies	41,624			41,624	
Repairs & Maintenance	9,511			9,511	
Equipment Lease	(3,002)			(3,002)	
Dues & Subscriptions	10,256	(398)	(5) 31.205-14	9,858	
Travel	2,910			2,910	
Shipping & Postage	13,269			13,269	
Payroll Charges	1,838			1,838	
Rent	136,939	(18,000)	(6) Rel. Party Trans.	118,939	
Licenses & Permits	5,280			5,280	
Depreciation	60,114	(3,802)	(7) 31.202/31.205-49	56,312	
Outside Services	361,553	(300,019)	(8) 31.202	61,534	
Insurance	83,651			83,651	
Education	6,346			6,346	
Business Meetings	6,396			6,396	
Environmental & Survey Sup.	22,419			22,419	
Vehicle Lease	55,068			55,068	
Courthouse Expense	5,750			5,750	
Printing Expense	8,593			8,593	
Taxes	32,439	-		32,439	
TOTAL GENERAL OVERHEAD	\$ 1,647,121	\$ (328,802)		\$ 1,318,319	
TOTAL INDIRECT COSTS	\$ 1,941,300	\$ (335,427)		\$ 1,605,873	154.04%
FACILITIES CAPITAL COST OF MONEY	\$ 13,376	\$ -		\$ 13,376	1.28%

Note: In the event that the consultant uses multiple rates, such as separate field office rates, they must be disclosed in the Schedule of Indirect Costs. Also, complete explanations of audit adjustments and their associated FAR references must be attached to the Schedule of Indirect Costs.

Criteria Description for FAR References and Other Audit Adjustments

(1) 31.202

Labor costs identified specifically with a contract are direct costs of the contract.

(2) 31.202/31.205-6(f)

Bonuses specifically related to a project are direct./Bonuses are **allowable** if paid according to an existing plan or consistent policy.

(3) 31.202/31.203

Labor costs identified specifically with a contract are direct costs of the contract. Indirect labor costs are those identified in the two or more cost objectives.

(4) 31.205-27(a)

Legal costs associated with a reorganization are **unallowable**.

(5) 31.205-14

Dues associated with social, dining or country clubs are **unallowable**.

(6) Related Party Transaction – See Note 5 on page 10.

(7) 31.202/31.205-49

Depreciation on costs charged to a specific contract are direct./Amortization of goodwill is **unallowable**.

(8) 31.202

Contractual services charged to a contract are direct costs.

Notes to the Schedule of Indirect Costs

Sample Engineering, Inc.
Notes to Schedule of Indirect Costs
For the Year Ended December 31, 1999

(1) **Principal Business Activity**

Sample Engineering, Inc. (the Company) was incorporated in 1994. The Company primarily provides engineering, survey, and construction management services to both the public and private sector.

(2) **Basis of Accounting**

The Company's indirect cost schedule was prepared on the basis of accounting practices prescribed in Part 31 of the Federal Acquisition Regulations (FARs). Accordingly, the schedule of indirect costs is not intended to present the results of operations of the Company in conformity with generally accepted accounting principles.

(3) **Distribution of Direct Labor Costs**

The Company distributes labor costs to direct projects for all employee classifications. Overtime premium costs are distributed directly to projects when applicable.

(4) **Direct Costs**

The schedule excludes the following classifications of costs which were related to projects:

- Automobiles
- CADD charges

Subcontracts:

The source of the direct charge is the vendor invoice received by the Consultant.

(5) **Related Party Transactions**

The firm incurred rental costs through the rental of a facility from a related party under common control. Common control is determined to exist when:

- The combined direct or indirect ownership of individual shareholders common to each entity equals 50% or more in each entity, **or**
- One entity leases property from another and either entity has 50% or more ownership in the other.

Allowable rental charges between any divisions, subsidiaries, or organizations under common control are limited to the actual costs of ownership as per the SHA guidelines. Any adjustment reflects the difference between the rents paid and the actual costs of ownership.

Recommended Report Disclosures

The examples are for illustrative and explanatory purposes only. They are not intended to be all-inclusive regarding every rule and regulation, nor appropriate to every situation for every consultant. Disclosures should be included with the Indirect Cost Audit for each fiscal year. Disclosures may be included in the Notes to the Schedule of Indirect Costs or as a separate section within the report.

DISCLOSURE NOTES AND EXAMPLES

1. DESCRIPTION OF THE COMPANY AND ITS ACCOUNTING POLICIES

Describe the consultant's financial accounting system (cash, accrual, hybrid, etc.) and job cost accounting system (job order, modified job order, standard, hybrid). Include a description of accounting policies and procedures governing the classification of costs as direct or indirect.

A schedule of indirect costs (see previous example on page 9-8) and overhead rate(s) computation should be included in the disclosure requirements package. A schedule should identify all indirect cost pools as well as allocation bases for the overhead rate(s). The disclosure package should:

- Identify the Reporting Unit: company wide, business segment, technical specialty (design, construction administration, geotechnical, environmental, etc.), and/or geographical location pertaining to the overhead rate(s).
- Identify that Other Direct Costs (ODC) are consistently charged to all projects, and not just projects that reimburse for ODCs (i.e. computer costs, reproduction, equipment charges and vehicle usage). Include an evaluation of the propriety and consistency of recording such costs in the accounting records.
- Describe how the company charges labor to all projects (i.e. actual, average, or standard hourly rates).
- Describe how and when variances are recorded if using other than actual labor costs.
- Explain the company's policy and accounting practice as to paid vacation, sick leave and comp time.

