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AASHTO
THE VOICE OF TRANSPORTATION

American Association of State Highway and Transportation Officials THE VOICE OF TRANSPORTATION

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ACKNOWLEDGMENTS

Discussions among AASHTO members at the regional level and at annual AASHTO meetings led to the creation of the first edition of the *Uniform Audit & Accounting Guide*, which was released in March of 2001. The Guide was designed to assist engineering consultants, independent CPAs, and State DOT auditors with the preparation, and/or auditing, of Statements of Direct Labor, Fringe Benefits, and General Overhead.

Over the years, many people have contributed to the Guide by providing input, conducting research, attending working sessions, facilitating meetings, editing, proofreading, and providing other support. Representatives from State Departments of Transportation, the FHWA, the ACEC, public accounting firms, and AASHTO participated. Their knowledge, time, travel funding, and supplies are greatly appreciated in the nationwide team effort that led to this 2010 edition of the Guide. Scot P. Gormley, External Auditor with the Ohio Department of Transportation, served as the primary designer and editor of this Guide.

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Preface

About This Guide

This Uniform Audit and Accounting Guide was developed by the American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee with assistance from the American Association of State Highway and Transportation Officials, the Federal Highway Administration (FHWA), and the American Council of Engineering Companies (ACEC). The AASHTO Audit Subcommittee is comprised of the senior audit representative from each State's transportation or highway department. This Guide was developed over several years and initially was approved by AASHTO at the organization's 2001 annual meeting.

During 2007, the members of the Audit Subcommittee approved the establishment of a Task Force to update this Guide. The purpose of the update was to help ensure that the Guide is consistent with current auditing standards and procedures, accounting principles, and Federal regulations. The update also was intended to strengthen the Guide by providing additional guidance and clarification regarding the existing policies and procedures set forth in the Federal Regulations. The update helps to address questions and concerns expressed by various parties, including the FHWA, State DOT audit agencies, Architectural and Engineering design firms (hereinafter referred to as "A/E firms" or "engineering consultants"), and public accounting firms. These questions and concerns were brought about through current practice and, in part, through the findings and recommendations in a then-pending audit by the U.S. Department of Transportation's Office of Inspector General (OIG). The OIG's audit report, entitled "Oversight of Design and Engineering Firms' Indirect Costs Claimed on Federal-Aid Grants" (Report Number: ZA-2009-033), was issued February 5, 2009.

This Guide was designed to be used as a tool by State DOT auditors, A/E firms, and public accounting firms that perform audits and attestations of A/E firms. The techniques presented herein primarily focus on examination, auditing, and reporting procedures to be applied to costs that are incurred by A/E firms for engineering and design related services, performed on various Federal, State, and Local transportation projects. These costs are normally billed to applicable agencies through their State DOTs.

The techniques discussed in this Guide were designed to be applied to audit and attestation engagements performed in connection with engineering consultants' *Statements of Direct Labor, Fringe Benefits, and General Overhead* (hereinafter referred to as "overhead schedules"), as well as the related accounting systems, job-costing systems, and labor-charging systems that serve as the basis for the overhead schedules.

This Guide is not intended to be an auditing procedures manual but is instead a guide to assist users in understanding terminology, policies, procedures and audit techniques, and sources for applicable Federal Regulations. This Guide is designed to provide general guidance only and is not meant to supersede the Federal Acquisition Regulation (FAR) or any related laws or regulations. Users should be aware that the FAR Cost Principles change frequently; accordingly, the applicable FAR version should be referenced in conjunction with the use of this Guide.

***Note**: Contact information for all States can be found on the preceding pages and on the AASHTO web site.*

An electronic version of this Guide is available on the AASHTO online bookstore: bookstore.transportation.org.

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1

Chapter 1 – Organization of this Guide and Defined Terms

1.1 – Organization of This Guide

This Uniform Auditing and Accounting Guide is organized in chapters. Chapters are subdivided into sections, subsections, and paragraphs. For the sake of brevity, internal references to this Guide most commonly follow the "short reference" format as illustrated in the following examples:

Short Reference	Full Reference
Section 2.4	Chapter 2, section 4
Section 3.2.D	Chapter 3, section 2, subsection D
Section 5.6.A.2	Chapter 5, section 6, subsection A, paragraph 2

1.2 – General Terms

In this Guide, words not defined shall be given their plain meaning. The following defined words and terms are used throughout this Guide—

- "AASHTO" refers to the American Association of State Highway and Transportation Officials.
- The terms "A/E firm," "engineering consultant," "consultant," "contractor," or "firm" refer to Architectural and Engineering design companies that perform work on Government contracts.
- "AICPA" refers to the American Institute of Certified Public Accountants, the national, professional organization for all Certified Public Accountants.
- The terms "the CPA auditor," or "the CPA" refer to independent CPA firms that perform audits, reviews, or other types of attestation engagements for A/E firms.
- The "*Code of Federal Regulations*" (CFR) is the codification of the general and permanent rules published in the *Federal Register* by the executive departments and agencies of the Federal Government. The CFR is divided into 50 titles that represent broad areas subject to Federal regulation. 48 CFR Chapter 12 sets forth the general guidelines used by State DOTs.
- The "*Cost Accounting Standards*," or "CAS," are issued by the Cost Accounting Standards Board (CASB), a section of the Office of Federal Procurement Policy within the U.S. Office of Management and Budget. The CASB has the exclusive authority to issue and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts that involve Federal funds. The CAS are codified at 48 CFR Chapter 99. Certain CAS provisions are incorporated into FAR Part 31 and therefore apply to most Federal-aid projects, while other provisions apply only to large contracts.
- The "*DCAA Contract Audit Manual*" (CAM or DCAA Manual 7640.1) is an official publication of the Defense Contract Audit Agency (DCAA). The CAM prescribes auditing policies and

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procedures and furnishes guidance in auditing techniques for personnel engaged in performing audits in compliance with FAR Part 31 and related laws and regulations. The CAM is published semiannually by the DCAA.

- The "*Federal Acquisition Regulation*, Part 31" (FAR). The FAR is codified at 48 CFR Part 31. The FAR is the primary regulation governing the acquisition of supplies and services with Federal funds. 48 CFR Part 31 sets the criteria for determining costs eligible for reimbursement on Federally funded agreements and also may be used to determine allowable costs for contracts funded solely by State funds.
- The "*Federal Travel Regulation*" (FTR) is contained in 41 CFR Chapters 300 through 304. The FTR implements policies for travel by Federal civilian employees and others authorized to travel at the Federal Government's expense. Certain FTR provisions are incorporated into the FAR and apply to contract costs charged by engineering consultants.
- "GAAP" refers to the *Generally Accepted Accounting Principles*, a widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board (FASB).
- "*Generally Accepted Auditing Standards*" (GAAS) are published by the American Institute of Certified Public Accountants (AICPA). GAAS apply to financial statement audits and contain guidance regarding auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.
- The "*Government Auditing Standards*," also known as "Generally Accepted Government Auditing Standards" (GAGAS) or "Yellow Book" standards, are issued by the U.S. Government Accountability Office (GAO).[1] GAGAS prescribe general procedures and professional standards that examiners must apply when performing audits or attestation engagements of firms that conduct business with governmental entities. GAGAS standards also incorporate the Generally Accepted Auditing Standards specific to financial-related audits.
- "Management" refers to A/E firm owners, officers, and/or others responsible for the formulation and execution of the firm's policies and procedures, including, but not limited to, internal controls, personnel policies, compensation policies, and labor-charging practices.
- "Overhead" or "indirect cost" refers to any cost that is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or with at least one intermediate cost objective. Engineering consultants charge their indirect costs by applying an overhead rate to an allocation base (e.g., direct labor cost).
- "Overhead rate" refers to a factor/ratio computed by adding together all of a firm's costs that cannot be associated with a single cost objective (e.g., general and administrative costs and fringe benefit costs), then dividing by a base value (usually direct labor cost) to determine a rate. This rate is applied to direct labor, as incurred on projects, to allow a firm to recover the appropriate share of indirect costs allowable per the terms of specific agreements. In this document, the terms "indirect cost rate" and "overhead rate" are used synonymously.
- "Overhead schedule" refers to the primary document used by engineering consultants to compute indirect cost rates (overhead rates) used for billings on Government projects. An overhead schedule is based on amounts obtained from the engineering consultant's general ledger (after the adjusting entries have been posted to the accounts), as well as from amounts in the engineering consultant's cost accounting system. This schedule must be in agreement with, or must be reconciled to, amounts from the engineering consultant's general ledger or post-closing trial balance. An overhead schedule also is commonly referred as a "schedule of indirect costs" or "Statement of Direct Labor, Fringe Benefits, and General Overhead."
- "State DOT" or "DOT" refers to a State department of transportation or other State transportation agency.

[1] *Government Auditing Standards*, GAO-07-731G (Washington, D.C.: July 2007 Revision).

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- "Statements on Auditing Standards" or "SASs" are interpretations of U.S. Generally Accepted Auditing Standards as issued by the Auditing Standards Board (ASB), the senior technical committee of the AICPA designated to issue auditing, attestation, and quality control standards and guidance.

1.3 – OTHER DEFINED TERMS

Actual Costs

Amounts determined on the basis of costs incurred. Actual costs are supported by original source documentation, such as invoices, receipts, and cancelled checks. Actual costs generally are not determined based on forecasts or historical averages.

Actual Cost Agreement

Costs reimbursed under an Actual Cost Agreement are limited to the specified criteria (actual allowable costs) described in the agreement. These limitations are based on the Cost Principles found in FAR Subpart 31.2 and may include additional restrictions mandated by the laws of specific State DOTs. Direct and indirect costs billed against Actual Cost Agreements must exclude all unallowable costs, including certain costs that may be fully or partially deductible for the purpose of computing income taxes (e.g., interest, entertainment, and bad debts).

Advance Agreement

Contract language that specifies the treatment of special or unusual costs. For example, the use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of FAR 31.109 between the engineering consultant and the cognizant audit agency. The advance agreement should specify the basic characteristics of the sampling process. FAR 31.109 provides that advance agreements 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."

Agreement

A contract between a State DOT and an A/E firm. An Agreement is a binding, legal document that identifies the deliverable goods/services to be provided, under what conditions, and the method of reimbursement for such goods/services. An Agreement may include both Federal and State requirements that must be met by the State DOT and the engineering consultant. Agreements usually indicate start and finish dates, record retention requirements, and other pertinent information relative to the work to be performed.

All-Inclusive Hourly Rate Agreement

A contract using a provisional hourly billing rate based on a firm's estimated direct labor and overhead costs, plus a negotiated profit margin. Generally, provisional hourly rates are temporary and are adjusted during the audit process. Negotiated hourly rates may be used for the life of an Agreement or instead may be adjusted periodically based on the provisions of the agreement.

Allocable Cost

FAR 31.201-4 provides that a cost is *allocable* to a Government contract if the cost—

(a) Is incurred specifically for the contract;

(b) Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received; or

(c) Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

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Allowable Cost

Depending on the nature of specific cost items, allowable costs may either be billed directly to contracts or included as overhead costs; however, FAR 31.201-2 provides that a cost is an *allowable* charge to a Government contract only if the cost is—

- reasonable in amount,
- allocable to Government contracts,
- compliant with Generally Accepted Accounting Principles and standards promulgated by the Cost Accounting Standards Board (when applicable),
- compliant with the terms of the contract, and
- not prohibited by any of the FAR Subpart 31.2 cost principles.

Audit

A formal examination, in accordance with professional standards, of accounting systems, incurred cost records, and other cost presentations to verify their reasonableness, allowability, and allocability for negotiating agreement fees and for determining allowable costs to be charged against Government contracts. Audits include an evaluation of an engineering consultant's policies, procedures, controls, and actual performance. Audit objectives include the identification and evaluation of all activities that contribute to, or have an impact on, proposed or incurred costs related to Government contracts.

Audit Cycle

The series of steps that auditors perform in completing an audit engagement. The procedures performed may vary somewhat, but the Audit Cycle generally includes audit planning, review of the auditee's permanent file, preliminary analytical review, audit fieldwork (including entrance and exit conferences), submittal of the draft audit report to the auditee for review and comment, and the issuance of the final audit report.

Audit Resolution Process

The process that State DOTs and the auditee engage in to resolve audit findings. This process may include the negotiation of a settlement and/or may involve legal counsel and court procedures.

Audit Trail

A record of transactions in an accounting system that provides verification of the activity of the system. A complete audit trail allows auditors to trace transactions in a firm's accounting records from original source documents into subsidiary ledgers through the general ledger and into general purpose financial statements and billings/invoices prepared and submitted by the engineering consultant.

Billing Rates (Hourly Labor Rates)

Generally refers to the hourly labor rates charged by an engineering consultant for work performed on an agreement. For a cost plus fixed fee agreement (the most common type of agreement), billing rates are determined based on employees' actual payroll rates. By contrast, for an all-inclusive hourly rate agreement, billing rates are determined based on actual payroll rates with additional amounts included for overhead and net fee (profit).

Contracting Officer

A position title used in FAR Part 31 to identify a person with the authority to bind a State or Federal agency to a contract. Within State DOTs, contracting officers are the individuals who enter into, administer, and/or terminate contracts and make related determinations and findings. In State DOTs, auditors generally act at the request of, and on behalf of, contracting officers.

Corporation

A business structure where stock is made available for purchase. A corporation typically has a president, numerous vice presidents, a chief financial officer and/or treasurer, and a secretary. Corporate employees usually are paid based on an hourly wage rate or annual salary. The liability of individual stockholders (owners) is limited to their investments in the corporation's stock.

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Depending on how a corporation is formed, it will be taxed under either Subchapter C or Subchapter S of Chapter 1 of the Internal Revenue Code. A C-Corporation is taxed on its income at the corporate level, and stockholders pay a second layer of tax on the dividends they receive from the corporation. By contrast, S-Corporations are not taxed at the corporate level; instead, the S-Corporation's income or losses are passed through to its shareholders, who then report the income or loss on their individual tax returns.

Cost Center

A non-revenue-producing element of a business organization. Cost centers are used to accumulate and segregate costs.

Cost Objective

An agreement/contract, function or organizational subdivision, or other work unit for which the costs of processes, products, jobs, or projects are accumulated and measured. An "intermediate cost objective" is a cost objective used to accumulate costs that are subsequently allocated to one or more indirect cost pools and/or final cost objectives.

Cognizant Audit

This concept was developed to assign primary responsibility for an audit to a single entity (the "cognizant agency") to avoid the duplication of audit work performed in accordance with Government Auditing Standards to obtain reasonable assurance that claimed costs are accordance with the FAR Subpart 31.2 cost principles. Such audit work may be performed by 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. Common control exists when a related party has *effective control* over the operating and financial policies of the related entity. Effective control may exist even if the related party owns less than 50 percent of the related entity.

Cost Plus Fixed Fee Agreement

An agreement in which all the cost factors, except the fixed fee, are based on the engineering consultant's actual allowable costs. The fixed fee is a specific, predetermined amount, as identified in the agreement.

Cost of Money (Facilities Capital Cost of Money)

Although interest costs associated with the financing of capital are unallowable, some costs associated with the engineering consultant's investment in fixed assets are allowable. Specifically, Cost of Money is an imputed cost determined by applying a charge rate to the facilities capital employed in contract performance. (See further discussion in Section 8.6.)

Cost of Money is not required to be recorded in the engineering consultant's formal accounting records; instead, Cost of Money is computed as a charge rate based on the following factors:

- The average annual net book value of the engineering consultant's investments in the fixed assets used for allowable business activities (in accordance with the cost principles of FAR Subpart 31.2),
- The prorated average Prompt Payment Act Interest Rate determined by the U.S. Secretary of the Treasury for the accounting period in question, and
- The engineering consultant's direct labor base used to determine overhead rates.

Cost Principles of FAR Subpart 31.2

These principles establish the framework for determining allowable and unallowable charges against Federal-aid contracts. FAR Subpart 31.2 lists expressly unallowable costs and establishes criteria for determining the allocability and reasonableness of cost items.

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Directly Associated Cost

Refers to a cost generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not also been incurred (see FAR 31.001 and FAR 31.201-6(a)). If a cost is determined to be unallowable, then its directly associated costs also must be disallowed.

Direct Cost

Any cost that is identified specifically with a particular final cost objective. Direct costs are not limited to items that are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.

Direct costs include labor, materials, and reimbursable expenses incurred specifically for an agreement. All direct labor costs allocable to design and engineering contracts (regardless of the contract type, e.g., lump-sum versus actual cost) must be included in the direct labor base regardless of whether the costs are billable to a client.

Entrance Conference

A meeting between the auditor and the auditee during which the purpose and scope of the audit are discussed.

Exit Conference

A meeting held after the completion of audit field work. The exit conference generally focuses on a discussion of the preliminary audit findings, which are subject to change based on further audit testing, supervisory review, and additional information submitted by the auditee.

Federal-Aid Contracts

Refers to agreements for the acquisition of supplies and services that are partially- or fully-funded from Federal sources. “Government contracts” is a more encompassing term, as it includes Federal-aid contracts and all other contracts with governmental entities, including contracts that are fully funded by State or municipal governments.

Field Office

A field office is a facility that the engineering consultant specifically establishes, or has furnished to it, at or near the project site. The field office must be used exclusively for project purposes. The use of a field office allows for the computation of a field office overhead rate, which is designed to reimburse the engineering consultant for the fringe benefits of the field personnel and the home office support that is provided to them. Field offices may exist in several forms. For example, an engineering consultant’s employees may work for a period of time in an on-site office maintained by a State DOT. Since the engineering consultant’s employees do not work out of their own offices and do not receive office support in their daily activities, the hours billed for these employees may not qualify for the engineering consultant’s full overhead rate. Instead, a field rate may need to be established to allocate a reasonable portion of the engineering consultant’s indirect costs to a field office.

Financial Statements

Financial statements are formal records that summarize a firm’s business activities. Financial statements usually are compiled on a quarterly and annual basis. In this Guide, the term “General Purpose Financial Statements” is used to refer to the basic financial statements, which include an Income Statement, Balance Sheet, and Statement of Cash Flows. This Guide also makes reference to an overhead schedule, which is a Special Purpose Financial Statement used to report specific financial information to governmental agencies such as State Departments of Transportation and the U.S. Department of Defense.

Finding (Audit Finding)

An audit finding may result from an engineering consultant’s deficiencies in internal control, fraud, illegal acts, the violation of contract or grant provisions, and/or abuse. When auditors identify deficiencies, they should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. In accordance with GAGAS, when documenting a finding, the auditor should include the condition, criteria, cause, effect, and a recommendation for

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correction. See GAGAS Chapters 4.14 to 4.18 for more details.

General and Administrative (G&A) Expenses

Costs of operating a company that are incurred by, or allocated to, a business unit and are not directly linked to the company's products or services.

Interim Audit

An audit conducted during the life of an agreement and designed to determine the actual allowable costs as of the audit date, including costs charged by the prime engineering consultant and any subconsultants. During an interim audit, auditors typically adjust the engineering consultant's billed costs (including direct labor, overhead, and other direct costs) to the allowable costs actually incurred. Interim audits generally involve the use of a standard audit program, although the procedures used may vary somewhat depending on the agency performing the audit.

Internal Controls

Include the plan of organization and the methods and procedures adopted by management to ensure that the firm's 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.

Limited Liability Companies (LLCs) and Limited Liability Partnerships (LLPs)

Business entities in which the members (owners) generally are liable only to the extent of their invested capital. LLCs and LLPs usually are taxed as partnerships (no taxation at the corporate level); although some LLCs elect to be taxed like C-Corporations (taxation applies at the corporate level, before the distribution of dividends).

Lump Sum (Fixed Price) Agreement

An agreement in which the method of payment for delivered goods and/or services is a fixed amount that includes salaries, overhead, and profit. Once the lump-sum amount is determined, the goods and/or services must be provided regardless of the engineering consultant's actual costs. No adjustments are permitted to compensate the engineering consultant for costs in excess of the contract's fixed amount unless there is a significant change in the scope of work that results in an approved change order.

Negotiated Hourly Rate Agreement

An agreement in which hourly billing rates (including labor, overhead, and net fee) are negotiated in advance and are listed for a period of one year or more.

Overtime Compensation

Compensation paid to employees who work more than 40 hours per week. Overtime pay rates may be based on employees' normal hourly rates or may include "premium overtime" such as time and a half or double time. In accordance with the Fair Labor Standards Act (FLSA), premium overtime pay generally is required for hourly workers but is optional for certain salaried employees (exempt employees).

Partnership

A business with two or more co-owners, who may or may not have established salaries. Generally, partners are jointly responsible for the firm's debts and other liabilities, and this liability exposure is not limited to the partners' individual investments in the firm. When establishing hourly pay rates that may be charged against Government contracts, partners may be treated the same as sole proprietors.

Post Audit (Project Close-Out Audit)

An audit done after an engineering consultant completes all scheduled work on a project. The scope of a post audit may include all costs billed to the project, including direct costs, overhead costs, and costs for subconsultants. Post audits generally involve the use of a standard audit program, although the procedures used may vary somewhat depending on the agency performing the audit.

Pre-Award Review

An examination conducted on behalf of State DOT management for the purpose of verifying financial information supplied by an engineering consultant. The examination may involve a desk review

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performed at the audit office and/or fieldwork at the engineering consultant's place of business. Upon completion, the audit results are provided to the State DOT contracting officer for use during contract negotiations.

Provisional Hourly Rate Agreement

An agreement in which hourly billing rates, including labor, overhead, and net fee, are negotiated in advance but are subject to adjustment after actual labor and overhead costs are determined through an audit.

Reasonable Cost

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. See Section 4.2 for additional discussion.

Sole Proprietorship

A business with only one owner. Sole proprietors commonly do not have established salaries, but instead may rely on draws from the firm's profits to obtain payment for their services.

Source Documents

Original documents that support the costs recorded in an engineering consultant's accounting records, including general and subsidiary ledgers. Source documents include, but are not limited to, time sheets, payroll registers, invoices, hotel receipts, rental slips, gasoline tickets, cancelled checks, tax returns, insurance policies, and minutes of corporate meetings.

Task Assignment (Task Order) Agreement

An agreement that specifies a time period for performance but does not include a complete description of all the work to be completed under the agreement. Tasks that require the engineering consultant's expertise are assigned as needed, and each task has its own maximum payable amount. The total amount paid on all the tasks may not exceed the total amount of the agreement.

Total-Hour Accounting System

A total-hour accounting system records all hours worked by all employees, regardless of whether the employees are exempt from overtime pay or whether all direct labor hours are billed to specific contracts. All engineering consultants that receive compensation under actual cost agreements must maintain a total-hour accounting system. See DCAAP 7641.90 Chapter 2-302.1(5) for details. The DCAAP is available at http://www.dcaa.mil/dcaap7641.90.pdf.

Unallowable (Cost)

An item of cost that is ineligible for cost reimbursement. Unallowable costs must not be billed to Government contracts either directly or through the application of an overhead rate. When an unallowable cost is incurred, its directly associated costs also are unallowable.

Uncompensated Overtime

FAR 52.237-10 defines *uncompensated overtime* as "hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act. Compensated personal absences such as holidays, vacations, and sick leave must be included in the normal work week for purposes of computing uncompensated overtime hours."

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Chapter 2 – Adequacy of Accounting Records

Management must maintain accurate financial information and must submit timely financial reports to governmental agencies, including Federal agencies, State DOTs, and/or municipal entities. These financial reports include general purpose financial statements, overhead schedules, and other schedules required to demonstrate an engineering consultant's compliance with Federal procurement regulations and State DOT laws. In most cases, special schedules and disclosures will be required to be submitted to State DOTs in addition to the annual general purpose financial statements prepared for stockholders, lending institutions, and management.

***Note**: In cases where a CPA performs an engagement to determine the engineering consultant's compliance with the cost principles of FAR Part 31.2, management also must ensure that Federal and/or State DOT auditors are granted full access to the CPA's workpapers.*

2.1 – Overhead Schedule

A. Generally

An overhead schedule is the primary document used to show the calculation of an overhead rate. An overhead schedule is based on amounts obtained from the engineering consultant's general ledger (after adjusting entries have been posted to the accounts), as well as from amounts in the consultant's cost accounting system. The overhead schedule must be in agreement with, or must be reconciled to, the general ledger.

The overhead schedule should clearly display the unallowable costs that have been removed from the various accounts (see Section 5.6.C.3 for sample overhead schedules). If the schedule is presented "net of unallowable costs," then the details of the unallowable costs must be disclosed in the accompanying notes. Additionally, disclosures must be included with the overhead schedule, other financial statements, and any special schedules. These disclosures must include explanatory information about the financial data, organizational structure of the firm, and operating policies (see further discussion in Chapter 11).

An overhead rate generally is computed as the ratio of allowable indirect costs to total allocable direct labor costs. Accordingly, the overhead schedule should identify direct labor cost as a separate line item, and direct labor must be in agreement with the general ledger and must reconcile to the cost accounting system (project accounting records).

B. Facilities Capital Cost of Money and Other Items

Other items, such as Facilities Capital Cost of Money (hereinafter "cost of money"), must be separately disclosed in the notes to the overhead schedule. Although cost of money generally is computed as a rate based on direct labor cost, cost of money should *not* be included as part of the overhead rate.

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C. Disclosure of Field Office Rates

The overhead schedule 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. When a company uses Field Office (onsite) rates in addition to Home Office (offsite) rates, costs and labor amounts for both rates should be displayed on the overhead schedule. The rate structure and allocation methodology should be clearly explained in the notes.

Engineering consultants are responsible for consistently estimating, accumulating, and reporting costs. Accordingly, all projects should be subject to the same accounting procedures and processes.

***Note**: Engineering consultants must account for costs appropriately and must maintain records, including supporting documentation, adequate to demonstrate that the costs claimed were incurred, were allocable to the contract, and complied with applicable FAR cost principles. Supporting documentation includes, but is not limited to, travel expense reports, hotel receipts, cancelled checks, time sheets, and usage logs.*

Contracting officers may disallow all or part of a claimed cost that is inadequately supported. Additionally, when an engineering consultant uses accounting practices that are not consistent with FAR requirements, costs resulting from such practices must be disallowed, to the extent that these costs exceed the amount that would have resulted from the consistent application of the FAR.

2.2 – UNALLOWABLE COSTS

A. Generally

FAR 31.201-6 and CAS 405-40 require unallowable costs and any directly associated costs to be identified and excluded from billings, claims, or proposals for Government contracts. In addition, unallowable costs must participate in indirect cost allocations just as if the unallowable costs were allowable. That is, all activities that benefit from the indirect cost, including unallowable activities, must receive an appropriate allocation of indirect costs.

***Note**: Section 8.30 (Table 8-1) includes a list of common unallowable costs.*

B. Directly Associated Costs

FAR 31.001 defines a *directly associated cost* as "any cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred." Engineering consultants must maintain adequate records to identify unallowable costs, including directly associated costs. Furthermore, CAS 405-40(e) states:

> All unallowable costs . . . shall be subject to the same cost accounting principles governing cost allocability as allowable costs. In circumstances where these unallowable costs normally would be part of a regular indirect-cost allocation base or bases, they shall remain in such base or bases. Where a directly associated cost is part of a category of costs normally included in an indirect-cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect-cost pool and be allocated through the regular allocation process.

For directly associated costs other than those described above in CAS 405, the directly associated costs, if material in amount, must be purged from the indirect cost pool.

FAR 31.201-6(e)(2) provides that, when material in amount, salary expenses for the time employees participate in activities that generate unallowable costs should be treated as directly associated costs. However, time spent by an employee outside the normal working hours should 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 were a part of the employee's regular duties.

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2.3 – FINANCIAL STATEMENTS

Financial statements will vary depending on the company ownership, type of business organization, and firm size. Publicly-traded companies generally will have audited financial statements that include a CPA's opinion. Other entities also may have audited financial statements to serve the needs of lending institutions, owners, and government agencies.

Many smaller A/E firms have financial statements that are *compiled* by, but not audited by, an accounting firm. In many cases, the accounting firm also will assist in preparing the overhead schedule. In other cases, an engineering consultant's internal accounting department and management personnel will prepare the financial statements. However, in all cases, the financial statements should include representations from management that the amounts are timely, accurate, and are prepared in compliance with regulations that apply to the specific circumstances.

2.4 – MANAGEMENT REPRESENTATIONS

When performing overhead engagements of A/E firms, it is important for auditors to obtain written representations from management personnel. Specific representations will vary depending on the circumstances, including the scope of the engagement and the availability of other information, such as audited financial statements. However, when performing any type of overhead engagement, auditors typically should require the following management representations:

- The financial information is accurate.
- The financial information is complete.
- The information is in compliance with Government regulations (e.g., FAR Part 31, the Internal Revenue Code, and the Federal Travel Regulation).
- Estimates are based on sound financial data and consistent assumptions.
- All actual indirect cost rates submitted to any governmental entity have been disclosed.

***Note**: Examples of management representation letters are included in Appendix E.*

In some contract audit environments, a management-certified cost proposal may be the starting point for an audit or examination-level attestation. The cost proposal also may serve as management's representation that the submitted costs are allowable in accordance with FAR Part 31 and other related laws and regulations. The auditor should consider obtaining additional representations, as necessary, for matters that arise during the course of the engagement.

Some states require annual submissions of financial, procedural, and other company information as well as overhead schedules. Additionally, some states require annual CPA audits of submitted cost information, including an overhead schedule.

Under the provisions of the *Sarbanes-Oxley Act* (SOX), publicly-traded companies must submit annual reports that include management representations of their firms' internal control structure. SOX also requires an independent CPA's opinion on internal controls.

2.5 – MANAGEMENT AND CPA'S ROLES AND RESPONSIBILITIES

A. Management Responsibilities

Management bears the sole responsibility for identifying, segregating, and removing unallowable costs from all billings to Government contracts. This requirement applies to direct costs, indirect costs, and any cost proposals that are submitted for Government contracts. In establishing a sufficient internal control system, the engineering consultant must train accounting staff, including payables clerks and staff members responsible for preparing project billings, in the FAR Subpart 31.2 cost principles so that unallowable cost items can be identified, segregated, and disallowed as transactions occur.

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B. The CPA Auditor's Responsibilities

1. Generally

Some state DOTs require CPA audits to be conducted on all overhead schedules that are prepared and submitted by engineering consultants. These audits may either be conducted by the same CPA that performs other accounting work for the engineering consultant (e.g., audits of general purpose financial statements or tax compliance work) or by a separate CPA. However, regardless of the CPA's overall business relationship with the engineering consultant, the overhead engagement must be performed in accordance with certain minimum standards, which are discussed in detail in the sample CPA Workpaper Review Program included in Appendix A of this Guide.

***Note**: Although Appendix A should be consulted for detailed requirements, the following discussion is a general summary of the CPA auditor's responsibilities.*

The CPA auditor is responsible for performing an audit or examination level attestation engagement in accordance with Government Auditing Standards (GAGAS) to obtain reasonable assurance that the engineering consultant complied with FAR Part 31 and applicable Cost Accounting Standards. Accordingly, before opining on or attesting to the reliability of the indirect cost rate, the CPA must perform adequate procedures appropriate to the specific type of engagement. The engineering consultant and CPA must execute an engagement letter that clearly specifies the type of engagement to be performed and the roles of each party.

The CPA auditor is responsible for—

- Issuing an independent opinion on the engineering consultant's compliance with Government regulations, including FAR Part 31 and related laws.[2]
- Issuing a report describing the extent of the auditor's testing of the engineering consultant's internal controls and the results of such testing.[3]

It must be noted that, although the CPA may be involved in some aspects of the overhead rate computation, the CPA's testing must be performed independently to verify that the engineering consultant's internal controls are working properly; accordingly, the CPA must *not* function as a component of the internal control system. As described above in Section 2.5.A, the engineering consultant should identify, segregate, and disallow unallowable costs as transactions occur. Management must not rely on the CPA's end-of-year audit testing as the sole method for detecting unallowable costs.

***Note**: Before accepting FAR audit engagements, CPAs must determine if they have the required specialized knowledge to complete the engagement (see Statement on Auditing Standards No. 105). In cases where a CPA's primary area of expertise does not include the A/E industry and the FAR Subpart 31.2 cost principles, said CPA should engage the services of a qualified specialist to consult with, conduct training, and/or review audit programs and audit reports. CPAs should document their qualifications to perform the audit, identify any specialists used in the engagement and must maintain adequate evidence of their professional registration status and results of peer reviews.*

[2] See sample opinion letter in Section 11.2.

[3] See sample internal control report in Section 11.3.

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2. The CPA's Responsibilities for Fraud Detection

The CPA must immediately notify the appropriate State DOTs of any findings such as those discussed below:

- ***GAGAS 5.04c and 6.31b***. Auditors must report deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.
- ***GAGAS 5.18 and 6.39***. When either of the following circumstances exists, auditors should report directly to parties outside the audited entity with respect to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse:
  (a) When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the information directly to the specified external parties.
  (b) When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriated steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.
- ***GAGAS 5.19 and 6.40***. Auditors should comply with the requirements discussed above even if the auditors have resigned or were dismissed from the audit prior to its completion.
- ***GAGAS 5.20 and 6.41***. Auditors have a professional obligation to obtain sufficient evidence that management of the audited entity appropriately reported findings to outside parties.

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C. Selection of CPA Firm as Overhead Auditor

There are many factors involved in selecting a CPA to perform an overhead audit. The CPA must follow AICPA professional standards and must obtain sufficient, appropriate audit evidence to support the opinion that the overhead schedule was prepared in compliance with the FAR 31.2 Cost Principles. The following list, although not comprehensive, provides some factors for consideration. The CPA should:

- Meet all GAGAS requirements, including requirements for adequate continuing professional education (CPE) in governmental auditing.
- Have received favorable peer review reports.
- Be well versed in GAGAS, the provisions of FAR Part 31 (including the FAR Subpart 31.2 cost principles), Cost Accounting Standards, related laws and regulations (e.g., the Internal Revenue Code, the Federal Travel Regulation, and 23 U.S.C. 112), and the guidelines and recommendations set forth in this Guide.
- Have adequate experience in applying GAGAS.
- Have a working knowledge of the A/E industry, including common operating practices, trends, and risk factors.
- Be well versed in job-cost accounting practices and systems used by A/E firms.
- Assign direct supervisory staff to the engagement who have prior experience performing overhead audits in compliance with FAR Part 31.
- Have experience performing FAR audits and have knowledge of Government procurement with regard to various types of contracts and contract payments terms affecting the development and/or application of an allowable overhead rate.
- Design and execute an audit program that meets the AICPA's professional standards, as well as the specific testing recommendations described in the sample CPA Workpaper Review Program provided in Appendix A of this Guide.

***Note**: The following documents provide additional useful information regarding the procurement of professional audit services:*

- *Selecting an External Auditor: Guide for Making a Sound Decision (Mid-America Intergovernmental Audit Forum, May 2007).*
- *How to Avoid a Substandard Audit: Suggestions for Procuring an Audit (National Intergovernmental Audit Forum, May 1988).*
- *Procuring Audit Services in Government: A Practical Guide to Making the Right Decision. AGA CPAG (Corporate Partner Advisory Group) Research Series, Report No. 19, February 2009.*

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Chapter 3 – Standards for Attestations and Audits

3.1 – Background

[References: 23 U.S.C. Section 112(b)(2)(C), 48 CFR Part 31]

Most State departments of transportation (DOTs) award contracts for engineering and related services using Qualifications Based Selection (QBS) procedures. Under QBS, engineering consultant selections are based solely on elements of qualification, without consideration of price; accordingly, engineering consultants do not submit bids or priced proposals to be used as a basis for selection. Once a State DOT has made a selection based on the engineering consultant's qualifications, contract prices are negotiated based on the engineering consultant's estimated costs, which should be based on actual costs incurred in prior periods. These prices must be reasonable for the work to be performed.

23 U.S.C. Section 112(b)(2)(C) requires contracts for engineering services to be performed and audited in compliance with the costs principles contained in Part 31 of the Federal Acquisition Regulation (FAR). Because State DOTs construct highway improvements using both State and Federal funds, most State DOTs use rules for selection and pricing of state-funded engineering consultant contracts that incorporate, or are similar to, Federal rules.

***Note**: The timing and types of audits performed to meet Federal requirements may vary between contracts, depending on State DOT procedures and other circumstances. Audits are performed to obtain reasonable assurance that consultant contract pricing is based on actual costs incurred, in compliance with FAR Part 31 and specific contract provisions.*

3.2 – Engagement Types

Contract engagements generally include the following:

A. Review of Indirect Cost Rates for Costs Incurred

This type of engagement requires an examination of the engineering consultant's indirect cost rate(s) for a specified period (usually a calendar or fiscal year). In addition to ensuring that unallowable costs have been removed from overhead, the auditor should ensure that allowable costs have been correctly measured and properly allocated. Indirect cost rates established in these engagements are used to adjust costs previously invoiced at provisional rates to actual costs.

Many State DOTs also use established indirect cost rates of the most recently completed calendar or fiscal year as provisional rates to be used for estimating and invoicing costs on new contracts. In applying these provisional rates, risk and materiality must be measured, with due consideration given to all contracts that may be priced using the indirect cost rates.

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B. Indirect Cost Rate (Forward Pricing) Review

This type of engagement requires an examination of the engineering 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 described above in Section 3.2.A in that forward pricing rates are based on historical costs. However, these rates are adjusted to reflect estimates of future costs and activity levels to project indirect cost rates for future periods.

When reviewing forward pricing rates, auditors should evaluate the reasonableness of future projections as well as the accuracy of historical cost information used as the starting point for rate development. While most contracts negotiated directly with Federal agencies utilize forward pricing rates, many DOTs only will negotiate contracts using indirect cost rates based on actual, historical cost information. Risk and materiality should be determined based on all contracts that may be priced using the indirect cost rate.

C. Contract Pre-Award Review

Contract pre-award reviews are performed to evaluate the reasonableness and accuracy of cost proposals for specific contracts. 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-awards reviews, auditors often rely on work done by other auditors; however, if other audit reports do not exist, then auditors performing the pre-award review may examine items such as indirect cost rates. Risk and materiality should be determined based only on the contracts being covered by the pre-award review. Auditors may be required to perform additional work for very large contracts.

D. Contract Cost Review

These engagements are performed to determine actual costs incurred on contracts. Auditors should consider both direct and indirect costs, to determine whether invoiced costs were allowable in accordance with applicable cost principles and were treated consistently with cost accounting practices used to develop the engineering consultant's indirect cost rate(s). When conducting such engagements, auditors often rely on opinions rendered by indirect cost rate auditors, including conclusions reached about the accounting and internal control systems. Risk and materiality should be determined based only on the contracts being covered by the contract cost review.

3.3 – AUDITING STANDARDS

Auditing procedures and responsibilities may vary, depending on the nature of the audit or examination-level attestation performed by the auditor. Several regulatory bodies may influence the types of procedures that will apply to planning the audit, performing audit testing, and reporting on the results. A description of applicable auditing standards follows.

A. Government Auditing Standards ("Yellow Book" or "GAGAS" Standards)

The Government Auditing Standards, also known as "Generally Accepted Government Auditing Standards" (GAGAS), are issued by the U.S. Government Accountability Office (GAO). GAGAS apply to audits of government entities as well as audits of Federal-aid funds paid to engineering consultants, non-profit organizations, and other non-governmental organizations.

GAGAS may be used in conjunction with professional standards issued by other authoritative bodies. For example, the AICPA has issued professional standards that apply to financial audits and attestation engagements performed by CPAs. GAGAS incorporate the AICPA's field work and reporting standards and, unless specifically excluded, also incorporate the related statements on auditing standards for financial audits. GAGAS incorporate the AICPA's general standard criteria, and the field work and reporting standards and the related statements on the standards for attestation engagements, unless specifically excluded.