EXAMPLES:

DESCRIPTION OF THE COMPANY AND ITS ACCOUNTING POLICIES

The Company's principal business activities are consulting engineering services. The Company maintains its accounting records on the accrual basis for financial reporting, while using the cash method of accounting for income tax purposes. The attached audited Schedule of Indirect Cost Pools has been prepared on the accrual basis. The Company is organized under Subchapter S of the Internal Revenue Code, wherein all income and expense items are passed through to shareholders and reported on their respective individual income tax returns.

The Company has 10 offices in three states, with approximately 500 employees. It engages primarily in civil engineering (highway design) and environmental studies.

The audited overhead rate is a unitary rate for all offices and both disciplines. Direct project costs and allocated indirect costs are included in project cost records.

The Company has a job order cost accounting system.

The allocation basis for indirect costs is direct labor. Direct labor of salaried employees is calculated using their standard hourly rate (annual salary/2080 hrs).

In-house costs such as computers, CADD, equipment, computer software programs, and corporate vehicles are included in the firm's overhead rate.

The Company has separate expense accounts for sub-consultants, personal vehicle mileage, and reproduction costs that are project-related. The Company maintains logs documenting direct project usage of certain reproduction costs. These costs are charged at the following firm-wide standard rates:

(Provide a list of firm-wide standard rates.)

Using these rates, the Company records direct usage costs by first charging the project, then crediting the indirect cost pool. These charges are consistently made to all projects, regardless of whether or not they are billed to the client. However, the above charges are not based on a detailed cost study, are not accumulated in a manner that allows the calculation of variances from actual cost, and the Company makes no periodic adjustments in the rates.

2. LABOR RELATED COSTS

PAID OVERTIME AND UNCOMPENSATED OVERTIME

Indicate where the premium portion of overtime pay is recorded in the cost accounting system. Detail the consultant's procedures for recording uncompensated overtime incurred by employees charging direct project time. Provide an assessment of the materiality of any such uncompensated overtime.

EXAMPLES:

PAID OVERTIME

Overtime costs are incurred in meeting certain deadlines. If an employee is eligible for overtime, they have their choice of a cash payment equal to time and a half (premium portion), or compensatory time off at time and a half. The premium portion of paid overtime is included in the indirect cost pool.

UNCOMPENSATED OVERTIME

The Company did not pay certain salaried employees for time worked in excess of 40 hours per week. The time in excess of 40 hours was credited to the indirect cost pool. The credited amount (\$xx,xxx) consisted of hours worked in excess of 40, times the employee's standard hourly rate.

HIGHLY COMPENSATED EMPLOYEES/OFFICERS

FAR §31.205-6(p) sets a specific dollar limit on the compensation [total compensation as defined in FAR §31.205-6(a)] of "senior executives. The reasonable compensation limit or range that was used by the auditor should be disclosed in the notes to the audit report.
Note: Due to confidentiality, detailed salary amounts should not be disclosed in the report but may be requested.

EXAMPLE:

The Company paid compensation to senior executives in excess of the FAR §31.205-6(p) limit of \$342,986 per person. The total, which was adjusted to the Schedule of Indirect Cost Pools, amounted to \$XXX,XXX.

PENSION FUND/DEFERRED COMPENSATION

If pension and/or deferred compensation costs (as defined by FARs §31.205-6(j) and §31.205-6(k) respectively) are included in indirect costs, identify whether the plan(s) meet the above regulations and explain how the costs were determined (e.g. - cash contribution, stock or options to purchase stock of the consultant, assets other than cash). In regard to Employee Stock Option Purchase (ESOP) plans, identify the dollar amounts of principal, interest, and administrative costs of the contribution to the Employee Stock Option Trust (ESOT).

EXAMPLE :

The Company has a 401(k) pension plan, meeting the requirements of FARs §31.205-6(j), to which it makes a cash contribution of 2% of employee salary per year.

In addition, the Company has a leveraged deferred compensation ESOP started in 1984. The plan provides for cash payments of the appraised value of the stock (held by the ESOT for the employee) upon retirement, leaving the Company after 10 years service, or death. Since CAS 9904.415(a)(3) has not been satisfied, the Company assigns the payments to the period in which the compensation is paid to the employee.

UNCOMPENSATED SICK LEAVE

Provide the consultant's policy as to accounting for accrued sick leave upon termination. (Note – there might be a disclosure even though there is no adjustment).

EXAMPLE :

The Company incorrectly accrued sick leave costs that were earned during the period, and included them in the overhead rate. However, because sick leave is not paid to an employee upon termination, \$X,XXX of this cost was eliminated from the indirect cost pool.

CONTRACT LABOR

Provide the methodology used by the consultant to account for contract labor (not sub-contracts).

EXAMPLE :

The Company uses contract labor for engineering related services, and bills this labor as if it were for regular employees. The Company provides office space, administrative support, and controls the contract laborers. Therefore, contract laborers are considered employees, and their labor costs (\$52,000 for the period audited) have been included in the direct labor base.

3. FACILITIES CAPITAL COST OF MONEY (FCCM)

Provide the cost-of-money rate, as calculated in accordance with FAR §31.205-10.

EXAMPLE :

The cost-of-money rate has been calculated in accordance with FAR §31.205-10, using average net book values of equipment and facilities multiplied by the average treasury rate for the applicable period. Equipment and facilities include furniture and fixtures, computer equipment, vehicles, and leasehold improvements. The calculation was made as follows:

	<u>12/31/xx</u>
<i>Net Book Value of Corporate Assets</i>	<i>\$267,520</i>
<i>Average Treasury Rate</i>	<i>5%</i>
<i>Computed Facilities Capital</i>	<i><u>\$ 13,376</u></i>
<i>Direct Labor Base</i>	<i>\$1,042,535</i>
<i>Cost-of-Money Rate</i>	<i><u>1.28%</u></i>

4. DEPRECIATION

EXAMPLE :

The depreciation reflected on the Company's financial statements differs from that used and acceptable for federal income tax purposes. Since the financial statement amounts are lower than the amounts used for federal purposes, the amounts included in the Schedule of Indirect Cost Pools are allowable under FAR §31.205-11(e).