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***Note**: GAGAS also prescribe requirements in addition to those provided by the AICPA; accordingly, auditors may need to apply additional standards, depending on the purpose and requirements of the audit or attestation engagement.*

B. GAGAS Engagement Types

GAGAS categorize engagements into three types: (1) Financial Audits, (2) Attestation Engagements, and (3) Performance Audits. These engagement types are discussed in the following paragraphs. The standards to be applied will vary based on the engagement type and audit objectives.

1. Financial Audits

In performing a financial audit, the auditor is primarily concerned with providing reasonable assurance about whether financial statements are presented fairly, in all material respects, in conformity with GAAP or with a comprehensive basis other than GAAP. An example would be an audit of an overhead schedule (considered a financial statement) performed in compliance with FAR Part 31. Financial audits also may include other objectives that provide different levels of assurance and entail various scopes of work.

2. Attestation Engagements

Attestation engagements concern examining, reviewing, or performing agreed-upon procedures on a subject matter or an assertion about a subject matter and reporting on the results. These engagements may cover a broad range of financial or nonfinancial subjects and can be part of a financial audit or performance audit. Examples include examining an entity's internal control over financial reporting, an entity's compliance with requirements of specified laws, regulations, rules, contracts, or grants, and various prospective financial statements or pro-forma financial information.

3. Performance Audits

Performance audits entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a specific program. These audits generally are performed to improve program operations and may encompass a wide variety of objectives. Examples include whether legislative, regulatory, and/or organizational goals are being achieved, the relative cost and benefits of a program, and the validity and reliability of performance measures.

***Note**: This Guide primarily deals with financial audits and attestations. A matrix is provided in the following subsection (see* Table 3-1*) to summarize applicable standards for these types of engagements. Performance audits are beyond the scope of this Guide.*

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C. GAGAS Matrix

GAGAS incorporate various AICPA standards and additional standards more specific to engagements performed on governmental entities. The following matrix may be used as a general guide to determine the applicable standards; however, GAGAS (the Yellow Book) should be consulted for the complete text of the standards.

Table 3-1: GAGAS Matrix

Standard Category	Source	Financial Audit Standards	Examination Level Attestation Engagement Standards
General	AICPA		Evaluation Against Criteria
	GAGAS	Independence	Same as Financial
	GAGAS	Professional Judgment	Same as Financial
	GAGAS	Competence	Same as Financial
	GAGAS	Quality Control and Assurance	Same as Financial
Field Work	AICPA	Planned and Supervised	Same as Financial
	AICPA	Understand Internal Control	Similar to Financial
	AICPA	Evidential Matter	Sufficient Evidence for Conclusion
	GAGAS	Auditor Communication	Similar to Financial
	GAGAS	Results of Previous Audits	Same as Financial
	GAGAS	Detecting Material Misstatements	Similar to Financial
	GAGAS	Elements of Finding	Similar to Financial
	GAGAS	Audit Documentation	Similar to Financial
	GAGAS	Determining Materiality	Similar to Financial
	GAGAS	Consideration of Fraud and Illegal Acts	Similar to Financial
	GAGAS	Consideration of Investigations and Legal Proceedings	Similar to Financial
Reporting	AICPA	GAAP or Not GAAP	
	AICPA	Consistent Between Periods	
	AICPA	Informative Disclosures	
	AICPA	Opinion or Expression of Non Opinion	
	AICPA		Engagement Subject Matter
	AICPA		Practitioner's Conclusion
	AICPA		Practitioner's Reservations
	AICPA		Report Distribution Restrictions
	GAGAS	In Accordance with GAGAS	Same as Financial
	GAGAS	Internal Control Report	Similar to Financial
	GAGAS	Reporting Deficiencies	Same as Financial
	GAGAS	Reporting Significant Matters	None
	GAGAS	Reporting Restatement of Financial Statements	None
	GAGAS	Views of Responsible Officials	Same as Financial
	GAGAS	Privileged and Confidential Information	Same as Financial
	GAGAS	Report Distribution	Same as Financial

***Note**: The applicable standards vary depending on the type of audit or attestation engagement. Additional audit standards and procedures (e.g., standards issued by the Institute of Internal Auditors and/or Federal agencies) may be appropriate, depending on the circumstances.*

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3.4 – OPINION ON INTERNAL CONTROL

[Reference: Sarbanes-Oxley Act of 2002]

The Sarbanes-Oxley Act of 2002 was major legislation that affected publicly-traded companies. It established the Public Company Accounting Oversight Board (PCAOB), which has the authority to set auditing standards for registered public accounting firms involved with publicly-traded companies. One key provision is the requirement that annual reports must include an internal control report from management, along with an attestation report from the firm's auditor. These standards, and the internal control reports, may provide assurances when determining the adequacy of controls for publicly-traded consulting firms.

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Chapter 4 – Cost Principles

4.1 – Overview of Federal Acquisition Regulation Part 31

State departments of transportation (DOTs) rely on FAR Part 31 for guidance when negotiating costs and reviewing project proposals with engineering consultants. The FAR contains cost principles and procedures for pricing contracts, subcontracts, and modifications to contracts.

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

The provisions apply to commercial organizations, educational institutions, State, local and Federally-recognized Indian tribal governments, and nonprofit organizations. FAR 31.105, dealing with construction and architect-engineering contracts, states that the allowability of costs shall be determined in accordance with FAR Subpart 31.2. Accordingly, the following discussion focuses 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 all costs that are reasonable, allocable, and are not prohibited by FAR Part 31.

In some cases, a contracting State DOT may enter into an advance agreement with an engineering consultant to clarify the allocability and allowability of special or unusual costs. FAR 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 should 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 FAR;
2. Allocability;
3. Cost Accounting Standards (CAS) promulgated by the Cost Accounting Standards Board (CASB); if applicable, otherwise, Generally Accepted Accounting Principles and practices appropriate to the particular circumstances;
4. Terms of the contract; and
5. Reasonableness.

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4.2 – REASONABLENESS AND ALLOWABILITY

[References: FAR 31.201-2, FAR 31.201-3]

A. Generally

Cost elements must be addressed for reasonableness in accordance with FAR 31.201-2 and 31.201-3. Reasonableness concerns may arise in any number of cost categories, including indirect labor and fringe benefits, among others. For example, the amount of indirect labor in the indirect cost pool in relation to direct labor may cause concerns regarding a firm's efficiency and the extent to which the Government should reimburse costs through the overhead rate. Additionally, certain categories of fringe benefits also may generate reasonableness concerns, especially in the case of privately-held firms with compensation cost structures not subject to the constraints of stockholders' oversight.

***Note**: The following section discusses the reasonableness of general cost items. See Chapter 7 for specifics regarding determining the reasonableness of compensation costs.*

B. Requirements of FAR 31.201-2 and FAR 31.201-3

FAR 31.201-2, Determining Allowability, provides the following (emphasis added):

(a) A cost is allowable only when the cost complies with all of the following requirements:

(1) *Reasonableness*.

(2) Allocability.

(3) Standards promulgated by the CAS Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the circumstances.

(4) Terms of the contract.

(5) Any limitations set forth in [FAR 31.201].

FAR 31.201-3, Determining Reasonableness, provides the framework for addressing the reasonableness of costs (emphasis added):

(a) A cost is reasonable if, in its nature and amounts, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs should be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

(b) What is reasonable depends upon a variety of considerations and circumstances, including—

(1) Whether it is the type of cost generally recognized as *ordinary* and necessary for the conduct of the contractor's business or the contract performance;

(2) Generally accepted sound business practices, arm's length bargaining, and Federal and State laws and regulations;

(3) The contractor's responsibilities to the Government, other customers, the owners of business, employees, and the public at large, and

(4) Any significant deviations from the contractor's established practices.

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C. Methodologies for Applying FAR 31.201-3

While the tests, standards, and other considerations referenced in FAR 31.205-3 entail varying degrees of subjectivity and professional judgment, it is strongly recommended, as a best practice, that greater emphasis be placed on quantitative analysis in addressing the reasonableness of costs. Specifically, ordinary costs are amounts that are common, usual, and otherwise characteristic of the industry segment. When analyzing cost elements for reasonableness, engineering consultants and auditors are strongly recommended to use the concept of ordinary cost as a starting point, as discussed below.

1. Determining Ordinary Cost Through Quantitative Analysis

The starting point in the analysis of reasonableness of a specific cost element is the establishment of an ordinary level of cost as a baseline for the analysis. The methodology for establishing this baseline may vary depending on the circumstances.

(a) Ratio Analysis. The methodology may include the use of ratios, for example, the use of mean or median values as a percentage of either direct labor or net revenues by type of engineering services, size of firm, and location, among other parameters. When this methodology is used, the ratios and other comparative statistics may be derived from nationally-published, independent industry surveys.

(b) Analysis of Trend /Historical Data. The methodology for establishing baseline costs also may include the use of trend analysis and/or analysis of historical cost data. When trend analysis is used, consideration should be given to both the trend within the firm in question as well as the industry overall. Additionally, a combination of both survey and trend analysis, as well as other empirically-based methodologies, may be used.

(c) Analysis of Variances. Once baselines for specific cost elements are established, variances in excess of benchmark thresholds, if determined to be material on the basis of professional judgment, should be identified, analyzed, and addressed by the engineering consultant and/or in the auditor's workpapers within the context of a multi-factor analysis, in accordance with the considerations outlined by FAR 31.205-3 and other related regulations. If costs with material variances are determined to be reasonable, then the basis for acceptance of the variances in the context of FAR 31.205-3 should be explicitly identified in the audit workpapers, so that the cognizant agency or other reviewer is made fully aware of the facts underlying this determination.

2. Determining Reasonableness: Common Cost Categories

Cost categories of frequent concern with respect to reasonableness include, but are not limited to, executive compensation (see Chapter 7), indirect labor, vehicle costs, travel costs, occupancy costs, pension costs, and the various elements of fringe benefits.

4.3 – ALLOCABILITY

[Reference: 31.201-4]

A cost is *allocable* if it is assignable or chargeable to one or more cost objectives or cost centers on the basis of either the 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 (direct cost);
2. Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received (direct and indirect cost); or
3. Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (indirect cost only).

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4.4 – UNALLOWABLE COSTS

[References 31.201-6, CAS 405 (48 CFR 9904.405)]

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 CAS 405 (48 CFR 9904.405), Accounting for Unallowable Costs.

4.5 – DIRECT AND INDIRECT COSTS

[References: FAR 31.202, FAR 31.203]

In evaluating an engineering consultant's overhead, auditors should 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 must be charged directly to the contract or project. All costs specifically identified with a project are direct costs of that project and may not be charged to another project, either directly or indirectly. Finally, a cost may not be charged as direct and also be included in an 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. However, any variances and credits should then also be treated as indirect costs.

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 engineering consultant must record indirect costs in accordance with GAAP and must consistently allocate these costs to intermediate or final cost objectives, as appropriate.

4.6 – APPLICABILITY OF COST ACCOUNTING STANDARDS

Contracts may be subject to the Cost Accounting Standards (CAS) promulgated by the Cost Accounting Standards Board (CASB), an independent board that reports to the U.S. Office of Management and Budget's Office of Federal Procurement Policy. Certain CAS provisions are incorporated into FAR Part 31 and apply to most Federal-aid projects reimbursed under actual-cost agreements, while other provisions apply only to large contracts. Engineering consultants that are subject to full CAS coverage for Federal contracts also should use full CAS-based cost accounting practices for State DOT contracts.

***Note**: For details regarding CAS Program Requirements, see FAR Subpart 30.2.*

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4.7 – ALLOCATION BASES FOR INDIRECT COSTS

[Reference: FAR 31.203(c)]

Generally. Allocation bases are used to distribute/allocate overhead costs to intermediate or final cost objectives. An allocation base common to all cost objectives or projects should be selected for the allocation of indirect costs. Although most engineering consultants use direct labor as the sole base for developing overhead rates, some engineering consultants have rate structures that are more complex and use multiple allocations bases to allocate costs. A typical example follows:

EXAMPLE 4-1: COMMON ALLOCATION BASES

Cost Pool	Allocation Base
Employee Fringe Benefits	Direct Labor
Overhead Expenses	Direct Labor and Fringe Benefits
General & Administrative Expenses	Total Cost Input*

** When using the Total Cost Input allocation base, the base includes direct labor, indirect labor, fringe benefits, general overhead, unallowable costs, materials, and costs for subconsultants.*

Rate Structures and Cost Allocation Methods. Once an appropriate base for distributing indirect costs has been accepted, the base should not be fragmented by removing individual elements. Rate structures and cost allocation methods must be consistently applied to all contracting entities, including State DOTs. As an example, a consultant with a single, company-wide cognizant audited rate should not establish and apply a segment rate for a contracting entity when the costs included in the segment rate also are included in the company-wide rate. Likewise, direct costs must be consistently allocated and applied to all benefited objectives, regardless of specific contract provisions. As an example, if a firm accounts for and allocates computer cost direct to benefited objectives, and a contracting entity negotiates not to allow computer costs as a direct cost by contract, the computer costs associated with this contract must be consistently allocated as a direct cost to this project.

Base Period for Allocating Indirect Costs. As provided in FAR 31.203(g)(2), " . . . the base period for allocating indirect costs shall be the contractor's fiscal year used for financial reporting purposes in accordance with generally accepted accounting principles. The fiscal year will normally be 12 months, but a different period may be appropriate (e.g., when a change in fiscal year occurs due to a business combination or other circumstances)." When a contract is performed over an extended period, as many base periods shall be used as are required to encompass the total period of contract performance. In certain instances, an agreed-upon provisional rate may be established for use over the duration of the contract.

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Chapter 5 – Cost Accounting

5.1 – Allocation Bases, Generally

As discussed in Chapter 4, allocation bases are used to assign/allocate certain overhead or other indirect costs to final cost objectives (projects). There are various allocation bases commonly used in cost accounting systems for allocating indirect costs; however, for engineering contracts administered by State DOTs, *direct labor cost* is the most frequently used base. Whatever base is used for cost allocation, it should be *consistent* for all contracts. Some of the common methods are discussed below.

A. Direct Labor Cost

Direct labor cost is the most common, accepted base used to allocate overhead costs on State DOT contracts. Direct labor costs generally are computed by multiplying all direct project labor hours by labor rates, as summarized for all employees within the applicable allocation unit. Labor rates are based on actual employee wages incurred.

B. 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.

C. Total Labor Hours (Total Hours Worked)

This method is similar to the 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 cost objective receiving a benefit as determined by the proportional number of hours assigned to that cost objective.

D. Total Cost Input

This base frequently is used to allocate General and Administrative (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.

E. Total Cost Value Added

This base is similar to the Total Cost Input base. However, the Total Cost Value Added base excludes materials (used primarily in production only) and subcontract costs, as distortion in allocations may occur due to a disproportionate amount of subcontract costs or materials in the pool.

F. Consumption/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.

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5.2 – ACCOUNTING FOR UNALLOWABLE COSTS IN ALLOCATION BASES

[References: FAR 31.201-6, CAS 405-40(e)]

FAR 31.201-6 expressly requires engineering consultants to comply with CAS 405 to account for unallowable costs. CAS 405-40(e) provides that all unallowable costs "shall be subject to the same cost accounting principles governing cost allocability as allowable costs."

CAS 405-40(e) further specifies that:

> In circumstances where these unallowable costs normally would be part of a regular indirect-cost allocation base or bases, they shall remain in such base or bases. Where a directly associated cost is part of a category of costs normally included in an indirect-cost pool that will be allocated over a base containing the unallowable cost with which it is associated, such a directly associated cost shall be retained in the indirect-cost pool and be allocated through the regular allocation process.

***Note**: Allocation bases contain allowable and unallowable costs, but indirect cost pools must be purged of unallowable costs. Additionally, regardless of whether State DOTs contractually limit the amount of direct labor that may be reimbursed on a contract, the engineering consultant's direct labor base must remain as allocated per the consultant's job cost system, and the direct labor base should not be adjusted for unallowable costs. A direct labor base should not be reduced for any excess compensation adjustments but should have allocated to it the allowable overhead in accordance with FAR 31.203(d), which provides that:*

"Once an appropriate base for allocating indirect costs has been accepted, the contractor shall not fragment the base by removing individual elements. All items properly includable in an indirect cost base shall bear a pro rata share of indirect costs irrespective of their acceptance as Government contract costs. For example, when a cost input base is used for the allocation of G&A costs, the contractor shall include in the base all items that would properly be part of the cost input base, whether allowable or unallowable, and these items shall bear their pro rata share of G&A costs."

EXAMPLE 5-1:

> *Sample Design Firm incurred $2.5 million in direct labor, of which $500,000 was not billable to contracts. The total $2.5 million must remain in the direct labor base, which will then be used to allocate the allowable indirect costs.*

5.3 – COST CENTERS

Cost centers are established to accumulate and segregate costs. Cost centers are developed to capture costs associated with a single purpose. The costs are then assigned to objectives (projects) based on unit charges. For example, unit charges frequently are computed for cost categories such as CADD, printing, computers, and vehicles. The over- or under-allocation of costs usually is handled as an adjustment to the overhead cost pool, which is where the costs would have been charged if they had not been directed to the cost center. However, if the over- or under-allocation is significant, then consideration should be given to adjusting the contract/project charges.

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

Some firms choose not to create cost centers and instead estimate the cost of providing certain services by computing unit rates based on certain elements from general ledger accounts (e.g., automobile depreciation from a depreciation account). Once established, these unit charges are offset to overhead as "credit backs" or cost recoveries for allocated direct costs 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. If handled on a direct-cost basis, the direct cost rates must be supported and audited. The burden is on the engineering consultant to prove the direct cost rates and that direct costs

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were properly removed from the indirect cost pool. The overhead audit should include disclosure notes regarding the audited direct cost rates and a listing of cost categories that the engineering consultant charges direct. See Chapter 8 for testing guidance and Chapter 9 for disclosure guidance.

***Note**: Firms that do create costs centers generally capture costs either by business activity (functional cost centers) or based on the firm's organizational structure, as discussed below.*

A. Functional Cost Centers

This method segregates costs unique to a business activity, typically for purposes of direct costing.

B. Subsidiaries, Affiliates, Divisions, and Geographic Locations

Another method of accumulating and segregating costs 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.

5.4 – ALLOCATED COSTS

A. Generally

Indirect costs should be accumulated by logical (homogeneous) cost groupings (pools), with due consideration of the reasons for incurring such costs, allocated to cost objectives in reasonable proportion to the beneficial and causal relationship of the pool costs to final cost objective (see FAR 31.203(c)). The auditor should make a thorough study of the indirect cost activity, including activity bases used for allocation and the cost allocated, to determine whether the activity base chosen by the engineering consultant is appropriate for cost allocation and results in a reasonable measure of the activity. The base should:

- be a reasonable measure of the activity;
- be measurable without undue expense, and, except for G&A expense;
- should fluctuate concurrently with the activity that generates the costs.

When an engineering consultant's activities are decentralized, the use of separate indirect cost rates for each geographic location will normally produce more equitable allocation of indirect costs than the use of composite or company-wide rates. Overhead rates determined for offsite/field activities should be based on eliminating from the overhead pool those types of indirect costs which do not benefit offsite activities. For example, occupancy costs may be eliminated from offsite pools because the engineering consultant uses Government facilities.

B. Fringe Benefits

Fringe benefits include costs for employee perquisites and costs associated with the employer's portion of payroll taxes and employment benefits. Such costs generally include, but are not limited to, payroll taxes, pension plan contributions, paid time off, medical insurance costs, life insurance, and certain employee welfare expenses.

C. 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 relative benefit. Some examples of overhead costs include rent, depreciation, employee recruitment and training, and general or professional insurance policy costs.

D. General and Administrative (G&A)

G&A expenses generally comprise all costs associated with business operations that cannot be specifically identified with a smaller unit of business activities. For 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 business segment.