5. RELATED PARTY TRANSACTIONS

Identify any related parties, to the extent that audit adjustments are required, and the amounts of required FARs adjustments [per §31.205-26(e) and §31.205-36(b)(3)].

EXAMPLE :

The Company rents one of its two offices from a shareholder. The actual occupancy costs include interest expense of \$140,500. The Facilities Capital Cost of Money for the shareholder totals \$118,939, resulting in an unallowable amount of \$21,561. The rent expense recorded in the Company's financial statements exceeds the owner's actual occupancy costs by \$18,000 (unallowable). Consequently, rental expense has been adjusted downward by \$118,939 to reflect the provisions of FARs §31.205-36(b)(3).

The officers of the Company have personal usage of Company vehicles. Amounts attributable to this personal use (\$X,XXX for 20xx) were disallowed.

6. AUDITOR CONTACT

The auditor's name, address, phone/fax numbers, and e-mail address are required.

EXAMPLE :

AUDITOR CONTACT

The person(s) to contact relative to this engagement is (are):

John Doe, CPA

C/O Department of Transportation

000 First St.

Denver, Co 80256

Phone: (xxx) 555-1212

Fax: (xxx) 555-1234

E-mail: jcdoe@xxx.xxx

Chapter Ten - Cognizant Audits

NHS Act - Section 307

In 1995, Congress passed the latest version of the National Highway System Designation Act (For detailed information, see the following site: www.fhwa.dot.gov/infrastructure/progadmin/consultant.) This legislation, which was subsequently signed into law, had a profound impact on how some states paid consulting engineers for the overhead portion of their costs on federally participating contracts. Heretofore, approximately half the states had self-imposed ceilings on overhead limits and/or maximum hourly rates associated with indirect labor. Section 307 of the NHS Act prohibited the use of such limitations on federally participating contracts. The NHS Act, however, did provide a one-year window for states to adopt statutes that would establish “an alternative process intended to promote engineering and design quality and ensure maximum competition.” If a statute were adopted by a state within this period, Section 307 would not bind the state. Thirteen states adopted such statutes within the allowed time period. Such states are referred to as “**opt out states.**” **They are: CT,DE,FL,KY,LA,ME,MD,MN,NY,NC,UT,TN,WV.**

Section 307 also strived to establish an audit environment that was uniform among the states and not duplicative. Uniformity was to be achieved by requiring states or other audit entities to use the cost principles found in the Federal Acquisition Regulations (Part 31 of Title 48, Code of Federal Regulations) when performing cost audits of consulting engineering firms. Though mandated in Section 307, the states had previously used the Federal Acquisition Regulations to determine eligibility of indirect costs on engineering contracts.

The avoidance of duplicate audits was addressed in Section 307 through the introduction of the term “**cognizancy.**” This term laid the groundwork for states and other audit entities to have to use the work of others if an audit had been previously performed by a “cognizant agency.” Unfortunately, Section 307 did not provide a definition for cognizant agency. In order to develop an acceptable definition of cognizant agency and cognizant audit, the American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee and the American Council of Engineering Companies (ACEC) Transportation Committee joined forces to develop acceptable definitions of these terms that

could be used by the Federal Highway Administration when adopting rules for the implementation of Section 307.

The AASHTO Audit Subcommittee and the ACEC Transportation Committee unanimously adopted the following definitions for these terms during their meetings conducted during the late summer of 2000.

A **“Cognizant Agency”** is any one of the following:

- Federal Agency
- The Home State Transportation or Highway Department (i.e., state where the firm’s accounting and financial records are located)
- A Non-Home State Transportation or Highway Department to whom the Home State has transferred cognizance in writing for the particular indirect cost audit of a firm.

A **“Cognizant Audit”** is achieved by any one of the following methods:

- A Cognizant Agency performs or directs the work of a CPA who performs the indirect cost audit.
- Non-Home State auditor or CPAs working under this State’s direction issue an audit report and the Home State issues a letter of concurrence. If the Home State does not accept the audit of another State, the Home State will have 180 days from receipt to issue a cognizant audit; otherwise, the Non-Home State audit report will be cognizant for the 1 year applicable accounting period.
- An indirect cost audit performed by a CPA hired by the firm will become a cognizant audit if one of the following conditions is met:
 - (a) The Home State reviews the CPA’s working papers and the Home State issues a letter of concurrence with the audit report.
 - (b) A Non-Home State reviews the CPA’s working papers and issues a letter of concurrence with the CPA report, which is then accepted by the Home State. If the Home State does not accept the Non-Home State’s review, the Home State will have 180 days from receipt to complete a review of the CPA audit report and either concur with it, modify it, or reject it due to a material error requiring re-submittal; otherwise, the CPA audit report with which

the Non-Home State has concurred will be cognizant for the 1 year applicable accounting period.

In addition to the above definitions, the AASHTO Audit Subcommittee adopted guidelines to be used in reviewing indirect costs audits performed by public accounting firms and issuing letters of concurrence. The guidelines can be found in the next section of this chapter.