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E. Internally-Allocated Costs (Company-Owned Assets)

1. Computer/CADD Costs

Generally, this cost center 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.

2. Fleet or Company Vehicles

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

3. Equipment

Costs accumulated to this center 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. Some examples include nuclear density meters, GPS equipment, and traffic counting machines.

4. Printing/Copying/Plan Reproduction

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

No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective.

***Note**: The "Like-Cost" Issue.*

FAR 31.202(a) provides that "[n]o final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective."

Like-cost categories should be consistently allocated in the accounting system. As an example, employee personal vehicle mileage must be allocated to similar cost objectives in the same manner as company vehicle mileage. One category of like costs may not be charged directly to contracts while the related like cost category are recovered as part of the indirect cost rate. Other common like cost categories are computers and telephones.

F. Internal Labor Costs

1. Direct Labor

Labor costs are usually the most significant costs incurred by design and engineering firms in the performance of Government contracts. Incurred labor costs form the basis for estimating labor for future contracts. Therefore, it is imperative that engineering 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. Employees should initial all time sheet changes and adjustments should be maintained as part of the audit trail.

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The engineering consultant should have procedures to ensure that labor hours are accurately recorded and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals. When evaluating the engineering consultant's timekeeping procedures, the auditor should consider whether the procedures are adequate to maintain the integrity of the timekeeping system.

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

***Note**: See Chapter 6 for further discussion of Labor-Charging System requirements.*

2. Uncompensated Overtime for Salaried Employees

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

The engineering consultant must have procedures covering the consistent recording and accounting for hours worked, whether paid or unpaid, to ensure 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.

Per DCAA CAM Section 6-410.3.d:

> If it is determined that Government contracts are being over charged by a material amount due to an inequitable allocation of costs because the contractor does not record all time worked, the contractor should be cited as being in noncompliance with FAR 31.201-4 and CAS 418. Any material excess allocation of costs to Government contracts should be questioned or disapproved as applicable. Materiality is the governing factor when determining whether noncompliances should be cited and whether a contractor should be required to implement a total-hour accounting system.

For firms with material amounts of uncompensated overtime labor, it is necessary to apply an adjustment to minimize the risk that Government projects will absorb disproportionate amounts of direct labor costs. This may be accomplished through either of the following common methods, or any other equitable method, so long as the method applied is consistent year to year, and the methodology is reasonable and supportable:

1. ***Effective Rate Method***. Using this method, effective hourly pay rates are computed weekly, based on actual time charges. This would require the client to divide each employee's total weekly salary by their respective hours worked, which would result in variable wage rates being charged to contracts. For example, if Employee Smith is paid $1,400 per week and works 40 hours per week, then Smith's effective hourly wage rate is $35. By contrast, if Smith actually works 55 hours in week 1 and 50 hours in week 2, then his effective wage rates are $25.45 and $28, respectively. Billings against Government contracts would be limited to the effective rates.
2. ***Salary Variance Method***. Under this method, overhead is reduced for the appropriate portion of labor costs generated by uncompensated overtime hours. The calculation may be completed one of two ways, based on the engineering consultant's use of standard or effective hourly rates. Standard rates are computed as the total paid labor cost compared to total paid hours (e.g., weekly pay divided by 40 hours, or annual pay divided by 2,080 hours).

   (a) Standard Wage Rates: If the engineering consultant records labor at standard rates, then at year end the overhead cost pool must be reduced by the number of uncompensated hours multiplied by the standard wage rate. For example, if Employee Smith earns $72,800, then his standard hourly wage rate is $35.[4] If Smith actually works 2,600 hours during the year, then there are 520 hours of uncompensated overtime.[5] Accordingly, the

[4] $72,800 divided by 2,080 standard hours.

[5] 2,600 actual hours minus 2,080 standard hours.

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indirect cost pool must be reduced by $18,200.[6] This example is illustrated below in *Table 5-1*.

Table 5-1: Salary Variance Method – Standard Rate Example

Employee	Direct Hours	Indirect Hours	Hours Worked	Annual Salary	Standard Hourly Rate	Direct Labor	Indirect Labor	Labor Variance	Total Labor
Smith	2,000	600	2,600	$ 72,800	$ 35	$ 70,000	$ 21,000	$ (18,200)	$ 72,800
Ending Direct Labor:			$ 70,000						
Ending Indirect Labor:			$ 2,800	($21,000 - $18,200)					

(b) Effective Wage Rates: If the engineering consultant records labor at effective hourly rates, then at year end the overhead cost pool must be reduced, and the direct labor base must be increased, by the number of direct labor hours multiplied by the difference between the standard and effective hourly rates. For example, if Employee Smith earns $72,800 working 2,600 hours during the year, his effective rate is $28. If 2,000 of Smith's hours were spent on direct projects, the indirect cost pool must be reduced and direct labor base increased by $14,000. This example is illustrated below in *Table 5-2*.

Table 5-2: Salary Variance Method – Effective Rate Example

Employee	Direct Hours	Indirect Hours	Hours Worked	Annual Salary	Standard Hourly Rate	Effective Hourly Rate	Direct Labor	Indirect Labor	Total Labor	Labor Variance
Smith	2,000	600	2,600	$ 72,800	$ 35	$ 28	$ 56,000	$ 16,800	$ 72,800	$ 14,000
Ending Direct Labor:			$ 70,000	($56,000 + $14,000)						
Ending Indirect Labor:			$ 2,800	($16,800 - $14,000)						

As illustrated in Tables 5-1 and 5-2 above, the end result of using the Salary Variance Method is the same regardless of whether the engineering consultant uses the Standard Rate or Effective Rate option.

***Note**: Significant amounts of uncompensated overtime may have a material impact on costs charged directly to State DOT contracts. Accordingly, State DOTs may seek billing adjustments when appropriate.*

Some engineering consultants may have accounting systems that do not capture costs for hours worked by salaried employees in excess of 8 hours per day or 40 hours per week. Because there is a serious risk of incorrect charging of 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 engineering consultant has an informal policy as to how employees are to select the objectives to be charged.

3. Overtime Premium

Engineering consultants should have the capability of maintaining records that segregate overtime premium amounts as direct or indirect costs. An acceptable method is to charge the premium portion of overtime as a direct charge when it is the engineering consultant's regularly established policy and when appropriate tests demonstrate that this policy results in equitable cost allocations.

When employees normally work on multiple contracts it is often difficult to determine which contract "caused" the overtime. Therefore, many companies have a policy that the overtime premium portion is allocated to the overhead pool.

[6] $35 per hour standard wage rate multiplied by 520 uncompensated overtime hours.

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***Note**: Engineering consultants may treat overtime premium as either a direct or indirect cost, depending on the specific circumstances; however, consultants must treat overtime premium costs consistently for all contracts, regardless of the customer (Government versus commercial) or type of contract involved.*

4. Other Considerations

- ***Approvals and Authorizations***. The engineering consultant should have procedures to ensure that labor hours are accurately recorded and that any corrections to time keeping records are documented, including appropriate authorizations and approvals.
- ***Reconciliation of Labor System to Payroll and General Ledger***. The engineering consultant should have procedures requiring that the total labor costs reflected in labor distribution summaries (job cost) agree with the total labor charges as entered in the time-keeping, payroll systems and general ledger. 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.
- ***Reconciliation of General Ledger and Overhead Schedule to Payroll Tax Returns (IRS Form 941s)***. The engineering consultant should have procedures requiring that the total labor costs recorded in the general ledger, and included on the overhead schedule, reconcile to the payroll data submitted to the Internal Revenue Service.
- ***Labor Costs Directly Associated with Unallowable Activities***. The engineering consultant should have procedures requiring that direct and indirect labor costs directly associated with unallowable costs are identified and segregated.

5. Potential Areas of Risk Regarding Internal Labor

- ***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.
- ***Significant Increases in Direct/Indirect Labor Accounts***. Trend analyses may disclose instances where charges to direct or indirect labor accounts have increased significantly. Two common ratios often used for trend analysis are the *Productivity Ratio* (direct labor/total labor) and the *Multiplier Ratio* (fee revenue/direct labor). Sufficient review should be performed to determine the nature of any significant increase or variance from prior years.
- ***Reorganization/Reclassification of Employees***. The organizational structure of the engineering 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.
- ***Adjusting Journal Entries/Exception Reports (Labor Transfers)***. Adequate rationale and supporting documentation should be available for all significant labor transfers.
- ***Budgetary Control***. Engineering consultants may operate management systems that require strict adherence to budgetary controls. If the system is inflexible, then labor charges may tend to follow the identical route of the budgeted amounts. Rigid budgetary control systems can result in predetermined labor charges.
- ***Mix of Contracts***. Costs should be identified and charged consistently in the accounting system, regardless of contract type. Significantly higher inherent risk exists for firms that use combinations of lump sum contracts and cost plus fixed fee contracts. The risk is that direct labor and other direct costs may not be accounted for under the correct cost objective, thereby resulting in understatement of direct labor and overstatement of indirect labor or incorrect direct project charging. Also see the discussion in Chapter 9–General Audit Considerations.

6. Sole Proprietors' and Partners' Salaries

The compensation of owners or partners must be charged as direct labor when they are personally engaged in performing tasks under contracts. If sole proprietors or partners do not receive a salary, then

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their compensation must be determined by advance agreements or negotiation.

G. Contract Labor/ Purchased Labor

[Reference: CAS 418]

In some cases, engineering consultants contract for services provided by outside engineers, technicians, and similar staff rather than hiring these individuals as employees. This is commonly referred to as "Contract or Purchased Labor." The accounting treatment varies, depending on the circumstances under which the purchased labor costs are incurred.

Two acceptable methods of accounting for this labor are:

1. Charged as a direct cost to projects, or
2. Treated as other labor (direct or indirect as appropriate)

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. Contract labor must share in an allocation of indirect expenses where such a relationship exists and the allocation method is consistent with the engineering consultant's disclosed accounting practices. A separate allocation base for purchased labor may be necessary to allocate significant costs to contract labor, such as supervision and occupancy costs, or to eliminate other costs, such as fringe benefits, that do not benefit purchased labor.

5.5 – OTHER DIRECT COSTS-OUTSIDE VENDORS/EMPLOYEE EXPENSE REPORTS

Other Direct Costs (ODCs) typically include subcontracts, travel, and outside printing. Internally allocated costs based on charge-out rates developed by the firm, such as company vehicle mileage and copying, are earlier in this chapter.

***Note**: To be treated as a direct cost, the item must have been required for, and used exclusively on, a specific job. The "but-for" principle should apply. "But for this job, the cost would not have been incurred." All similar costs must also be treated as direct costs and excluded from overhead costs.*

The audit procedures for ODCs involve determining if unallowable costs were handled correctly. Per CAS 405-40 (Fundamental Requirement): "All unallowable costs shall be subject to the same cost accounting principles governing cost allocability as allowable costs. If a direct cost is unallowable, then it must remain allocated as a direct cost and may not be included in any indirect cost pool.

5.6 – FIELD OFFICE RATES

[Reference: FAR 31.203(f)]

A. Generally

Engineering consultants are not always able to perform contracted services from their established home- or branch offices, as certain contracts may require establishment of offices in field locations, or the engineering consultant may be required to locate personnel in office space provided by a State DOT. Some engineering consultants may even establish a separate company for field projects. Engineering consultants may have both field (construction management) and project (design) office rates. Both rates may be required or established by contract if the consultant did not have previously established field rate accounting.

Per FAR 31.203(f): "Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives." In some cases, projects involve engineering consultants working in State DOT provided office(s) for an extended period of time. The life of the field office is basically determined by the project.

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For projects where the engineering consultant's employees do not work out of their own offices and do not receive office support in their day-to-day activities, the hours billed for them may not qualify for the engineering consultant's full overhead rate. The purpose of the field rate is to pay the engineering consultant for the fringe benefits, project employee management, and home office administrative support they do provide to their field employees.

Approved costs directly identified with the project and consistently treated, as direct costs in the engineering consultant's accounting records will be allowed as direct project costs.

***Note**: Field offices may exist in several forms. Regardless of the engineering consultant's organization, consistency in allocating costs to cost objectives is critical. This Guide presents several suggested methods for computing field office rates. The use of alternative methods may be acceptable. The use of all methodologies must be supported by notes to the overhead schedule or in a separate disclosure statement.*

B. Types of Field Offices

There are many situations that may require the development of a field- or project-office rate. For example:

- ***Construction Contract Administration/Construction Inspection (Field Office)***. These contracts involve the management of construction projects and often involve the engineering consultant's personnel being located in an on-site project trailer provided by the contractor or the State DOT. For larger, "mega" projects, the engineering consultant's personnel may be located in the State DOT's main or regional office.
- ***Project Office***. These contracts usually involve services such as design, real estate, traffic center operations, and utilities. When working on these types of contracts, the engineering consultant's personnel typically work out of an office provide by the State DOT.
- ***"On Call" Engineers***. Consultants with on-call service contracts for short-term projects and tasks may be required by contract to apply a field rate if the consultant is located in a State DOT's offices.
- ***Contract Employees***. State DOTs contract with engineering consultants to provide administrative functions and the engineering consultant's personnel are located in the State DOT's offices to perform these functions.

C. Cost Accounting Considerations

Engineering consultants must be consistent in the development and application of field rates. Accordingly, if an engineering consultant has computed a field rate, this rate must be consistently applied across all business segments and disciplines.

Field rate accounting has an impact on the home office rate. If an engineering consultant has an established field rate for a particular project or State DOT, then the engineering consultant's home office rate will be higher than if the consultant had only a single company-wide rate. As such, for consistent cost accounting application, a State DOT that does not have a field office project would have a higher home rate applied to their State DOT projects.

1. Field Office Direct Labor

Direct field labor is based on actual labor hours multiplied by actual labor rates for field assigned employees. If historical data is not available when establishing a provisional field rate for the first time, then an estimate of direct hours for the contract(s) may be used to distribute direct labor to the field office overhead pool and/or a provisional rate may be negotiated.

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2. Field Office Indirect Costs

There are many considerations to use when developing methodologies for field and project office rates, and these may vary between engineering consultants. However, direct labor is the common base used in the development of field rates. The following method described for allocating costs is a preferred methodology. Field- and project-office rate calculations based on different methodologies than what is provided in this Guide may be acceptable. Many firms disclose their methodology in their audit footnotes or have an approved Cost Allocation Disclosure Statement that documents their field office accounting methodology.

If an alternative allocation method is used, then the consultant's allocation must have resulted from a "reasonable and determinable allocation plan, consistently applied." The engineering consultant should provide a note or other disclosure to describe the allocation methodology in sufficient detail so an auditor can examine the methodology and verify its logic and reasonableness.

As a general rule, State DOTs do not require extensive administrative staffing of engineering 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, depend largely on the engineering consultant's customary accounting practices. Some State DOTs require separate cost pools for accumulation of field office costs. Certain home office indirect cost should be fully allocated to the home office overhead pool, and certain field office indirect cost should be fully allocated to the field office pool (see further discussion in Section 5.6.C.3).

Fringe Benefits. The fringe benefits applicable to the field office direct labor costs should be allocated to the field office overhead pool. If the engineering consultant's accounting records do not maintain separate accounts for field office fringe benefits, then the fringe benefits may be allocated using the Field Office Direct Labor Rate shown below in Table 5-3:

TABLE 5-3: COMPUTATION OF FIELD OFFICE DIRECT LABOR RATE

$$\frac{\text{Field Direct Labor Cost}}{\text{Total Direct Labor Cost}} = \text{Field Office Direct Labor Rate}$$

Indirect Labor–Non Project Time. Labor costs pertaining to non- project time of professional staff working in the field office (training, staff development, staff meetings, and/or similar activities) is generally recorded specifically within the Field Office Indirect Labor accounts. If these costs are not identified or accounted for separately, then a ratio based on the Field Office Labor Rate may be used to allocate costs to the Field Offices, as shown below in Table 5-4:

TABLE 5-4: COMPUTATION OF FIELD OFFICE LABOR RATE

$$\frac{\text{Total Field Labor Cost}}{\text{Total Labor Cost}} = \text{Field Office Labor Rate}$$

Indirect Labor—Support Staff. Indirect salaries, such as accounting, legal, purchasing, personnel, management, and/or similar costs, should also be allocated to the field office overhead pool. Project managers who spend significant amounts of time managing field office staff may account for this management time as actual indirect in the field office overhead pool. This actual time must be supported and documented on the managers' time report. All other support staff time that is not specifically accounted for may be allocated between the home office overhead pool and the field office overhead pool. A ratio of Field Office Labor Percentage would be a reasonable method to allocate these costs.

3. Other Considerations Regarding Indirect Cost Allocations

Indirect Costs Fully Allocated to Home Office. Certain home office indirect costs should be fully allocated to the home office overhead cost pool. These costs include, for example, depreciation, facilities rent, real estate taxes, facility maintenance and repairs, utilities, facility insurance, and/or similar types of costs associated with home office direct labor. (Costs of support functions that support both home and field offices should be allocated accordingly.)

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Indirect Costs Fully Allocated to Field Office. Likewise, certain field office indirect costs should be fully allocated to the field office overhead pool. Some examples of these costs include field equipment, on-site trailer rental, field supplies, field equipment, software specific to projects, and/or similar types of costs.

Indirect Costs Ratably Allocated to Field Office. Other general indirect costs are allocated to the field office overhead pool based on a reasonable estimate of the benefits accruing to the field office pool. One recommended method is to allocate general indirect costs on the basis of the field office labor percentage. This allocation method involves applying the field office labor percentage to the various general expense line items on the company's overhead schedule. Costs such as rent, real estate taxes, facility maintenance and repairs, utilities, facility insurance, and/or other similar costs should be allocated between the G&A portion of the home office costs and to the field offices on a basis that appropriately reflects the benefits received. For example, the space costs for accounting staff and other support services benefit all offices, including field offices; therefore, these costs should be allocated proportionately among the home and field offices.

Separate Accounting for General and Administrative (G&A) Costs. Some engineering consultants account for G&A office costs in a separate cost pool. In this situation, G&A costs may be allocated to both field and home office operations. When G&A costs are allocated on a base other than direct labor cost, then the G&A allocation rate must be separately disclosed on the overhead schedule.