In conclusion, Section 307 of the NHS Act did not make changes in how indirect costs audits should be performed by audit entities. The focus of Section 307 was to remove the ceilings on overhead rates and indirect salaries that had been established by some states, avoid duplicate indirect cost audits of the same firm by multiple audit entities, and reinforce the need for all audit entities to use the Federal Acquisition Regulations for the purpose of determining cost eligibility.

Guidelines for Reviewing CPA Indirect Cost Audits

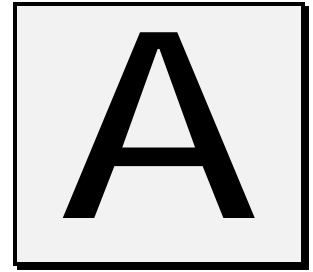
The following minimum guidelines should be followed when a state transportation/highway department audit organization reviews a CPA indirect cost audit report and issues a letter of concurrence for purposes of establishing a cognizant audit as referenced in 23 CFR Part 172.

- The reviewing state should obtain documentation that evidences the CPA's accomplishment of the continuing education requirements identified in paragraphs 3.6 and 3.7 and the external quality control review requirements found in paragraph 3.33 of the Governmental Auditing Standards (Yellow Book).
- The reviewing state should determine that the CPA's audit report format is in material compliance with the "Uniform Indirect Cost Rate Audit Report Format For Engineering Consulting Firms" prepared and adopted by the AASHTO Audit Subcommittee and the ACEC Transportation Committee.
- The reviewing state should determine that the CPA audit was conducted in accordance with the Field Work Standards for Financial Audits found in chapter four of the Governmental Auditing Standards and the Federal Acquisition Regulations.

The following steps should be performed to make these determinations:

1. Review the CPA's working papers.
2. Request any additional supplemental tests the reviewing state deems necessary.

The reviewing state upon satisfactory completion of this review shall issue a letter of concurrence with the CPA's indirect cost audit report of the firm. The state auditor and audit manager who performed and supervised the review shall sign the letter. Documentation to support this review shall be retained by the reviewing state for a minimum of three years from the date of the letter of concurrence. The letter of concurrence shall be addressed to the audited firm.



Appendix A - State Cost Principles

This section provides key contact audit personnel from the respective states. Individuals should be contacted for specific detailed limits and/or guidelines. Contact information is also available in the AASHTO, Administrative Subcommittee on Internal and External Audit, Membership Directory (August 2000).

State	Audit Contact Person	Phone Number
Alabama	C. Lamar McDavid	334-242-6359
Alaska	Robert W. Janes	907-465-2080
Arizona	Michael Schwartz	602-712-7334
Arkansas	Leonard E. Grinstead	501-569-2516
California	Gerald Long	916-323-7122
Colorado	Casey Tighe	303-757-9661
Connecticut	William P. Scholl	860-594-2181
Delaware	Robert Uhle	302-760-2055
Florida	Cecil T. Bragg	850-488-2501
Georgia	Jerry M. Satterfield	404-656-5247
Hawaii	Bert Nishimura	808-587-2133
Idaho	Carolyn A. Rosti	208-334-8834
Illinois	David G. Campbell	217-782-7427
Indiana	Tom Becher	317-232-531
Iowa	Tom Devine	515-239-1625
Kansas	Dale Jost	785-296-3545
Kentucky	Mike Coffey	502-564-6830
Louisiana	J. Preston Perilloux	225-237-1313
Maine	Richard Alessandro	207-287-2902
Maryland	Romi Shah	410-545-8702
Massachusetts	Michael J. Byrne	617-973-7411
Michigan	Jerry J. Jones	517-373-2384
Minnesota	Ronald W. Gipp	651-296-3254
Mississippi	P. Diane Gavin	601-359-7500
Missouri	Donna Ruder	573-526-1244
Montana	J. Dennis Sheehy	406-444-6343
Nebraska	Jim Dietsch	402-479-4558
Nevada	Bob Dimmick	775-888-7007
New Hampshire	Douglas S. Rowden	603-271-1557
New Jersey	Timothy Maloney	609-530-2343
New Mexico	Mike R. Miera	505-827-3751
New York	Thomas J. Goodfellow	518-457-3180

North Carolina	Todd Jones	919-733-3624
North Dakota	Roberta L. Keller	701-328-2486
Ohio	Sam Kelley	614-644-6395
Oklahoma	John K. Parker	405-521-2511
Oregon	Dan Motley	503-986-3957
Pennsylvania	John Yodock	717-787-7003
Rhode Island	James R. Choquette	401-277-2297
South Carolina	Glynis Davis	803-737-1604
South Dakota	Tim P Flannery	605-773-3591
Tennessee	Julia Burton	615-253-4272
Texas	Dalton Ritter	512-463-8638
Utah	Stephen C. Reitz	801-965-4633
Vermont	Michael R. Pollica	802-828-3598
Virginia	Judson D. Brown	804-225-3597
Washington State	Wayne Donaldson	360-705-7004
West Virginia	Albert O. Adams	304-558-3101
Wisconsin	Dennis Schultz	608-266-3799
Wyoming	Jennifer Jessen	307-777-4391
Puerto Rico	Juan E. Encarnacion Medina	809-729-1530
AASHTO Liaison	Roger Roberts	202-624-5803
FHWA Liaison	John Jeffers	404-562-3578

Uniform Audit Guide – AASHTO Regional Representatives

<u>Region</u>	<u>Name</u>	<u>Home State</u>	<u>Phone Number</u> <u>Email</u>	<u>States Represented</u>
Northeastern States (NAASHTO)	William Scholl and Mike Pollica	CT VT	860-594 2181 william.scholl@po.state.ct.us 802-828-3598 mpollica@aot.state.vt.us	Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont, District of Columbia, Puerto Rico
Southeastern States (SAASHTO)	John Greene	FL	850-488-2501 ext 138 john.greene@dot.state.fl.us	Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia
Midwestern States (Mississippi Valley)	Jerry Koerner and Bruce Kalland	WI MN	608-267-3077 gerald.koerner@dot.state.wi.us 651-296-3097 bruce.kalland@dot.state.mn.us	Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, Ohio, Wisconsin
Western States (WAASHTO)	Mickey Schwartz	AZ	602-712-7334 mschwartz@dot.state.az.us	Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Texas, Utah, Washington, Wyoming

Acknowledgements:

Many people have contributed to this guide over the last few years. Their knowledge, time and travel money is greatly appreciated and represents a nationwide team effort. Some of the more significant contributors are listed below.

Individual States

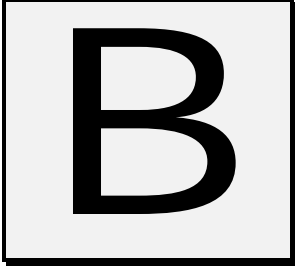
Alabama	C. Lamar McDavid
Arizona	Michael Schwartz
Florida	John Greene
Illinois	David Campbell & Carl D. Richards
Iowa	Tom Devine & Matt Swanson
Minnesota	Lee Anderson
Missouri	Donna Ruder
Nebraska	Dave Vondra
New York	Thomas J. Goodfellow
North Carolina	Todd Jones
Pennsylvania	John Yodock
South Dakota	Mary Johnston
Tennessee	Julia Burton
Wisconsin	Randy Knoche & Jerry Koerner

FHWA Southern Resource Center

John Jeffers & Michael Thomas

ACEC

Jim Anderson & Betsy Scott, HNTB
Jennifer Foutts, Otak, Inc.
Tim Stowe, Anderson & Associates
Ray Williams, Ralph Whithead Associates, Inc.
Mark Wilson, Kimley-Horn & Associates



Appendix B Glossary of Terms

The following terms are used throughout this guide:

Actual Cost Agreement

The term Actual Cost Agreement does not mean that a consultant will be reimbursed for all actual costs incurred for performing a job. Costs are reimbursed subject to the limitations described in the agreement, contract, or specified criteria. These limitations can be very restrictive. An example is interest on borrowed money. This is a cost of doing business, yet it is not reimbursable as an actual cost of doing business.

Actual Costs

Amounts determined on the basis of costs incurred and supported by original source documentation, as compared to forecasted costs, or costs thought to have been incurred, or costs based on historical averages.

Advance Agreement

An understanding included in an agreement by the contracting officer and the consultant as to the treatment of special or unusual costs not already included in FARs. The agreement must be in writing, executed by both the contracting parties, and incorporated into applicable current and future contracts. An advance agreement shall contain a statement of its applicability and duration. See 48 CFR 31.109.

Agreement

A contract. A binding, legal, document which identifies the deliverable goods and services being provided, under what conditions, and the method of payment for such services. The document may include federal criteria and state requirements which will have to be adhered to by the state and the consultant. The document will usually indicate start and finish dates, record retention requirements, and other pertinent information relative to the actual work to be performed.

All-Inclusive Hourly Rate Agreement

An agreement using an hourly rate developed for billing purposes which may include a firm's actual direct labor cost, overhead rate allowed or negotiated, and negotiated profit margin. Provisional hourly rates generally are temporary and will be adjusted by an audit. Negotiated hourly rates may be used for the life of an agreement, or may be adjusted from time to time depending on the agreement provisions.

Allocable

A cost is allocable (to an agreement or cost of work being performed for the government) if it benefits both the agreement and other work of the firm and the cost can be distributed in reasonable proportion to the benefits of incurring that cost.

Allowable (Cost)

An item of cost that can be billed directly as a project cost or indirectly as an overhead cost by the consultant.

Audit Cycle

The series of steps auditors go through in completing their assigned work. The process includes a review of a firm's permanent file maintained by the Audit Office, preliminary audit work including scheduling of billed costs, arranging an appointment to conduct the audit, entrance conference, field work, review of a

firm's documentation, exit conference, report write up, submittal of draft report to auditee for comment, and issuance of the final report.

Audit Resolution Process

The process that SHA management and the auditee go through in resolving audit findings. It may involve negotiation of a settlement, legal counsel, and court procedures.

Audit Trail

The auditable record left by a transaction in a firm's accounting records from original source document into subsidiary ledgers through the general ledger and into financial statements and invoices.

Billing Rate

The billing rate generally refers to the hourly labor rate being charged for work on an agreement. For a cost plus fixed fee agreement, the billing rate will be the employee's actual payroll rate. For an all-inclusive hourly rate agreement, the billing labor rate will include the actual payroll rate plus an overhead percentage plus an amount for fee.

Cognizant Audit

This concept was developed to assign primary responsibility for the audit to one organization and to avoid duplication of audit work when auditing the indirect cost schedule. The audit work may be done by the home state auditors, a Federal audit agency, a CPA firm, or a non-home state auditor designated by the home state auditor.

Common Control

Exists in related party transactions when business is conducted at less than arm's length between businesses and/or persons that have a family or business relationship. Examples are transactions between family members, transactions between subsidiaries of the same parent company, or transactions between companies owned by the same person or persons.

Contracting Officer

A title sometimes used in private and public sectors to indicate the person having authority to enter into a contract or agreement for goods and services.

Corporation

A business structure where stock is made available for purchase. The firm may have a president, vice president, treasurer, and secretary. Anyone working for the corporation is usually paid an hourly wage rate or is salaried. In theory, the liabilities of the individual stock owners are limited in this type of business structure.