Note*: If the engineering consultant computes a field office overhead rate, then this must be disclosed on the overhead schedule. The schedule should include a separate column listing the indirect field expenses, direct field labor, and resulting field rate. The schedule also should include a footnote to describe the allocation method(s) used. Tables 5-6 and 5-7 show examples of an overhead schedule with a field office rate and supporting computations (see the following pages).*

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TABLE 5-5: SAMPLE OVERHEAD SCHEDULE

SAMPLE CONSULTING COMPANY, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead
For the Year Ended December 31, 201x

Account Number & Description	General Ledger Account Balance	Direct Costs	Disallowed Costs	Proposed Company Wide	% of Direct Labor
DIRECT LABOR	$ 1,950,501	$ 1,950,501	$ -	$ 1,950,501	100.00%
INDIRECT COSTS:					
FRINGE BENEFITS					
6300 Benefits: Bonuses	$ 234,060	$ -	$ (28,560) (a)	$ 205,500	10.54%
6310 Benefits: 401(k)	97,525	-	-	97,525	5.00%
6320 Benefits: PTO (vac., sick, and holiday)	253,565	-	-	253,565	13.00%
6820 Insurance: Disability	58,515	-	-	58,515	3.00%
6830 Insurance: Life	21,846	-	(800) (b)	21,046	1.08%
6840 Insurance: Medical	136,535	-	-	136,535	7.00%
6850 Insurance: Workers' Comp	15,799	-	-	15,799	0.81%
7500 Payroll Taxes: FICA and Med	180,421	-	-	180,421	9.25%
7510 Payroll Taxes: FUTA and SUTA	78,020	-	-	78,020	4.00%
TOTAL FRINGE BENEFITS	$ 1,076,286	$ -	$ (29,360)	$ 1,046,926	53.67%
GENERAL OVERHEAD					
6700 Indirect Labor	$ 741,190	$ -	$ (3,300) (c)	$ 737,890	37.83%
5010 Direct: Lodging, Meals, and Travel	122,101	(122,101)	- (d)	-	0.00%
5020 Direct: Employee Mileage Reimbursements	159,941	(159,941)	- (d)	-	0.00%
5030 Direct: Rentals and Supplies	21,651	(21,651)	- (d)	-	0.00%
5040 Direct: Subconsultants	44,862	(44,862)	- (d)	-	0.00%
6000 Advertising and Marketing	23,991	-	(6,750) (e)	17,241	0.88%
6100 Automobile Expense	68,268	-	(13,580) (f)	54,688	2.80%
6200 Bank Service Charges	9,753	-	-	9,753	0.50%
6400 Contributions and Gifts	14,629	-	(14,629) (g)	-	0.00%
6500 Depreciation Expense	117,030	-	-	117,030	6.00%
6600 Dues and Subscriptions	16,189	-	(350) (h)	15,839	0.81%
6800 Insurance: Automotive	15,409	-	-	15,409	0.79%
6810 Insurance: Business Liability	23,406	-	-	23,406	1.20%
6900 Interest Expense	36,084	-	(36,084) (i)	-	0.00%
7000 Licenses and Permits	21,456	-	-	21,456	1.10%
7100 Maintenance and Repairs	97,135	-	-	97,135	4.98%
7200 Meals & Entertainment	19,310	-	(1,050) (j)	18,260	0.94%
7300 Misc. Fees, Fines, Penalties	6,827	-	(6,827) (k)	-	0.00%
7400 Office Expense: Cleaning	8,192	-	-	8,192	0.42%
7410 Office Expense: Postage and Delivery	4,486	-	-	4,486	0.23%
7420 Office Expense: Office Supplies	32,183	-	-	32,183	1.65%
7430 Office Expense: Other Office Expense	35,889	-	-	35,889	1.84%
7600 Personal Property Tax	42,911	-	-	42,911	2.20%
7700 Prof Fees: Accounting and Legal	30,428	-	-	30,428	1.56%
7800 Rent	180,049	-	(2,400) (l)	177,649	9.11%
7900 Telephone	60,466	-	-	60,466	3.10%
8000 Utilities	29,472	-	-	29,472	1.51%
Credit for Internal Allocations	-	-	(107,278) (m)	(107,278)	-5.50%
TOTAL GENERAL OVERHEAD	$ 1,983,306	$ (348,555)	$ (192,247)	$ 1,442,505	73.96%
TOTAL INDIRECT COSTS & OVERHEAD RATE	$ 3,059,593	$ (348,555)	$ (221,607)	$ 2,489,431	**127.63%**

FAR References and Notes:

(a) 31.205-6(a)(6)(ii)(B): Owners' compensation in excess of reasonable amount is disallowed (distribution of profits).
(b) 31.205-19(e)(2)(v): Officers' life insurance is disallowed.
(c) 31.201-6(e)(2): Marketing, lobbying, and any labor associated with unallowable activities is disallowed.
(d) 31.202: Excluded direct project costs (both billable & non-billable costs) from indirect cost pool.
(e) 31.205-1: Costs for general marketing materials are disallowed.
(f) 31.205-6(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
(g) 31.205-8 & 31.205-13(b): Contributions and gifts are disallowed.
(h) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
(i) 31.205-20: Interest is disallowed.
(j) 31.205-14 & 31.205-51: Costs for entertainment and alcoholic beverages are disallowed. (The entertainment cost principle supersedes all others.)
(k) 31.201-4, 31.205-15, & 31.205-20: Disallowed late fees; Government-imposed fines and penalties; and credit card interest.
(l) 31.205-36(b)(3): Related-party rent (not an arm's-length transaction) is limited to actual cost of ownership, net of interest and other unallowable items.
(m) 31.202: Direct costs segregated and removed from indirect cost pool.

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TABLE 5-6: SAMPLE OVERHEAD SCHEDULE (WITH FIELD RATE)

SAMPLE CONSULTING COMPANY, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead (with Field Rate)
For the Year Ended December 31, 201x

Account Number & Description	General Ledger Account Balance	Direct Costs	Disallowed Costs		Proposed Company Wide	ALLOCATIONS Proposed Home Office	ALLOCATIONS Proposed Field Office		Percent to Field Office
DIRECT LABOR	$ 1,950,501	$ 1,950,501	$ -		$ 1,950,501	$ 1,826,853	$ 123,648	(n)	6.34%
INDIRECT COSTS:									
FRINGE BENEFITS									
6300 Benefits: Bonuses	$ 234,060	$ -	$ (28,560)	(a)	$ 205,500	$ 193,000	$ 12,500	(n)	
6310 Benefits: 401(k)	97,525	-	-		97,525	91,255	6,270	(n)	
6320 Benefits: PTO (vac., sick, and holiday)	253,565	-	-		253,565	241,421	12,144	(n)	
6820 Insurance: Disability	58,515	-	-		58,515	54,806	3,709		6.34%
6830 Insurance: Life	21,846	-	(800)	(b)	21,046	19,711	1,334		6.34%
6840 Insurance: Medical	136,535	-	-		136,535	127,880	8,655		6.34%
6850 Insurance: Workers' Comp	15,799	-	-		15,799	14,798	1,002		6.34%
7500 Payroll Taxes: FICA and Med	180,421	-	-		180,421	168,984	11,437		6.34%
7510 Payroll Taxes: FUTA and SUTA	78,020	-	-		78,020	73,074	4,946		6.34%
TOTAL FRINGE BENEFITS	$ 1,076,286	$ -	$ (29,360)		$ 1,046,926	$ 984,928	$ 61,998		
GENERAL OVERHEAD									
6700 Indirect Labor (G&A and support allocation)	$ 741,190	$ -	$ (3,300)	(c)	$ 737,890	$ 680,506	$ 38,736	(o)	5.25%
6700 Indirect Labor (field labor allocation)	-	-	-		-	-	18,648	(n)	
5010 Direct: Lodging, Meals, and Travel	122,101	(122,101)	-	(d)	-	-	-		5.25%
5020 Direct: Employee Mileage Reimbursements	159,941	(159,941)	-	(d)	-	-	-		5.25%
5030 Direct: Rentals and Supplies	21,651	(21,651)	-	(d)	-	-	-		5.25%
5040 Direct: Subconsultants	44,862	(44,862)	-	(d)	-	-	-		5.25%
6000 Advertising and Marketing	23,991	-	(6,750)	(e)	17,241	16,336	905		5.25%
6100 Automobile Expense	68,268	-	(13,580)	(f)	54,688	51,817	2,871		5.25%
6200 Bank Service Charges	9,753	-	-		9,753	9,241	512		5.25%
6400 Contributions and Gifts	14,629	-	(14,629)	(g)	-	-	-		5.25%
6500 Depreciation Expense	117,030	-	-		117,030	117,030	-	(p)	
6600 Dues and Subscriptions	16,189	-	(350)	(h)	15,839	15,008	831		5.25%
6800 Insurance: Automotive	15,409	-	-		15,409	14,600	809		5.25%
6810 Insurance: Business Liability	23,406	-	-		23,406	22,177	1,229		5.25%
6900 Interest Expense	36,084	-	(36,084)	(i)	-	-	-		5.25%
7000 Licenses and Permits	21,456	-	-		21,456	20,329	1,126		5.25%
7100 Maintenance and Repairs	97,135	-	-		97,135	92,036	5,099		5.25%
7200 Meals & Entertainment	19,310	-	(1,050)	(j)	18,260	17,301	959		5.25%
7300 Misc. Fees, Fines, Penalties	6,827	-	(6,827)	(k)	-	-	-		5.25%
7400 Office Expense: Cleaning	8,192	-	-		8,192	8,192	-	(p)	
7410 Office Expense: Postage and Delivery	4,486	-	-		4,486	4,486	-	(p)	
7420 Office Expense: Office Supplies	32,183	-	-		32,183	32,183	-	(p)	
7430 Office Expense: Other Office Expense	35,889	-	-		35,889	35,889	-	(p)	
7600 Personal Property Tax	42,911	-	-		42,911	42,911	-	(p)	
7700 Prof Fees: Accounting and Legal	30,428	-	-		30,428	28,830	1,597		5.25%
7800 Rent	180,049	-	(2,400)	(l)	177,649	177,649	-	(p)	
7900 Telephone	60,466	-	-		60,466	57,291	3,174		5.25%
8000 Utilities	29,472	-	-		29,472	29,472	-	(p)	
Credit for Internal Allocations	-	-	(107,278)	(m)	(107,278)	(107,278)	-	(p)	
TOTAL GENERAL OVERHEAD	$ 1,983,306	$ (348,555)	$ (192,247)		$ 1,442,505	$ 1,366,008	$ 76,497		
TOTAL INDIRECT COSTS	$ 3,059,593	$ (348,555)	$ (221,607)		$ 2,489,431	$ 2,350,936	$ 138,495		
OVERHEAD RATES (as percentages of direct labor cost)					127.63% Company Wide	128.69% Home Office	112.01% Field Office		

FAR References and Notes:

(a) 31.205-6(a)(6)(ii)(B): Owners' compensation in excess of reasonable amount is disallowed (distribution of profits).
(b) 31.205-19(e)(2)(v): Officers' life insurance is disallowed.
(c) 31.201-6(e)(2): Marketing, lobbying, and any labor associated with unallowable activities is disallowed.
(d) 31.202: Excluded direct project costs (both billable & non-billable costs) from indirect cost pool.
(e) 31.205-1: Costs for general marketing materials are disallowed.
(f) 31.205-6(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
(g) 31.205-8 & 31.205-13(b): Contributions and gifts are disallowed.
(h) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
(i) 31.205-20: Interest is disallowed.
(j) 31.205-14 & 31.205-51: Costs for entertainment and alcoholic beverages are disallowed. (The entertainment cost principle supersedes all others.)
(k) 31.201-4, 31.205-15, & 31.205-20: Disallowed late fees; Government-imposed fines and penalties; and credit card interest.
(l) 31.205-36(b)(3): Related-party rent (not an arm's-length transaction) is limited to actual cost of ownership, net of interest and other unallowable items.
(m) 31.202: Direct costs segregated and removed from indirect cost pool.
(n) Field employee labor and fringe specifically identified.
(o) Indirect general administrative and support labor less identified field portion is allocated.
(p) Accounts specifically identified as home office only.

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TABLE 5-7: FIELD OFFICE COMPUTATIONS

Field Employee Worksheet

Employee Name & Classification	Direct Labor	Indirect Labor (general)	Bonuses (fringe benefit)	401(k) (fringe benefit)	Paid Time Off (fringe benefit)	Field-Specific Totals
Name 1 - Project Manager	-	10,920	-	-	-	10,920
Name 2 - Senior Engineer	50,176	3,136	7,500	2,620	4,928	68,360
Name 2 - Project Engineer	41,216	2,576	3,500	1,966	4,048	53,306
Name 4 - Technician 1	32,256	2,016	1,500	1,685	3,168	40,625
	123,648	18,648	12,500	6,270	12,144	173,210

Field Office Direct Labor Calculation

Direct Labor (Field Office)	123,648
	÷
Total Direct Labor (Home + Field)	1,950,501
Direct Labor Based Field %	6.34%

Field Office Labor Calculation

	Company Wide	Field Office
Direct Labor	1,950,501	123,648
PTO (vacation/sick/holiday)	253,565	12,144
Indirect Labor	737,890	18,648
Totals	2,941,957	154,440
		÷
Total Company Labor		2,941,957
General Overhead Field %		5.25%

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6

Chapter 6 – Labor-Charging Systems and Other Considerations

The purpose of this chapter is to provide interpretive guidance only. This chapter is not intended to be authoritative or to supersede the FAR. The entire text of the FAR should be consulted when determining proper accounting treatment.

6.1 – Background

Compensation for personal services is one of the largest components of cost incurred under Government contracts. It includes all remuneration paid currently or accrued, in whatever form, for services rendered by an engineering consultant's employees during contract performance.

The objective of a compensation system is to provide the level of pay and benefits necessary to attract, retain, and motivate employees to direct their efforts toward achieving the goals of the organization. To be considered adequate, an engineering consultant's compensation system must be reliable, be subject to applicable management control objectives and activities, and must result in allocable, allowable, and reasonable compensation costs to be charged to Government contracts in accordance with FAR provisions.

6.2 – Labor Costs, Generally

As discussed previously in Chapter 5, labor costs typically are the most significant costs charged to Government contracts and usually comprise the base used for allocating indirect costs. Historical labor costs are often used to estimate labor for follow-on or similar item Government contracts.

Unlike other cost items, labor is not supported by third party documentation such as an invoice, purchase order, or receipt. Instead, consultants' employees have complete control over the documents or devices of original entry, whether consisting of timecards, electronic media, or some other means.

Responsibility for labor reporting is diffused throughout the engineering consultant's organization. Consequently, there are significant risks associated with the accurate recording, distribution, and payment of labor costs.

6.3 – Allowability and Reasonableness of Indirect Labor

[Reference: FAR 31.201-3]

Labor cost may take one of two paths—either as a direct charge to a project, or as an indirect charge to overhead. When consultants use an overhead rate to recover indirect costs, Government contracts will participate in these costs. To assess the reasonableness of the labor cost pools in accordance with FAR 31.201-3, State DOTs may apply productivity or efficiency measurements. These measurements are compared to industry standards or State DOTs' expectations to assess the reasonableness of the submitted labor costs.

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Productivity and/or other efficiency measures may be used by a State DOT to assess the reasonableness of a consultant's labor distribution. If indirect labor appears to be unreasonably high, then the State DOT may make further inquiries of the consultant, may perform additional analytical procedures, and/or may conduct intensive labor testing.

Conversely, consultants must consistently monitor the recording of direct and indirect labor cost to ensure accuracy and must monitor staffing levels to ensure the maximum utilization of employees to minimize excess or idle capacity. Productivity or efficiency measurements consistently below industry standards should warrant discussions between the consultant and the State DOT(s). However, this type of ratio/measurement should not be used as the sole measure of reasonableness.

***Note**: Two areas of indirect labor costs,* Bid and Proposal *costs and* Selling *costs, provide consistent areas of concern to State DOTs and audit agencies. The allowability of these costs is discussed specifically below.*

A. Bid and Proposal Costs (B&P)

[References: FAR 31.205-18, CAS 420.30(a)(2), CAS 420]

1. Definition

FAR 31.205-18(a) and CAS 420.30(a)(2) provide that Bid and Proposal (B&P) costs are the—

> [E]xpenses incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-government contracts, provided that the effort is neither sponsored by a grant, nor required in the performance of a contract.

FAR 31.205-18(b) further provides that all contracts, regardless of whether full CAS coverage applies, are subject to the cost identification and accumulation provisions of CAS 420.

2. Identification and Accumulation of B&P

As further discussed in CAS 420, consultants must identify and accumulate B&P costs by individual project. CAS 420 also requires that costs for B&P projects be accounted for in the same manner as contracts and include costs that would be treated as direct costs of that contract, if incurred in like circumstances, and all allocable indirect costs, with the exception of general and administrative expenses. For example, if a consultant charges clerical and technical support costs directly to final cost objectives, then it must also charge them directly to B&P projects. If, however, the consultant charges these costs to indirect cost pools, such costs incurred in support of B&P efforts also should be charged to indirect cost pools.

3. Efforts Sponsored by Grant or Required by Contract

In accordance with the B&P definition at FAR 31.205-18(a), any efforts that are "sponsored by a grant or required in the performance of a contract" are not B&P. Accordingly, consultants must not include costs in the B&P cost pools for developmental efforts that are specifically required in the performance of a contract, or those efforts that are not explicitly stated in the contract but are necessary to perform the contract.

- Consultants must consistently require senior managers and executives to accurately track and record their time associated with B&P activities as required by CAS 420. This issue is of particular concern, as many executives and managers do not track B&P activities separately from other overhead functions.
- The consultant should establish clear guidance regarding the specific activities that comprise B&P activities and should ensure that all staff members are adequately trained. The consultant should regularly monitor the time coded by senior managers and executives to B&P activities to determine the accuracy of efforts expended. Labor costs associated with B&P activities should be clearly identified and must be segregated from other indirect labor activities.

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B. Selling Effort and Activities

This section contains general guidance in determining the allocability, allowability, and reasonableness of selling costs under Government contracts, as discussed in FAR 31.205-38.

1. Direct Selling

[Reference: FAR 31.205-38(b)(5)]

Direct selling is characterized by person-to-person contact and includes such efforts as familiarizing a potential customer with the consultant's products or services, conditions of sale, service capabilities, and similar items. It also includes negotiation, liaison between customer and consultant personnel, technical and consulting efforts, individual demonstrations, and any other efforts having as their purpose the application or adaptation of the consultant's products or services for a particular customer's use. Generally, the costs of direct selling efforts are allowable.

2. Brokerage Fees, Commissions, and Similar Costs

[Reference: FAR 31.205-38(c)]

Notwithstanding any other provision of FAR 31.205-38, sellers' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the consultant for the purpose of securing business.

3. Other Cost Principles Related to Selling Efforts

[References: FAR 31.205-1, FAR 31.205-12, FAR 31.205-14, FAR 31.205-18, FAR 31.205-27, FAR 31.205-38, CAM Section 7-1200, CAM Section 7-1500]

The nature of costs classified and charged as selling expense should be compatible with the provisions of FAR 31.205-38. Although the generic term "selling" encompasses all effort to market a consultant's products, the acceptability of the costs of this effort is governed by several subsections of FAR 31.205. Costs that fall into the following categories should be classified accordingly. These costs should be evaluated using the appropriate subsection of FAR 31.205 as discussed below:

- ***Advertising Costs (FAR 31.205-1 & -38)***. Also see DCAA Contract Audit Manual Section 7-1200. In most instances, allowable advertising is limited to help-wanted advertisements.
- ***Corporate Image Enhancement and Public Relations Costs (FAR 31.205-1 & -38)***. Also see DCAA Contract Audit Manual Section 7-1200. Allowable public relations costs include the following examples: costs specifically required by contract, costs of communicating with the public, costs for participating in community service activities, and costs of plant tours and open houses (excluding any entertainment costs associated with these efforts). Unallowable public relations costs include costs for disseminating messages calling favorable attention to the firm's products or services; most costs for trade shows; and costs of sponsoring meetings, conventions, seminars, and other events when the principal purpose of the event is other than the dissemination of technical information or the stimulation of production.
- ***Bid and Proposal/Independent Research and Development Costs (FAR 31.205-18)***. Also see DCAA Contract Audit Manual Section 7-1500. These costs generally are allowable, subject to the limitations provided in FAR 31.205-18.
- ***Entertainment Costs (FAR 31.205-14)***. Entertainment costs are expressly unallowable, regardless of the purpose or intent of the entertainment. Costs made specifically unallowable under FAR 31.205-14 are not allowable under any other cost principle.
- ***Long-Range Market Planning Costs (FAR 31.205-12)***. Costs associated with general long-range management planning are allowable; however, organizational or reorganizational costs are unallowable (see FAR 31.205-27 for more details).

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4. Recordkeeping Requirements

[References: FAR 31.201-2(d)]

Pursuant with FAR 31.201-2(d), consultants must maintain adequate records to demonstrate that claimed costs have been incurred and are allocable to the Federal-aid contracts. Accordingly, consultants must require all employees, including senior managers and executives, to maintain a contemporaneous record of all time devoted to selling activities. To accomplish this, the consultant must establish clear guidance regarding the specific activities that comprise selling activities and must ensure that all staff members are adequately trained.

***Note**: The consultant must regularly monitor the time recorded by all employees, including senior managers and executives, to determine the accuracy of efforts expended. Labor costs associated with selling activities must be easily identified and must be segregated from other indirect labor activities.*

6.4 – DCAA ACCOUNTING GUIDE

[References: FAR 31.002, DCAAP No. 7641.90]

The Defense Contract Audit Agency (DCAA) issued Pamphlet No. 7641.90 (DCAAP 7641.90), *Information for Contractors*.[7] The DCAAP provides useful guidance but does not have the effect of law. The DCAAP is referenced at FAR 31.002 and provides extensive guidance regarding labor charging systems. Specifically, sections 2-301 through 2-302.2 provide guidance regarding the—

- Accounting system,
- Labor charging system,
- Timecard preparation methods, and
- Timekeeping policy.

***Note**: Pertinent sections of DCAAP No. 7641.90 have been extracted and paraphrased below for emphasis and further discussion.*

A. Accounting System Internal Control

When performing work in connection with Government contracts, it is essential for engineering consultants to maintain an operable accounting system under general ledger control. A properly designed system includes the following attributes:

- Proper segregation of direct costs and indirect costs.
- Identification and accumulation of direct costs by cost objective/contract.
- A logical and consistent method for allocating indirect costs to intermediate and final cost objectives.
- Accumulation of costs under general ledger control.
- A timekeeping system that identifies employees' labor by intermediate and final cost objectives.
- A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.
- Interim (at least monthly) determination of costs charged contracts through routine posting to books of account.
- Exclusion from costs charged to Government contracts of amounts that are not allowable pursuant to FAR Part 31 or other contract provisions.
- Identification of costs by appropriate units, if required by the contract.

[7] Dated January 2005. The DCAAP is available via the Internet at http://www.dcaa.mil.

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B. Labor Charging System Internal Control

1. Generally

The key link in any sound labor time charging system is the individual employee. It is critical to labor charging internal control systems that management indoctrinates employees on their independent responsibilities 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 and waste in the labor charging function.

To be effective, the internal controls over labor charging should meet the following criteria:

- The engineering consultant should have adequate segregation of duties for labor-related activities; for example, the responsibility for timekeeping and payroll accounting should be separated.
- Supervisors who are accountable for meeting contract budgets should not have the opportunity to initiate employee time charges. (It is recognized that, for a very small company, this type of segregation may not be possible, whereas for a larger company, this type of segregation would be required in order to have good internal controls over labor costs.)
- The engineering consultant's procedures and controls must be evident, well defined, and reasonable so there is no confusion concerning the reason for the controls and no misunderstanding as to what is and what is not permissible.
- The engineering consultant must continuously maintain the controls and verify their effectiveness. Controls must be updated to correct any deficiencies, and violations must be remedied through prompt and effective action to serve as a deterrent to prospective violations.
- Individual employees must be constantly, although unobtrusively, made aware of controls that act as an effective deterrent against violations. Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through the posting of signs throughout the workplace to remind employees of the importance of accurate and current timecards.
- The engineering consultant should have a system of feedback to provide employees with opportunities to report to management any suspected mischarging or violations of the consultant's system of internal controls, with anonymity guaranteed.

2. Timecard Preparation

The engineering consultant should provide detailed instructions for timecard preparation in a timekeeping pamphlet and/or company procedure. Specific issues associated with automated and manual timecard systems are provided below:

(a) Automated Timekeeping System. When an automated timekeeping system is in place, procedures should provide for the accurate and current recording of labor hours by authorized employees, as well as appropriate controls to ensure corrections to labor charges are accurate and authorized. Generally, controls should be in place to ensure the following:

- Only the employee uses his or her labor charging instrument to access the labor system.
- Changes are initialed, authorized, and dated by the employee and supervisor and include a description of the reason for the change. This may be done electronically.
- A verifiable audit trail process is in place that collects all initial entries and subsequent changes.
- When an engineering consultant uses an employee badge system, badge issuance must be sufficiently controlled so that no badge number is duplicated and badges are not issued to unauthorized persons. Additionally, procedures must be in place to require employees to report lost badges promptly.

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(b) Manual Timekeeping System. When a manual system is in place, procedures should provide for the accurate and complete recording of labor hours, as well as appropriate controls to ensure corrections to labor records are accurate and authorized. Generally, controls should be in place to ensure—

- Supervisory observation of employee arrival and departure to prevent improper clock-in/clock-out.
- Employee possession of timecard/timesheet.
- The employee prepares his or her timecard/timesheet in ink, as work is performed.
- Only one timecard/timesheet is prepared per employee per period; timecards/timesheets are preprinted with employee name and identification number; and timecards/timesheets are submitted to the designated timekeeping office or are collected by an authorized person.
- Pre-coded data is printed on job cards for identification purposes (e.g., codes for various leave types or indirect labor).
- Direct labor employees record their time no less often than daily. Sufficient formal subsidiary records must be maintained, if necessary, to ensure accuracy in labor recording and the proper allocation of labor costs to intermediate and final cost objectives when multiple jobs are worked in a day.
- Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.
- The correct distribution of time by project numbers, contract number or name, or other identifiers for a particular assignment. To ensure accuracy, a listing of project numbers and their descriptions should be provided in writing to the employee.
- Recording all hours worked whether they are paid or not. This is necessary because labor costs and associated overheads are affected by *total* hours worked, not just paid hours worked. Therefore, labor rate computations and labor overhead costs should reflect all hours worked. Unpaid hours worked are termed "uncompensated overtime."
- Employees and supervisors sign the timecards/timesheets in accordance with procedures, verifying the accuracy of the recorded effort.
- The job cost system is reconciled to the general ledger on a regular and consistent basis. This reconciliation should occur no less frequently than once every 30 days.

***Note**: A labor-charging checklist is attached at the end of this chapter to assist engineering consultants and accounting professionals in the assessment of the consultant's labor-charging system.*

3. Timekeeping Policy

The engineering consultant should implement a written policy that requires the following:

- Supervisors must approve and cosign all timecards.
- The supervisor is prohibited from completing an employee's timecard unless the employee is absent for a prolonged period of time on some form of authorized leave. If the employee is on travel status, the supervisor for the employee may prepare a time sheet. Upon his or her return, the employee should turn in his/her time sheet and attach it to the one prepared by the supervisor.
- The guidance should state that the nature of the work determines the proper distribution of time, not availability of funding, type of contract, or other factors. Accordingly, direct labor hours must be assigned to the cost objective/project that caused the hours to be incurred, regardless of whether the hours are billable to clients. Non-billable labor hours may not be charged, or later reassigned, to other projects or to overhead.
- Procedures must be established to verify that the total labor hours reflected in labor distribution summaries agree with the total labor charges as entered into the timekeeping and payroll systems. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and such costs are appropriately recorded in the according records. Each employee's time charge should be distributed as recorded, regardless of whether all the labor is billable to clients.

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- The company policy should state that the accurate and complete preparation of timecards is a part of each employee's job. The policy also should state that careless or improper preparation of timecards may lead to disciplinary actions under company policies and/or applicable State and Federal statutes.

6.5 – COMPLIANCE AND REVIEW

Auditors are encouraged to apply the requirements of DCAAP 7641.90 to their examinations of engineering consultants' labor-charging systems, as State DOTs may challenge any FAR audit or attestation engagement that does not adequately address the reliability and accuracy of a consultant's labor-charging system. In the absence of any deficiencies noted in such examinations, State DOTs generally will accept audit opinions that are developed in compliance with DCAAP criteria. This includes attestations or audits performed by independent CPAs or Government auditors, such as the DCAA.

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TABLE 6-1: LABOR CHARGING CHECKLIST

Model Characteristics of Labor-Charging Systems:	Yes	No	N/A	Note
• Is there segregation of responsibilities for labor-related activities? For example, the responsibility for timekeeping and payroll accounting should be separated.				
• Do supervisors who are accountable for meeting contract budgets have the opportunity to initiate employee time charges? (It is recognized that, for a very small company, this type of segregation may not be possible, whereas for a larger company, this type of segregation would be required in order to have good internal controls over labor costs.)				
• Are individual employees routinely made aware of controls that act as effective deterrent against violations? Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through posting of signs throughout the workplace that reminds employees of the importance of accurate and current timecards.				
• Were detailed instructions for timecard preparation established through a timekeeping pamphlet and/or company procedure?				
• If a manual system is in place, were instructions published to inform employees that they are personally responsible for the following?				
(1) Recording his/her time on a daily basis.				
(2) Recording time on the timecard in ink.				
(3) The correct distribution of time by project numbers, contract number or name, or other identifiers for a particular assignment. To ensure accuracy, a listing of project numbers and their descriptions should be provided in writing to the employee.				
(4) Changes to the timecard. All changes should be lined through, with the employee's initials beside the change indicating the employee personally made the change and that the change is correct.				
(5) Recording all hours worked whether they are paid or not. This is necessary because labor costs and associated overheads are affected by total hours worked, not just paid hours worked. Therefore, labor rate computations and labor overhead costs should reflect all hours worked. Unpaid hours worked are termed "uncompensated overtime."				
(6) Signing the timecard at the end of each work period.				
• Do supervisors approve and cosign all timecards?				
• Are supervisors prohibited from completing an employee's timecard unless the employee is absent for a prolonged period of time on some form of authorized leave?				
• If the employee is on travel status, the supervisor for the employee may prepare a timesheet. Upon the employee's return, does the employee turn in his/her time sheet and attach it to the one prepared by the supervisor, or does the firm in some other way document the reason why the employee did not prepare and sign the original timesheet?				
• Does the consultant's published guidance/policy state that the nature of the work determines the proper distribution of time, not availability of funding, type of contract, or other factors? (Does the consultant emphasize that the proper characterization/categorization of labor hours is not dependent upon whether such labor hours are billable to a client?)				
• Does the consultant's policy state that the accurate and complete preparation of timecards is a part of each employee's job?				
• Does the consultant's policy state that careless or improper preparation of timecards may lead to disciplinary actions under company policies as well as applicable Federal statutes?				
Evaluation of Accounting System - Critical Elements:				
• Does the consultant's accounting system provide for proper segregation of direct and indirect costs?				
• Does the accounting system provide for identification and accumulation of direct costs by cost object (contract)?				
• Does the accounting system provide for a logical and consistent method for the allocation of indirect costs to intermediate and final cost objectives? (A contract is a final cost objective).				
• Does the accounting system articulate with a timekeeping system that identifies employees' labor by intermediate or final cost objectives?				
• Does the accounting system include interim (at least monthly) determination of costs charged to contracts through routine posting of books of account (i.e., project data is transferred from the labor distribution system to the cost accounting system)?				
• Does the accounting system include controls to exclude from costs charged to government contracts amounts that are unallowable, per the Cost Principles of FAR Part 31 and/or other applicable laws or regulations, including state audit guidance?				
• Is the accounting system currently in full operation? If not describe which portions of the system are:				
(1) operational;				
(2) set up, but not yet operational;				
(3) anticipate to be placed into operation; or				
(4) nonexistent.				
• **Final Assessment of Consultant's Accounting System:**				
☐ Fully Acceptable.				
☐ Provisionally Acceptable - Describe requirements for status to be changed to Fully Acceptable.				
☐ Unacceptable.				

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7

Chapter 7 – Compensation

7.1 – General Principles

[Reference: FAR 31.205-6]

Pursuant to FAR 31.205-6—

> (a) Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of [FAR 31.205-6] . . . .
>
> > (1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages. . . .
> >
> > (2) The total compensation for individual employees or job classes of employees must be reasonable for the work performed; however, specific restrictions on individual compensation elements apply when prescribed.
> >
> > (3) The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.
> >
> > (4) No presumption of allowability will exist where the contractor introduces major revisions of existing compensation plans or new plans and the contractor has not provided the cognizant state DOT, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.
> >
> > (5) Costs that are unallowable under other paragraphs of . . . [FAR] Subpart 31.2 are not allowable under . . . [FAR] 31.205-6 solely on the basis that they constitute compensation for personal services.

7.2 – Allowability of Compensation

[Reference: FAR 31.205-6]

Total compensation generally includes allocable and allowable wages, salaries, bonuses, deferred compensation, and employer contributions to defined contribution pension plans. Individual elements of compensation must be reviewed for allowability in compliance with the FAR.

FAR 31.205-6 distinguishes between allowability and reasonableness of compensation. It lists specific requirements for the allowability of certain elements of compensation. For an element of compensation to be allowable, it must meet the FAR requirements specific to that element. The total of all allowable compensation elements must be reasonable for the work performed. Reasonableness of compensation is discussed below in Section 7.3.

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7.3 – REASONABLENESS OF COMPENSATION

[References: FAR 31.201-3, FAR 31.205-6, DCAA CAM Sections 6-413 & 6-414]

Pursuant to FAR 31.205-6(b)(2), compensation not covered by labor-management agreements for each employee or job class of employees must be reasonable for the work performed. Furthermore,

> Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provisions of FAR 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms—
>
> > (i) Of the same size;
> >
> > (ii) In the same industry;
> >
> > (iii) In the same geographic area; and
> >
> > (iv) Engaged in similar non-government work under comparable circumstances.

The engineering consultant is responsible for preparing an analysis to support the reasonableness of claimed compensation costs in accordance with FAR 31.205-6. Typically, this analysis focuses on executive positions because those positions comprise the highest compensation levels and the most significant area of audit risk.

Additionally, pursuant to FAR 31.205-6 (a)(6)(i)(A) and (B):

> Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include—
>
> > (A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families; and
> >
> > (B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.

Accordingly, in compliance with FAR 31.205-6, engineering consultants must ensure and properly document that the compensation for each employee or job class of employees is reasonable for the work performed. The auditor is responsible for reviewing/testing the engineering consultant's compensation analysis, to the extent considered necessary based on the auditor's risk assessment. Additional audit guidance appears in DCAA Contract Audit Manual (DCAA CAM) Sections 6-413 and 6-414. Much of the guidance included therein has been incorporated into this Guide in the following sections.

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7.4 – STATUTORY COMPENSATION LIMIT: THE BENCHMARK COMPENSATION AMOUNT (BCA)

[References: FAR 31.205-6(p), Public Law 105-85 Section 808(b), DCAA CAM Section 6-413.7]

Pursuant to FAR 31.205-6, an engineering consultant is permitted to charge reasonable compensation to Government contracts as either a direct cost, indirect cost, or a combination of both. FAR 31.205-6(p) limits allowable compensation for Senior Executives(†) to the Benchmark Compensation Amount (BCA) as determined by the Office of Federal Procurement Policy (OFPP), Section 808(b) of Public Law 105-85. The BCA is established based on the compensation of executives of publicly-owned U.S. corporations with annual sales over $50 million for the fiscal year. The BCA applies to Senior Executives at corporate offices and business segments.

(†) ***Note****: FAR 31.205-6(p)(2)(ii)(B) defines "Senior Executives" as "the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters." Additionally, CAS 410 defines "segment" as "one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service."*

Although the BCA is the statutory maximum for Senior Executive compensation costs that may be charged to Government contracts, the BCA must not be construed as an entitlement or a guaranteed amount of cost recovery. Instead, compensation is subject to the reasonableness provisions of FAR 31.205-6, and owners of closely-held firms are subject to an additional restriction—no payment that represents a distribution of profits may be submitted as a cost against a Government contract.

7.5 – DETERMINING THE REASONABLENESS OF EXECUTIVE COMPENSATION

[References: FAR 31.205-6, DCAA CAM Section 6-414, *Techplan Corporation*, *Information Systems* (ASBCA cases)]

A. Generally

Pursuant to DCAA CAM Section 6-614.4c:

> Executive positions within a company are usually unique positions within that company. Only the largest of firms have the potential for a class of employees performing vice-presidential level duties, which can be described as having similar rank, function, and responsibility. Normally, executives are not part of a class of employees and must be evaluated individually.

The engineering consultant's policies and procedures should provide descriptions of how executive compensation levels are established and who approves these levels, as well as the eligibility criteria and basis for establishing base salary, cash bonuses, long-term perquisites, benefits, services, and incentive pay bonuses.

In developing FAR-allowable overhead rates, engineering consultants should evaluate the reasonableness of executive compensation costs in accordance with FAR 31.205-6 and should prepare documentation to support this evaluation. Additional guidance on the evaluation of executive compensation costs appears in DCAA CAM Sections 6-413 and 6-414, which should be consulted for more details prior to performing the analysis.

B. Procedures for Determining Reasonableness

The engineering consultant must determine the reasonableness of executive compensation in a manner compliant with the criteria established in FAR 31.205-6 and the two major Armed Services Board of Contract Appeals (ASBCA) decisions dealing with compensation: *Techplan Corporation*,[8] and

[8] *Techplan Corporation*, ASBCA Nos. 41470, 45387, and 45388, 1996 ASBCA LEXIS 141. Techplan is the seminal case that established a methodology for applying the reasonableness provisions of FAR 31.205-6 to compensation issues.

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Information Systems and Networks Corporation.[9]

The engineering consultant should prepare a compensation analysis in accordance with the procedure described below in Section 7.5.C. In compliance with FAR 31.205-6, the consultant must disallow costs in excess of the amount deemed reasonable as determined by the compensation study.

***Note**: In cases where a consultant does not perform an acceptable compensation analysis, State DOTs may use the National Compensation Matrix (NCM), which will be designed to meet the requisite Techplan and Information Systems criteria, as a baseline for determining the reasonableness of claimed compensation costs. The specifics of the NCM are discussed below in Section 7.7.*

C. Performing a Compensation Analysis in Compliance with FAR 31.205-6, *Techplan*, and *Information Systems*

The approach that engineering consultants should use to evaluate compensation reasonableness should include the following steps:

Step 1. Examine all elements of compensation and eliminate from FAR-allowable overhead those elements which are defined as unallowable under FAR 31.205-6 or other applicable FAR cost principles. For example, compensation calculated based on changes in corporate securities (such as stock options) is expressly unallowable, and should be excluded from overhead and from the compensation evaluated.

Step 2. For the individual executives or classes of employees to be examined, prepare a schedule listing all allowable components of compensation and the amount paid for each. Compensation includes wages, salary, bonuses, incentive compensation, deferred compensation, and employer contributions to defined contribution pension plans.

Step 3. Obtain nationally-published compensation surveys to match the engineering consultant in terms of revenue, industry, geographic location, and other relevant factors. Engineering consultants and auditors should ensure survey data used to support reasonableness determinations is based on reliable and unbiased surveys that are representative of the engineering consultant's relevant market or industry. In most cases, no one survey is sufficient to determine the market rate of pay for all the engineering consultant's positions. A primary survey may be selected with secondary surveys used to corroborate the results of the primary survey. Typically, industry best practices include the use of three surveys. DCAA CAM Section 5-808.8c(2) provides guidance on evaluating compensation survey data. Some types of surveys that should generally not be used include magazine or newspaper surveys, free internet surveys, and GSA schedules.

Nationally published surveys typically identify the mean, median or percentile amounts of salary, bonus and other elements of compensation by revenue ranges, number of firm employees, or discipline. Geographical regions, position title, job descriptions, and additional data analysis typically are standard topics.

The engineering consultant must match the job description and duties of each of its executives to the survey data. However, matching positions based solely on job titles may result in an inaccurate comparison. For instance, in a small business an executive will perform certain duties that are performed by multiple people in a larger company.

Step 4. From these surveys, develop an estimated reasonable compensation amount for each executive position. First, determine the survey median compensation amounts for each comparable position, selecting survey data for firms of comparable size and geographic area. Some surveys will classify firms by size based on number of staff, while others will use total revenues. Use the category that best matches the survey data to the subject firm.

For example, assume the subject firm has 45 employees and revenues of $9 million. Survey data, such as the sample shown below in Table 7-1, should be analyzed as described in the following steps.

[9] *Information Systems and Networks Corporation*, ASBCA No. 47849, 1997 WL 381263 (A.S.B.C.A.), 97-2 BCA P 29132.

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TABLE 7-1: SAMPLE SURVEY DATA FOR DETERMINING REASONABLENESS OF COMPENSATION

Position: President / CEO

Survey 1	Number of Employees	Salary (median)	Bonus / Incentive (median)	Other Compensation (median)	Total Compensation (median)
	1-20	$101,000	$15,000	$8,000	$124,000
	21-50	**145,000**	**32,000**	**11,000**	**188,000**
	51-100	210,000	47,000	18,000	275,000
	101-200	241,000	82,000	24,000	347,000

Step 5. Apply appropriate escalation factors to adjust survey data to a common date of July 1 of the same year or the mid-point of the Consultant's Fiscal Year. The escalation factor used should be supported by survey data on trends in compensation for the years examined. Often, surveys will include an executive summary section that will present data on such trends.