Cost Accounting Standards

Cost Accounting Standards (CAS) are the rules, regulations and standards, which are promulgated by the Cost Accounting Standards Board (CASB). The CASB is located within the Office of Federal Procurement Policy, which is under the direction of the Office of Management and Budget (OMB) of the Federal government.

Cost Center

Cost centers are used to accumulate and segregate costs.

Cost Objective

An agreement, contract, function or organizational subdivision for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capitalized projects, etc.

Cost of Money

Facilities capital cost of money in an imputed cost determined by applying a cost-of-money rate to facilities capital employed in contract performance.

Cost Plus Fixed Fee Agreement

An agreement in which all the cost factors except fee are actual cost. The fixed fee is a set dollar amount in the agreement.

Cost Principles

The underlying basis for determining how costs should be recorded when they are allowable or unallowable, and the specific basis for treating various costs as either allowable or unallowable.

Courtesy Audit

An audit performed for another state, another state agency, or city or county government. The audit could be a preaward, interim or post, with the requesting agency paying for the cost of the audit.

Direct Cost

Any cost that can be identified specifically with a particular final cost objective, i.e., a project related cost. Direct costs would include labor, materials, and reimbursables incurred specifically for an agreement. It is irrelevant whether or not the costs are actually billed. All direct labor costs must be included in the direct labor base. All costs for lump sum agreements must be included in direct costs.

Entrance Conference

A meeting between the auditor and the auditee, at which time the purpose and scope of the audit are discussed.

Exit Conference

A meeting held after the auditor completes field work at the auditee's place of business. Topics of discussion are preliminary findings of the audit, which are subject to change and revision during the supervisory workpaper review process, and/or a formal request for the auditee's response to the draft audit report.

Federal Acquisition Regulations (FARs) Code of Federal Regulations No. 48

Sets the criteria for allowable and unallowable costs for federally funded agreements. The FARs are also used as a guideline for other government contracting such as State contracts. Part 31.2 is the primary section pertaining to State Highway Agencies.

Finding

A statement of noncompliance with the terms of an agreement. A finding includes the condition, criteria, cause, effect, and a recommendation for correction.

General and Administrative Expenses

Any management, financial, and other expense which is incurred by or allocated to a business unit, and which is for the general management and administration of the business as a whole.

Generally Accepted Auditing Standards (GAAS)

These are standards for financial statement audits set forth by the American Institute of Certified Public Accountants. The standards pertain to auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.

Generally Accepted Governmental Auditing Standards (GAGAS)

These are standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other non-government organizations. These standards also incorporate GAAS for financial-related audits.

Indirect Cost

Any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. Consultants recover their indirect costs in their overhead rate.

Interim Audit

An audit, which may be of limited scope, during the life of an agreement. The purpose is to determine the actual allowable costs to date, review and adjust a firm's overhead rate, and audit a prime consultant's subcontracts. This audit follows a standard audit plan.

Internal Control

The plan of organization and methods and procedures adopted by management to ensure that its goals and objectives are met; that resources are used consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports.

Lump Sum (Fixed Price) Agreement

An agreement where the method of payment for delivery of goods and services is one set amount that includes salaries, overhead, and profit with no adjustments. Once the lump sum amount is agreed upon, the services or goods must be provided regardless of the actual cost to the consultant.

Negotiated Hourly Rate Agreement

An agreement in which hourly billing rates that include labor, overhead, and fee are negotiated in advance and are listed for a 12-month period or more.

Overhead Expenses

All allowable general administrative expenses and fringe benefit costs (sometimes called payroll additives). Depending on the size of the firm, these costs may or may not be separately identified on a schedule of overhead costs.

Overhead Rate

A computed rate usually developed by adding together all of a firm's costs that cannot be associated with a single cost objective, including general and administrative costs, fringe benefit costs, then dividing by a base value, usually direct labor dollars, to get a percentage. This rate is applied to direct labor to allow a firm to recover the share of indirect costs allowable to the agreement.

Overtime Compensation

Compensation paid to employees who work more than a certain amount of hours within a pay period, usually 40 hours. The pay rate may be based on the normal salary rate or may include "premium overtime" such as time and a half, or double time. In most cases, premium overtime is required for hourly workers and is optional for certain salaried employees.

Partnership

A business with two or more co-owners, who may or may not have established salaries. The liabilities of the firm are the owners' responsibility. Owners may be treated the same as sole proprietors by the auditors regarding the establishment of a salary rate.

Post Audit

An audit done after the completion of all work by a consultant. Its scope may include all billed costs by the prime consultant and/or any sub consultants providing services. This audit follows a standard audit plan.

Preaward Review

An audit conducted on behalf of SHA management for the purpose of validating financial information supplied by a potential contractor. The audit may require an on site visit or information may be reviewed at the Audit Office. Upon completion, the information is provided to the SHA contracting officer in an audit report for use during agreement negotiations. This audit follows a special pre-award audit plan.

Provisional Hourly Rate Agreement

An agreement in which hourly billing rates that include labor, overhead, and fee are negotiated in advance, but are subject to adjustment after an audit determines actual labor and overhead rates.

Reasonable Cost

A cost, if in its nature and amount, does not exceed that which would be incurred by a prudent person in the conduct of competitive business.

Record of Negotiation

A summary memorandum prepared by the SHA contracting officer regarding the reconciliation between the consultant's proposal and the SHA estimate. It includes contract rate negotiations, disposition of significant matters in the pre-award audit report, and reasons why audit recommendations were not followed. It is required by 48 CFR 42.706(b).

Single Audit

In theory, an audit which satisfies the needs of all parties involved with funding or doing business with an organization, either private or public.

Sole Proprietorship

A business with one owner. From an audit standpoint, this person may not have an established salary, but instead may rely on draws from the profits of the firm to obtain their payment for services.

Source Documentation

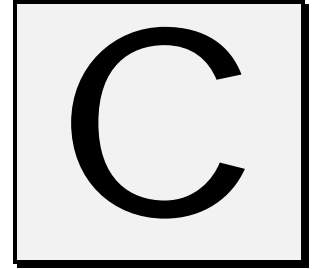
Original documents, including but not limited to time sheets, invoices, hotel receipts, rental slips, gasoline tickets, canceled checks, tax returns, insurance policies, minutes of corporate meetings, etc., which support the costs recorded in the firm's accounting ledgers and which may be used for billing purposes to the government or for income tax purposes.

Task Assignment Agreements

An agreement without a definite description of work, but with a specified time period. Tasks which require the consultant's expertise are assigned as needed. Each task will have its own maximum payable amount. The total amount paid on all of the tasks cannot exceed the total amount of the agreement.

Unallowable (Cost)

An item of cost which cannot be billed directly or indirectly by a consultant. These types of costs, if found during an audit will be purged from the costs billed directly, or from those billed indirectly via an overhead rate or cost center. When an unallowable cost is incurred, its directly associated costs are also unallowable.



Appendix C - Listing of Resource Materials

This section provides a listing of resource materials that are commonly used as guides by auditors in performing government contract audits. The listing is not all-inclusive but attempts to highlight the most frequently used materials. While paper copies are available most of the publications are now also available on CD ROM disks or via the Internet. These are especially useful because of the built-in search features that enable the users to quickly find specific information. The listing is presented in the order of most useful or relevant first followed by publications that are least useful.

Government Auditing Standards (“Yellow Book”)

Published by: United States General Accounting Office (GAO), By the Comptroller General
(Current version available at: _____)

Purpose: (quote from introduction)

“This document contains standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernmental organizations. These standards, often referred to as generally accepted government auditing standards (GAGAS), are to be followed by auditors and audit organizations when required by law, regulation, agreement, contract, or policy. The standards pertain to auditors’ professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.”

Federal Acquisition Regulations (FARs)

Published jointly by:
United States Department of Defense (DOD), General Services Administration (GSA) and National Aeronautics and Space Administration (NASA)

Format:

Available in paper, CD ROM and on the Internet at www.amnet.gov/far. Another good source is at the Federal Government main home page which is www.firstgov.gov, then search for “Federal Acquisition Regulations.”

Contained in:

Code of Federal Regulations at 48 CFR Chapter 1

Relevant Part:

Part 31 - Contract Cost Principles and Procedures

Purpose:

Provides primary authoritative guidelines for acquisition of supplies and services by government agencies. Provides detailed explanations of specific rules for allowable and unallowable costs.

DCAA Contract Audit Manual

Published by:

United States Department of Defense, Contract Audit Agency (DCAA)

Formats:

Two volume set of paper manuals published twice per year

Available on CD ROM called "Defense Acquisition Deskbook"

Available on the Internet at: <http://www.deskbook.osd.mil> or www.dcaa.mil

Purpose: (quote per manual)

"It prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission."

American Institute of Certified Public Accountants (AICPA)

Published by:

The AICPA is the premier national professional association for CPAs in the United States. This organization produces numerous publications to assist accountants and auditors in following accounting principles and auditing standards.

Formats:

1. AICPA materials are generally available in hard-copy form in a variety of formats including Audit & Accounting Guides, Audit Guides, Professional Standards Binders, Statements of Position, Newsletters, Exposure Drafts and others.
2. All of the AICPA's professional literature is available on CD-ROM with built in search capabilities.
3. Many of the materials are available on the Internet at the AICPA website which is: <http://www.aicpa.org>

Partial Listing of Helpful Materials:

1. AICPA Professional Standards (Two Volume Set)
2. Audits of Federal Government Contractors - Audit and Accounting Guide (1998)
3. Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments and Non-Profit Organizations (1998)
4. Codification of Statements on Auditing Standards as of January 1, 2000
5. Accounting Trends and Techniques -CD-ROM
6. Audit Sampling - Auditing Practice Release
7. Auditing in Common Computer Environments - Auditing Practice Release

Accounting Standards - Current Text

Published by:

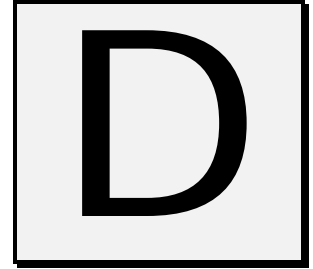
Financial Accounting Standards Board

Format:

Hard-copy 3 volume set

Purpose:

This guide is an integration of currently effective accounting and reporting standards. Material is drawn from AICPA Accounting Research Bulletins, APB Opinions, FASB Statements of Financial Accounting Standards, and FASB Interpretations. While its focus is primarily publicly-traded corporations, some of the material may be helpful for government auditors.



Appendix D - Listings, Tools and Examples

D-2. Listing of Common Unallowable Expenses

D-3. Example of Schedule of Indirect Costs (Home & Field Office Rates)

Listing of Common Unallowable Expenses

The following table provides a listing of expenses that are generally not allowed (under provisions of the Federal Acquisition Regulations, part 31.2) by commercial enterprises performing contracts for the government. The list identifies transactions that are commonly incurred by consulting engineering firms.