Step 6. Develop a composite median amount by averaging the median total compensation amounts, after application of any necessary escalation factors.

Step 7. Next, increase the composite median by 10 percent, based on DCAA guidance (see DCAA CAM Section 6-414.4) which allows for a 10 percent range of reasonableness to be applied in developing estimated reasonable compensation.

Disclaimer: The following data in Table 7-2 are presented for illustration purposes only and must not be relied upon or applied to an analysis of actual compensation costs.

TABLE 7-2: ESTIMATED REASONABLE COMPENSATION

(M = million)

Position: President / CEO		Salary (median)	Bonus / Incentive (median)	Other Compensation (median)	Total Compensation (median)
Survey 1	Staff size 21-50	$145,000	$32,000	$11,000	$188,000
Survey 2	Revenue $5-10M	127,000	35,000	15,000	177,000
Survey 3	Revenue $5-15M	146,000	42,000	14,000	202,000
				Average	189,000
		Range of reasonableness (ROR) factor			* 10%
		Adjusted for 10% ROR			207,900
		President / CEO estimated reasonable compensation			207,900

Note: If survey data from prior years is used, then adjust to the current year using an appropriate escalation factor. In this example, only one year of data is presented.

***Note**: Only allowable elements of compensation should be included in the analysis. Survey and actual data should be reviewed for allowability prior to inclusion. Allowability of specific compensation elements is discussed in FAR 31.205-6 and elsewhere in this chapter. The term "Other Compensation" as used here includes all FAR-allowable compensation other than salary and bonus or incentive compensation.*

Step 8. Compare total actual compensation for each executive to the estimated reasonable compensation developed in Step 7 for that position.

Disclaimer: The following data in Table 7-3 are presented for illustration purposes only and must not be relied upon or applied to an analysis of actual compensation costs.

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TABLE 7-3: COMPARISON TO ACTUAL EXECUTIVE COMPENSATION:

	Actual Salary	Actual Bonus / Incentive	Actual Other Comp.	Actual Total Comp.	Estimated Reasonable Total Comp.(†)	Potential Unreasonable Comp.
President / CEO	$144,000	$52,000	$18,000	$214,000	$207,900	$6,100

Perform this analysis for each executive as defined in this chapter, and accumulate total potential unreasonable compensation.

(†)***Note****: No compensation claimed for any Senior Executive may exceed the benchmark compensation amount (BCA) discussed previously in Section 7.4.*

Step 9. In the cases where total compensation exceeds the estimated reasonable amount, FAR-allowable compensation for that executive should generally be limited to the estimated reasonable compensation, with one notable exception, as explained below in Section 7.6.

7.6 – CRITERIA FOR DEMONSTRATING SUPERIOR PERFORMANCE

[References: DCAA CAM Section 6-414.4h]

A. Generally

Pursuant to DCAA CAM Section 6-414.4h (entire text reproduced below)—

> Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. Above average levels of compensation are usually identified by percentiles, such as the 75th percentile. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry's average. The ASBCA, in its decision on Information Systems & Networks Corporation ASBCA No. 47849, "capped" executive compensation at the 75th percentile when justified by performance.
>
> (1) Examples of financial performance measures may include the following:
>
> - Revenue Growth
> - Net Income
> - Return on Shareholder's [sic] Equity
> - Return on Assets
> - Return on Sales
> - Earnings per Share
> - Return on Capital
> - Cost Savings
> - Market Share
>
> (2) The contractor must show that the measure chosen is representative of the executive's performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive's performance, and certainly there should be no extra compensation

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due to performance which results primarily from the contractor's status as a Government contractor. Performance is typically measured using more than one criterion of performance. For example, a contractor may have significant sales growth through acquisitions and mergers while operating at a loss. In this situation, the contractor would not be considered to have superior performance based on the lone measure of sales growth.

(3) Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable.

B. Procedure for Establishing Compensation Amounts in Excess of Survey Medians

To justify the superior performance necessary to evaluate an engineering consultant's executive compensation at higher than the median (up to but not exceeding the 75th percentile), the consultant must prepare and document an analysis of the firm's performance in comparison to selected performance measures from the list above (as excerpted from DCAA CAM 6-414.4h(1)). Typically, superior performance may not be based on only one performance measure; instead, superior performance in comparison to three or more measures must be established to present a compelling case for the allowability of higher than median executive compensation.

The analysis methodology steps include the following—

Step 1. Calculate a minimum of three financial performance measures stated above using the engineering consultant's actual financial data for the same time period.

Step 2. Calculate the firm's composite financial performance measure. This is done by calculating the simple average of the financial performance measures calculated in the previous step.

Step 3. Using proxy data available from SEC filings and the following criteria, identify the same financial performance measures used in the engineering consultant's analysis:

- in SIC code 87;
- in the same revenue range; and
- for the same time period as the engineering consultant's data.

***Note**: If no SEC proxy data are available commensurate with the engineering consultant's revenue amount, it may be appropriate to consider financial data from other sources, such as Dun and Bradstreet or Standard & Poor's.*

Step 4. Calculate the proxy composite financial performance measure. This is done by calculating the simple average of the financial performance measures calculated in the previous step.

Step 5. Compare the engineering consultant's composite financial performance measure to the proxy composite financial performance measure to identify the consultant's applicable percentile.

Step 6. Provide a copy of each executive's position description, job duties, and the relationship between executives' performance and the firm's performance.

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If the engineering consultant can successfully demonstrate superior performance, then the analysis performed in compliance with this Section (7.6) should be performed using survey data at the applicable percentile. For example, if the firm's financial performance is at the 75th percentile, then the compensation analysis should use compensation survey data at the 75th percentile as well. Some surveys are robust enough to provide data at any percentile ranking; however, it may be necessary to extrapolate survey data if the applicable percentile is not presented. Additionally, pursuant to DCAA CAM Section 6-414.4h(3):

> Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increase and decreases in the performance measures reflective in the changes to compensation claimed as reasonable.

***Note**: Regardless of firm performance, executive compensation costs in excess of the Benchmark Compensation Amount[10] are unallowable.*

[10] See prior discussion in Section 7.4.

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7.7 – NATIONAL COMPENSATION MATRIX (NCM)

[References (ASBCA cases): *Techplan Corporation*, *Information Systems Corporation*]

A. Generally

As discussed previously in Section 7.5.B, engineering consultants are responsible for preparing a compensation analysis to demonstrate that claimed compensation costs are reasonable in compliance with FAR 31.205-6, as interpreted and clarified by the ASBCA in the *Techplan* and *Information Systems* cases. State DOTs and/or independent CPA auditors should review the consultant's analysis to validate compliance with the procedures described in Section 7.5.B.

In cases where engineering consultants do not prepare an appropriate, compliant compensation analysis, State DOTs may use the National Compensation Matrix (NCM) as a tool for determining reasonable levels of compensation. The NCM will establish compensation amounts deemed reasonable for certain key positions within consulting firms. The NCM methodology will be developed based on the criteria established in Section 7.5.B.

The Audit Guide Task Force recommends that the NCM be prepared under the direction, guidance, and authority of the Federal Highway Administration (FHWA). Accordingly, the FHWA would provide details regarding the specific criteria, methodology, and surveys used in the preparation of the NCM. Additionally, FHWA would have the sole discretion to determine the surveys used to develop the NCM, and funding for the purchase of the surveys and preparation of the matrix would be shared by the various State DOTs.

The NCM will be updated and published on an annual basis. In the event that the NCM has not been updated in a given year, the amounts stated in the most recent NCM should be escalated based on guidance issued by FHWA. The methodology and application of the NCM is discussed in the following section.

B. Position Descriptions

The following position descriptions should be used to match the individual's job duties to the formal job title assigned to such employee.

The following position descriptions[11] were used in developing the sample NCM—

1. ***Chief Executive Officer (CEO).*** According to PSMJ, "[t]he CEO is responsible for day-to- day operations and business strategies carried out by the firm. Comparable titles include that of president, chief operating officer, or managing partner. . . ." ERI further indicates that the CEO "[p]lans, develops, and establishes policies and objectives of organization in accordance with board directives and corporation charter. This is the top executive and principal organization leader in the organization . . . . This position is distinguished from others in that it is the top ranking executive and, in most cases, is the highest paid executive in the organization. Reports to Board of Directors and often is a member of the board. Responsible for the profitability of the entire organization."

2. ***Executive Vice President (EVP).*** According to PSMJ, "[t]he executive vice president (EVP) assists the CEO with overall firm responsibilities. Unlike administration or operations directors, this executive typically has authority over all business functions of a firm rather than over only a limited, defined area. The EVP usually shares responsibilities with the CEO; each has day-to-day responsibility for separate, designated business areas. The EVP usually shares responsibilities with the CEO; each has day-to-day responsibility for separate, designated business areas. This executive will usually assume CEO operational responsibilities in the absence of the CEO." ERI further indicates that the EVP "[a]pproves, revises, and implements overall corporate growth strategies and personnel activities. As title practices vary among organizations, this level may be called Executive Vice President, Senior Vice President, or other

[11] The position descriptions were taken from the PSMJ and ERI surveys; however, this Guide does not endorse the use of any particular survey.

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variations depending on the organization. . . . This position is distinguished in that it is responsible for a broad range of activities or functions in the organization."

3. ***Senior Vice President (SVP)***. PSMJ describes this position as "[r]esponsible for a segment of a firm's practice, such as a design discipline, business unit, geographic region, or project type. The SVP usually reports directly to the CEO or the executive vice president. Usually, firms with greater than 50 total staff will have more than one senior vice president. The SVP has more authority than most firms' principals, and may supervise various principals who report to the specific senior vice president." ERI indicates "[a]s title practices vary among organizations, this level may be called Executive Vice President, Senior Vice President, or other variations depending on the organization. In smaller organizations the Senior or Executive title may not exist and the position may be referred to as a Vice President."

4. ***Other Principals***. According to PSMJ, "[o]ther principals usually have some ownership interest in the firm and focus on project delivery. Typically these individuals spend significant time working with clients and charging to projects. Other than top management or business development management, these principals spend more time in marketing and sales than other managers. Many firms have principals with no added functional titles. This indicates that design firms continue to focus certain senior individuals (i.e., principals) on project delivery rather than dividing responsibility for project delivery between their other functional managers."

5. ***Director of Finance***. According to PSMJ, "[t]he director of finance has full responsibility for the firm's financial operations. The ability to commit the firm's resources or to bind the firm to financial commitments is what differentiates this title from other financial positions. This title is generally given to individuals who have a substantial authority to manage all of the firm's business assets. Director of finance is the highest-ranking management position with no project or technical design responsibilities. Alternative titles include vice president of finance and chief financial Officer." ERI describes this position as the "Top Financial Officer," that typically reports to the CEO or COO and director level personnel report to this position.

6. ***Director of Administration***. According to PSMJ, "[t]he director of administration has management responsibility for all support areas of a firm's operations except technical and project production. This includes responsibility for finance, human resources, marketing, and general administration. Alternative titles include vice president of administration or general manager. Generally, the person reports directly to the CEO, and managers of specific administrative functions report to this individual. This position is not common in most design firms. Fewer than 20% of firms report having a director of administration. As such, the analysis for this position is based on a small sample. It is most common in mid-sized firms."

7. ***Director of Operations***. According to PSMJ, "[t]he director of operations has responsibility and authority to deliver completed projects to the firm's clients. Normally, those directly in charge of projects (project managers, department heads, or branch office managers) report to this individual. Typical responsibilities include allocation of the production staff, resolving scheduling conflicts, and efficient utilization of the design staff. Large firms with multiple offices typically assign more than one person to this position. In this case, the individual's management responsibility is limited to local, regional, or client-service type organizations (e.g., office, environmental business, Northeast region)." ERI describes the Operations Director as "Directs the operations function in conjunction with business growth, introduction of new operational systems, meeting organizational financial objectives, and meeting organizational goals in relation to safety, quality, and timely delivery of products or services. Assists with development of organization's policies, practices, and attainment of operating goals, while maintaining some management responsibility."

8. ***Director of Information Technology (IT)***. PSMJ describes this position as, ". . . responsible for a firm's computer assets, including hardware, software, and networks. Alternative titles include data processing manager, manager of automated services, computer manager, manager of information systems, and chief information officer." ERI further indicates that alternative position titles may include "[d]irector Computer Operations; Information Systems Director;

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Information Technology Director; IT Director."

Disclaimer: A sample, proposed NCM format appears below in Table 7-4 and is presented for illustration purposes only. Table 7-4 *must not* be relied upon or applied to an analysis of actual compensation costs. The sample NCM amounts below are provided merely to illustrate how revenue might be categorized/bracketed in a final NCM, which is currently being considered for development and implementation by the FHWA. If the NCM concept is accepted by the FHWA, then a compensation study will be commissioned, and a final NCM will be issued for use by State DOTs as a baseline for determining reasonableness.

Note Regarding Revenues in Excess of NCM Bracket 9: AASHTO has proposed that, for engineering consultants with revenues that exceed Bracket 9 of the NCM, a 20 percent premium may be appropriate. As noted by the ASBCA in the *Techplan Corporation* case, "every time revenues double, there is a 20 percent increase in the Chief Executive Officer's compensation." AASHTO has recommended that, for purposes of determining premium values above the NCM limits, this 20 percent should be applied to all positions, if applicable—not only to the CEO's compensation. However, the maximum amount permitted for any position may not exceed the BCA in effect at that time.

TABLE 7-4: PROPOSED FORMAT FOR NATIONAL COMPENSATION MATRIX (NCM)

National Compensation Matrix
Year 2007 Maximum Compensation Thresholds as Classified by Gross Revenue

	A/E Revenues								
	Bracket 1	Bracket 2	Bracket 3	Bracket 4	Bracket 5	Bracket 6	Bracket 7	Bracket 8	Bracket 9
Position	**<$1,000,000**	**>$1,000,000 ≤$2,274,900**	**>$2,274,900 ≤$5,687,250**	**>$5,687,250 ≤$11,374,500**	**>$11,375,000 ≤$28,436,250**	**>$28,436,250 ≤$56,872,500**	**>$56,872,500 ≤$113,745,000**	**>$113,745,000 ≤$227,490,000**	**>$227,490,000**
Chief Executive Officer	$85,725	$171,450	$212,397	$266,079	$325,084	$388,473	$593,295	$597,912	$597,912
Executive or Senior Vice President	$87,109	$174,219	$162,073	$194,829	$237,528	$301,261	$304,962	$519,305	$597,912
Other Principals	$64,405	[illegible]	$161,[illegible]55	[illegible]	$178,8[illegible]	$195,[illegible]	$20[illegible]	$290,259	$348,311
Director of Finance	$43,782	[illegible]	[illegible]	[illegible]	$119,2[illegible]	[illegible]86	[illegible]23[illegible]	$395,234	$474,281
Director of Administration	$32,117	$64,233	$73,296	$75,930	$95,421	$105,098	$170,595	$201,436	$241,723
Director of Operations	$64,403	$128,806	$119,931	$135,783	$170,009	$160,134	$228,397	$255,085	$306,101
Director of IT Operations	$36,785	$73,569	$84,610	$89,548	$101,549	$122,436	$154,331	$256,711	$308,053

Sample Data - Do Not Use

7.8 – APPLICATION OF THE NATIONAL COMPENSATION MATRIX (NCM)

[References: FAR 31.205-6, *Techplan Corporation*, *Information Systems Corporation* (ASBCA cases)]

A. Generally

The engineering consultant is responsible for preparing an acceptable compensation analysis in compliance with the criteria established by FAR 31.205-6 and the *Techplan* and *Information Systems* cases. State DOTs will be required to accept the engineering consultant's analysis, if deemed to be compliant with the *Techplan* and *Information Systems* criteria discussed previously in Section 7.5.B. Accordingly, State DOTs will not be permitted to impose any additional state limitations, unless mandated by State law. However, if the engineering consultant does not prepare an acceptable analysis, State DOTs may use the NCM as a tool for determining the reasonableness of claimed compensation costs.

B. State DOT Contracting Terms

The methodology and application of total compensation related to the NCM is separate and independent of a State DOT's contracting terms. Under the NCM methodology, the focus is on total compensation rather than on the category of labor (i.e., direct or indirect).

Engineering consultants should be aware that if a State DOT imposes a direct hourly rate cap pursuant to contractual agreement, then the difference between the paid versus billed amounts must still be considered a direct charge to the contract. The amount not reimbursed by the State DOT may not be moved to another project or transferred to an indirect labor account. Accordingly, the unrecovered amount represents a reduction to the profitability of that specific contract.

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7.9 – EXECUTIVE COMPENSATION—REQUIRED SUPPORTING DOCUMENTATION

Engineering consultants are required to prepare a schedule to demonstrate the application of, and compliance with either:

- A compensation analysis prepared in accordance with the criteria discussed above in Section 7.5, or
- The NCM.

Each year, the schedule must be submitted to the engineering consultant's home State DOT and the consultant's CPA along with an updated overhead schedule. For engineering consultants working in multiple states, the non-home State DOT should contact the home State DOT to ensure that the schedule has been submitted by the consultant and accepted by the home State DOT. If the engineering consultant receives a cognizant audit, the schedule would only be submitted to the State DOT that performs the cognizant agency review.

For each Senior Executive, the engineering consultant must voluntarily disallow all compensation that exceeds the maximum amounts established by the consultant's analysis, or alternatively, the NCM, as determined by the firm's gross revenue. The following information must be provided on the schedule and must be disclosed separately for each applicable position:

1. Employee/owner/officer first and last name or employee identification (ID) number.
2. Position title.
3. Total wages/salaries paid including taxable fringe benefits.
4. Total bonuses paid.
5. Total employer contributions to defined contribution pension plans (whether paid, earned, or otherwise accrued).
6. Total of items 3 through 5 above.
7. The applicable amount from the consultant's analysis or the NCM.
8. The excess compensation required to be disallowed from the indirect labor or bonus line item.

***Note**: The reviewing State DOT must be able to verify and reconcile the schedule to the consultant's financial records.*

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7.10 – ADDITIONAL PROCEDURES – RELATED PARTIES

An important aspect of a FAR audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under GAAP to disclose material related-party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party.

Potential related-party indicators[12] that may impact audit risk include, but are not limited to, the following:

- Agreements under which one party pays expenses on behalf of another party.
- Circular business arrangements and transactions between related parties.
- Engaging in business deals (such as leases) at greater or less than market value.
- Discovery of an undisclosed related party.
- Inadequate disclosure.
- Payments for services at inflated prices.
- Revenue recognition based on sales that lack economic substance.
- Sale of land with arranged seller financing.
- Sale of securities.
- Services or goods purchased from a party at nominal cost or no cost.
- Unusual, high-value transactions, particularly close to quarter- or year-end.
- Use of a related party to mitigate market risks.

The consultant must provide a list of all employees who are related to company executives as reported above. For each related party, the list should include the following six items:

1. Employees' first and last names or employee IDs.
2. Name or employee ID of related executive, and nature of relationship.
3. Position title or job classification.
4. Brief description of the employee's job duties.
5. Total wages or salaries paid, including taxable fringe benefits.
6. Total bonuses paid.

Auditors should review this information to evaluate whether there is a risk that compensation paid to a related party is unreasonable given the nature of their position or job responsibilities. Based on auditor judgment and risk assessment, the auditor should determine if additional audit procedures are necessary.

7.11 – SPECIAL CONSIDERATION FOR CLOSELY-HELD FIRMS

[Reference: FAR 31.205-6(a)(6)(i)(A)]

Pursuant to FAR 31.205-6(a)(6)(i)(A), compensation for certain individuals in closely-held firms requires special review and consideration. This is required because small firms typically do not have compensation committees, and the owners and officers of these firms may exercise considerable influence over their own levels of compensation.