<u>FAR</u> <u>Reference</u>	<u>Unallowable Expenses</u>
31.205-1	Advertising
31.205-1	Trade Show Expenses
31.205-1	Trade Show Labor
31.205-1	Promotional Material/Brochures
31.205-1	Souvenirs/Imprinted Clothing Provided to Public
31.205-1	Membership in Civic and Community Organizations
31.205-3	Bad Debts
31.205-3	Collection Costs
31.205-6	Personal Use of Company Vehicles
31.205-8	Contributions or Donations
31.205-13	Employee Gifts & Recreation
31.205-14	Membership in Social/Dining/Country Clubs
31.205-14	Social Activities
31.205-15	Fines/Penalties
31.205-19	Key-Man Life Insurance
31.205-19	Re-Work Insurance
31.205-20	Interest Expense
31.205-22	Lobbying Costs
31.205-27	Organization/Re-organization Legal Fees
31.205-27	Organization/Re-organization Accounting Fees
31.205-27	Organization/Re-organization Incorporation Fees
31.205-27	Organization/Re-organization Labor
31.205-27	Capital Raising (Equity or LT Debt) Legal Fees
31.205-27	Capital Raising (Equity or LT Debt) Accounting Fees
31.205-27	Capital Raising (Equity or LT Debt) Lender Fees
31.205-30	Patent Costs
31.205-33	Retainer agreements
31.205-35	Relocation Costs (If Over \$1,000)
31.205-46	Travel Costs in Excess of FTR Rates
31.205-49	Goodwill
31.205-51	Alcoholic Beverages

Schedule of Indirect Costs

Example: (Showing Field Plus Home Office Rates)

Sample Engineering, Inc. Schedule of Indirect Costs & Rate Calculation For the Year Ended December 31, 1999						
DIRECT LABOR:		Home Office		1,343,665		
		Field Office		<u>948,220</u>		
		Total Direct		<u>\$ 2,291,885</u>		
					Allocation	
	Proposed	Unallowabl		Audited	Field	Home Office
	Allocable	e Expenses	FAR Reference	Expenses	Office	Home Office
	Expenses					
FRINGE BENEFITS						
Insurance - Group	\$ 111,354	\$ -		\$ 111,354	\$ 46,070	\$ 65,284
Insurance - Life	4,197	(670)	31.205-19	3,527	\$ 1,459	2,068
Payroll - Bonus	164,650	0		164,650	\$ 68,121	96,529
Payroll - Holiday	83,722	0		83,722	\$ 34,638	49,084
Payroll - Sick	22,343	0		22,343	\$ 9,244	13,099
Payroll - Vacation	90,838	0		90,838	\$ 37,582	53,256
Payroll - Taxes	<u>240,003</u>	<u>0</u>		<u>240,003</u>	<u>\$ 99,296</u>	<u>140,707</u>
Total Fringe Benefits	\$ 717,107	\$ (670)		\$ 716,437	\$296,411	\$ 420,026
GENERAL OVERHEAD						
Indirect Labor	621,191	0		621,191	\$257,005	364,186
Accounting & Legal	9,357	0		9,357	1,224	8,133
Advertising & Promotion	3,362	0		3,362	440	2,922
Auto Expense	60,665	(3,413)	31.205-6	57,252	7,489	49,763
Computer Service	6,288	0		6,288	822	5,466
Continuing Education	7,407	(972)	31.205-44	6,435	842	5,593
Convention & Seminars	5,144	0		5,144	673	4,471
Depreciation & Amortization	138,625	0		138,625	18,132	120,493
Dues, Memberships, Licenses	4,590	(320)	31.205-1	4,270	559	3,711
Employee Welfare	11,197	0		11,197	1,465	9,732
Equipment Rental	23,481	(1,622)	31.205-1	21,859	2,859	19,000
Insurance - Auto & Trucks	29,683	(2,908)	31.205-6	26,775	3,502	23,273
Insurance - General	204,035	(49,973)	31.205-19	154,062	20,151	133,911
Insurance - Workers' Comp	17,584	(5,455)	31.205-19	12,129	1,586	10,543
Miscellaneous Expenses	5,189	0		5,189	679	4,510
Office Supplies & Expenses	79,429	0		79,429	10,389	69,040
Postage & Delivery	15,557	0		15,557	2,035	13,522
Professional Fees	32,259	0		32,259	4,220	28,039
Rent - Building	100,173	0		100,173	13,103	87,070
Repairs & Maintenance	42,831	0		42,831	5,602	37,229
Subscriptions	6,178	0		6,178	808	5,370
Survey Supplies	24,318	0		24,318	3,181	21,137
Taxes	11,923	0		11,923	1,560	10,363
Telephone	38,299	0		38,299	5,010	33,289
Travel	15,476	(65)	31.205-46	15,411	2,016	13,395
Utilities	20,732	0		20,732	2,712	18,020
Gain on Sale of Assets	(500)			(500)	(65)	(435)
Contributions	698	(698)	31.205-8	0	0	0
Entertainment	<u>9,851</u>	<u>(9,851)</u>	<u>31.205-14</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total General Overhead	\$ 1,545,022	\$ (75,277)		\$ 1,469,745	\$367,997	\$ 1,101,748
Indirect Cost Overhead Rate				<u>95.39%</u>	<u>70.07%</u>	<u>113.26%</u>
Notes:						
(1) Indirect salaries were allocated to field office on the basis of direct labor.						
(2) Indirect expenses were allocated to field office based on a ratio of allocated indirect salaries to total home office salaries (Home Office Direct Labor plus Total Indirect Labor) resulting in 13.08 % to the field.						
Fringe Benefit Allocation: Field = 31.26% of Field DL Home = 31.26% of Home DL						
General OH Allocation: Field = 38.82% of Field DL Home = 82.06% of Home DL						