[12] As discussed in the AICPA Publication, *Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors.* December 2001.

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Additionally, small firms typically have principals who are responsible for a variety of job duties. For example, it is common for a principal in a small firm to perform some overlapping job duties of CEO, CFO, Division Manager, and/or Project Manager. Many of these duties involve material amounts of direct labor that must be tracked to the appropriate projects. However, the following practices may cause a disproportionate distribution/allocation of principals' labor to the direct and indirect labor pools—

- Principals take infrequent draws in lieu of taking regular salaries.
- Principals take low salaries coupled with high bonuses.
- Principals wait until the firm's profitability is known at year end and treat any remaining cash surplus as compensation.

***Note**: For additional guidance regarding labor distribution, see Chapter 5 (Cost Accounting) and Chapter 6 (Labor Charging Systems and Other Considerations).*

To address the issue stated above, consultants must review executive compensation to ensure that labor is appropriately distributed to the direct and indirect labor pools. Absent other guidance, compensation costs should be distributed based on the ratio of each principal's direct and indirect labor hours. If material, an adjustment should be made to correct distortions of the labor pools.

7.12 – BONUS AND INCENTIVE PAY PLANS

[Reference: FAR 31.205-6(f)(1), FAR 31.205-6(a)(6)(ii)(B)]

Payments made under bonus and incentive-pay plans frequently represent a large portion of the total compensation costs claimed by consultants. To be allowable charges against Government contracts, bonus payments must be allocable to Government contracts, reasonable in amount, and must not represent a distribution of profits to owners.[13] FAR 31.205-6(f)(1) further specifies that bonus payments are allowable, provided the:

> Awards are paid or accrued under an agreement entered into in good faith between the contractor [consultant] and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor [consultant] so consistently as to imply, in effect, an agreement to make such payment; and . . . [b]asis for the award is supported.

FAR 31.205-6(a)(6)(ii)(B) states that for owners of closely-held firms, allowable bonus amounts may not represent a distribution of profits. Accordingly, there must be clear distinctions of the various portions of total compensation; specifically, which portion is a true bonus based on stated objectives and which portion is a profit distribution.

A. Bonus Plans

Typically, bonus plans are applicable to a broad class of employees. Some plans include eligibility for all employees, while others limit eligibility to professional and management staff. Individual participation may be based on the productivity of an individual, team, overall company, or some combination of these factors. Bonuses may be based on a percentage of an employee's base salary, or alternatively may be issued as lump sum distributions, based on the available pool of money to be distributed.

B. Profit-Distribution Plans

By contrast, profit-distribution plans involve a distribution of net earnings to owners. Individual distributions are based on partners' capital account balances, level of partnership (e.g., junior versus senior partner), number of owned shares, or some other factor linked to ownership.

[13] See FAR 31.201-3, FAR 31.201-4 and FAR 31.205-6(a)(6)(ii)(B), respectively.

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C. Documentation of Bonus and Profit-Distribution Plans

Some companies have both bonus plans *and* profit-distribution plans. However, only the portion that is a valid bonus is allowable as a recoverable overhead expense. Consultants should prepare and maintain written bonus plans that identify eligibility requirements and provide details regarding how bonus payments are determined. Profit-distribution agreements also should be in writing. This will serve to reduce confusion as to what is a bonus and what is a profit distribution. An acceptable bonus policy should include an adequate description of the performance measures used to determine bonus amounts, such as employee performance evaluation ratings, contributions toward the firm's revenue growth, and responsibilities for cost containment.

Written bonus plans should include, at a minimum, the following components–

- Eligibility criteria.
- Period of bonus plan.
- Performance criteria (e.g., individual expectations—must be measurable and verifiable criteria).
- Incentives awards/spot bonuses must be related to performance, as measured by quantitative and qualitative factors.
- Form of payment to be received.
- Distribution timeline.

7.13 – FRINGE BENEFITS

[Reference: FAR 31.205-6(m)]

Fringe benefits are defined at FAR 31.205-6(m) as the cost of "vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans." Fringe benefit costs are allowable to the extent that they are reasonable and are required by law, an employer-employee agreement, or an established policy of the consultant.

Frequently, additional fringe benefits are available to all employees. The more common elements are discussed in the following sections.

A. Deferred Compensation, Generally

[References: FAR 31.001, CAS 415]

FAR 31.001 defines *deferred compensation* as:

> [A]n award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of the receipt of compensation by the employee. This definition shall not include the amount of year end accruals for salaries, wages, or bonuses that are to be paid within a reasonable period of time after the end of a cost accounting period.

To be allowable as charges against Government contracts, the cost of deferred awards must be measured, allocated, and accounted for in compliance with CAS 415.

B. Pension Plans

[References: FAR 31.001, FAR 31.205-6(j), ERISA, I.R.C., CAS 412, CAS 413]

Defined. FAR 31.001 defines a *pension plan* as a "deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirements, provided that the benefits are paid for life or are payable for life at the option of the employees." Pension plan accounting is complex and is subject to various laws, regulations, and policies including FAR Part 31, the Internal Revenue Code (I.R.C.) and related regulations, the Employee Retirement Income Security Act (ERISA), CAS 412 (cost accounting standard for composition and measurement of pension cost), and CAS 413 (adjustment and allocation of pension cost). Accordingly, costs associated with pension plans must be reviewed carefully to determine the allowability of claimed costs.

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Funding Requirements. "Qualified pension plans" are definite, written programs that meet the eligibility criteria set forth in the Internal Revenue Code. All other pension plans are considered unqualified pension plans. Costs for either type of plan may be allowable, depending on the specific circumstances. Except for nonqualified pension plans using the pay-as-you-go method, one of the critical FAR 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, including extensions. Pension costs assigned to the current year but not funded timely are unallowable in any subsequent year.

Allowable Contributions. The amount contributed to qualified pension- or profit-sharing plans on behalf of principals and other 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 consultant and employees, before the work or services are performed and pursuant to the terms and conditions of the established plan. Contributions for pension costs must comply with FAR 31.205-6(j), which incorporates CAS 412 and 413.

Changes in Pensions Plans. As noted in FAR 31.205-6(j)(1), the cost of changes in pension plans are not allowable if the changes are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future. Additionally, 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 option of the employee. Finally, increased payments to retired participants for cost-of-living adjustments are allowable if paid in accordance with a consistent policy or practice.

C. Employee Stock Ownership Plans (ESOPs)

[References: FAR 31.205-6(q), CAS 412, CAS 415]

Defined. An ESOP is a stock bonus plan designed to invest primarily in the stock of the employer corporation. The consultant's contributions to an Employee Stock Ownership Trust (ESOT) may be in the form of cash, stock, or property. An ESOP may be designed as a deferred compensation plan or as a supplementary pension plan; each would be covered by different regulations. To determine whether certain ESOP costs are allowable, FAR 31.205-6(q) should be referenced along with applicable CAS provisions (see note below). Private companies must have an annual outside valuation performed to determine the market value of their ESOP shares.

Note*: On May 1, 2008, the Cost Accounting Standards Board, Office of Federal Procurement Policy, issued a final rule amending Cost Accounting Standard 412, "Cost Accounting Standard for composition and measurement of pension cost," and CAS 415, "Accounting for the cost of deferred compensation." These changes to the CAS direct that costs of all Employee Stock Ownership Plans, regardless of type, be accounted for in accordance with CAS 415, and provide criteria in CAS 415 for measuring ESOP costs and assigning those costs to cost accounting periods. The amendments specify that the provisions of CAS 415, and not any other standard, govern accounting for ESOP costs. Pursuant to CASB 9904.415-20, CAS 415 applies to the cost of all deferred compensation except the cost for compensated personal absence, and the cost for pension plans that do not fit the description of an ESOP, as defined in CASB 9904.415-30. The final rule also revises CASB 9904.415-40 to specify the requirements for measurement and assignment of ESOP costs.*

** The FAR has not been revised to reflect the changes in CAS 412 and 415.*

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General Considerations. FAR 31.205-6(q)(2) provides that the costs of ESOPs are allowable subject to the following conditions:

(i) For ESOPs that meet the definition of a pension plan at [FAR] 31.001, the contractor—

A. Measures, assigns, and allocates the costs in accordance with 48 CFR 9904.412;

B. Funds the pension costs by the time set for filing of the Federal income tax return or any extension. Pension costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year; and

C. Any amount funded in excess of the pension cost assigned to a cost accounting period is not allowable in that period and shall be accounted for as set forth at 48 CFR 9904.412-50(a)(4). The excess amount is allowable in the future period to which it is assigned, to the extent it is not otherwise unallowable.

(ii) For ESOPs that do not meet the definition of a pension plan at [FAR] 31.001, the contractor measures, assigns, and allocates costs in accordance with 48 CFR 9904.415.

(iii) Contributions by the contractor in any one year that exceed the deductibility limits of the Internal Revenue Code for that year are unallowable.

(iv) When the contribution is in the form of stock, the value of the stock contribution is limited to the fair market value of the stock on the date that title is effectively transferred to the trust.

(v) When the contribution is in the form of cash—

(A) Stock purchases by the ESOT in excess of fair market value are unallowable; and

(B) when stock purchases are in excess of fair market value, the contractor shall credit the amount of the excess to the same indirect cost pools that were charged for the ESOP contributions in the year in which the stock purchase occurs. However, when the trust purchases the stock with borrowed funds which will be repaid over a period of years by cash contributions from the contract to the trust, the contractor shall credit the excess price over fair market value to the indirect cost pools pro rata over the period of years during which the contractor contributes the cash used by the trust to repay the loan.

(vi) When the fair market value of unissued stock or stock of a closely held corporation is not readily determinable, the valuation will be made on a case-by-case basis taking into consideration the guidelines for valuation used by the IRS.

Note*: Given the complexity of ESOPs, specific guidance should be consulted for the proper cost accounting treatment relating to ESOP costs, including stock forfeitures and similar items.*

D. Severance Pay

[Reference: FAR 31.205-6(g)]

The FAR defines severance pay as "a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated." Severance pay does not include payments under early-retirement incentive plans.

FAR 31.205-6(g)(2) provides that severance pay is allowable only when payment is required either by: (1) law, (2) an employer-employee agreement, (3) an established policy that is, in effect, an implied agreement on the consultant's part, or (4) the circumstances of the particular employment.

Normal severance pay relates to recurring, partial layoffs, cutbacks, and involuntary separations. These costs are allowable when they are properly allocated. By contrast, *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 consultant's facility. Accruals of normal severance pay are acceptable if the amount is both (1) reasonable in light of prior experience, and (2) is allocated to both Government and non-government work. For accruals, FAR 31.205-6(g)(5) notes that "Abnormal or mass severance pay is of such a conjectural nature that accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, the Government will consider allowability on a case-by-case basis." Special compensation paid to terminated employees after a change in management control is unallowable to the extent that it exceeds normal severance pay.

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7.14 – SUPPLEMENTAL BENEFITS

In many cases, executives have available to them enhanced or supplemental benefits that are not available to the majority of the workforce. These supplemental benefits or executive benefits should be evaluated on a case-by-case basis to determine their levels of compliance with applicable subparts of FAR 31.205-6 and the Cost Accounting Standards. The reasonableness of these benefits should be evaluated based on market surveys or other available data. The prevalence of such plans within the industry should also be considered in determining reasonableness.

A. Supplemental Executive Retirement Plans (SERPs)

[References: FAR 31.205-6, CAS 412, ERISA]

These plans are designed to provide executives with earned benefits in excess of amounts payable under qualified retirement plans. These plans are often referred to as "ERISA Excess Plans." These plans should be evaluated in accordance with FAR 31.205-6(j) and CAS 412.

B. Long-Term Incentive (LTI) Plans

[Reference: FAR 31.205-6(i)]

LTI plans are compensation plans that have an award period of two or more years. These payments typically are based on the achievement of long-term business goals or as a method of retaining key executives. The most common LTI plans for publicly-traded companies are based on stock options, which are unallowable per FAR 31.205-6(i).

C. Executive Severance

[Reference: FAR 31.205-6(g)]

Severance payments should be evaluated in accordance with FAR 31.205-6(g). Most severance policies are based on a formula that relies on length of service/employment as the determining criterion in the calculation of the severance amount. In many cases, executives are awarded severance in excess of the normal or established policy. In many instances, severance payments are based on executive employment contracts; however, the fact that a severance payment is based on an executive employment contract does not necessarily support the amount as reasonable.

D. Golden Parachutes

[Reference: FAR 31.205-6(l)(1)]

"Golden parachutes" are payments made under a contract entered into by a consultant and key personnel under which the consultant agrees to pay certain amounts to its key personnel in the event of a change in ownership or control of the consultant. The costs of golden parachute benefits are expressly unallowable per FAR 31.205-6(l)(1).

E. Golden Handcuffs

[Reference: FAR 31.205-6(l)(2)]

FAR 31.205-6(l)(2) provides that special compensation paid to an employee is unallowable if the compensation is contingent on an employee remaining with the organization after an actual or prospective change in management control. These costs are frequently referred to as "golden handcuffs."

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8

Chapter 8 – Selected Areas of Cost

This chapter was designed to provide FAR interpretation guidance only. This chapter is not meant to be authoritative or to supersede the FAR. The entire text of the FAR should be consulted when determining proper accounting treatment (see Appendix D for a listing of resource materials). Specific requirements for State DOTs based on individual State statutes or policies must be separately addressed with the individual DOTs. For use as a quick reference, a listing of common unallowable expenses appears in Section 8.30.

8.1 – Background

The purpose of this chapter is to provide guidance for *selected items of cost*, as identified in FAR 31.2. This chapter is organized by FAR Part 31.2 sub-sections in ascending order, numerically.

As with all costs charged to Government contracts, the selected items of cost discussed in this chapter are allowable only if they are reasonable in amount, allocable to intermediate or final cost objectives, are properly assigned/allocated to appropriate cost objectives, and are not otherwise prohibited by FAR Part 31 and/or related Federal and State laws, regulations, and policies.

Additionally, the deductibility of costs per the Internal Revenue Code (I.R.C.) is not necessarily determinative of their allowability under Government cost-reimbursement type contracts, as there are many types of costs that are deductible for Federal tax purposes but fail to satisfy the allocability, allowability, or reasonableness criteria of FAR Part 31. For example, the I.R.C. allows deductions for advertising; interest; 50 percent of entertainment costs, including alcoholic beverages; and full rental costs of property under common control, while FAR Part 31 requires disallowances for these items.

***Note**: For additional useful guidance, see the* FAR Cost Principles Guide*, which is published by the Defense Contract Audit Agency and available at: http://www.dcaa.mil/FAR_Cost_Principles_Guide.pdf.*

A. Directly-Associated Costs

One of the concepts that must be addressed, per FAR 31.201-6 Accounting for Unallowable Costs, is that costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that 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.

B. Burden of Proof

Costs must be supported and, per FAR 31.201-2(d), engineering consultants must maintain adequate records, including supporting documentation, to demonstrate that the costs comply with applicable FAR cost principles. The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

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C. Determining Reasonableness

In accordance with FAR 31.201-3, 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 must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by an engineering consultant. The burden of proof shall be upon the consultant to establish a cost is reasonable.

What is reasonable depends upon a variety of considerations and circumstances, including:

- Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the engineering consultant's business or the contract performance;
- Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;
- The engineering consultant's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and
- Any significant deviations from the engineering consultant's established practices.

D. Direct Costs

In accordance with FAR Part 31, a direct cost is a cost attributable to a single final cost objective. The fact that a direct cost is not reimbursed through a contract does not allow the engineering consultant to include the cost in the indirect cost pool. Any direct cost, whether reimbursed or not, is unallowable as part of the indirect cost rate, except as follows: for reasons of practicality, the engineering consultant may treat any direct cost of a minor dollar amount as an indirect cost if the accounting treatment—

- Is consistently applied to all final cost objectives; and
- Produces substantially the same results as treating the cost as a direct cost.

8.2 – ADVERTISING AND PUBLIC RELATIONS

[Reference: FAR 31.205-1]

Per FAR 31.205-1(c), advertising and public relations costs include " . . .the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities . . . ."

A. Advertising Costs

Selected allowable advertising costs include:

- Employee recruitment, including help-wanted advertising costs in accordance with FAR 31.205-34; and
- 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.

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.

B. Trade Show Expenses and Labor

Per FAR 31.205-1(f)(2), unallowable public relations and advertising costs include "[a]ll costs of trade shows and other special events which do not contain a significant effort to promote the export sales of products normally sold to the U.S. Government."

The unallowable costs specified in FAR 31.205-1(f)(2) pertain to *exhibiting* products and services at trade shows. Accordingly, labor costs for booth attendants, and other associated costs such as booth rental and promotional items, must be disallowed—unless incurred for the export sales purposes

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described above. By contrast, labor costs generally are allowable for employees who merely attend trade shows for the purpose of training.

C. 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 engineering consultant 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. Costs of sponsoring meetings, symposia, seminars and other special events when the principal purpose of the event is other than the dissemination of technical information are 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.

D. Bad Debts and Collection Costs

[Reference: 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.

8.3 – COMPENSATION

[Reference: FAR 31.201-3, FAR 31.205-6]

Costs must be *reasonable* in amount considering what is normal for a comparable business, the established compensation plan or practice of a given engineering consultant, or restraints imposed by business circumstances. (See FAR 31.201-3 & 31.205-6(b) for more information.) Auditors may challenge either the reasonableness of individual components of employee compensation or the reasonableness of total compensation costs.

For more specifics and details regarding Compensation, see Chapter 7.

8.4 – PERSONAL USE OF COMPANY VEHICLES

[Reference: FAR 31.205-6(m)(2)]

This cost is unallowable, including the portion of cost related to transportation to and from work regardless of whether the cost is reported as taxable income to the employees. Costs associated with luxury vehicles warrant additional attention to ensure costs are reasonable, allowable, and allocable.

8.5 – CONTRIBUTIONS OR DONATIONS

[Reference: FAR 31.205-8]

Contributions or donations, including cash, property, and services, are unallowable except for costs of participation in community service activities such as blood bank drives, charity drives, disaster assistance, and/or similar types of activities.

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8.6 – FACILITIES CAPITAL COST OF MONEY (COST OF MONEY)

[Reference: FAR 31.205-10, CAS 414, FAR 15.404-4]

Facilities capital cost of money is an imputed cost related to an engineering consultant's investment in fixed assets/facilities used in contract performance, regardless of whether the source of the investment is equity or borrowed capital. Cost of money is charged as a rate, in a manner similar to overhead. 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.

Engineering consultants are not *required* to propose facilities capital cost of money in pricing and performing a contract. However, when an engineering consultant chooses to claim cost of money, 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 facilities capital cost of money generally occurs through a memorandum entry of the cost. The engineering consultant must maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to fully support the entry.

On the engineering consultant's overhead schedule, the facilities capital cost of money amount must be shown as a separate line item or, alternatively, must be disclosed in the notes. This is necessary to distinguish cost of money from the company's other expenses. This is required because, per FAR 15.404-4, profit/fee does not include amounts applicable to facilities capital cost of money.

The cost of money rate (Prompt Payment Act Interest Rate) is the arithmetic mean of certain interest rates specified by the Secretary of the Treasury. These rates are published semiannually in the *Federal Register* on or about 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 resulting value is divided by the allocation base units (e.g., direct labor hours or dollars of total cost input) for the corresponding indirect cost pool.

Appendix A to CAS 414 contains the standard form used to compute facilities capital cost of money and includes a detailed example in which the total cost of money on facilities capital is computed on a step-by-step basis.

8.7 – DEPRECIATION

[Reference: FAR 31.205-11]

In general, depreciation of plant, equipment and other capital/fixed assets is allowable if it does not exceed the amount used for financial reporting purposes. Depreciation is generally based on the useful business life of the asset and should not be based on accelerated depreciation methods that may be acceptable for IRS tax purposes. Special consideration must be given to consistency between organizations under common control, fully depreciated assets, asset disposals, capital leases, rentals and other special CAS provisions contained in the FAR.

Normal depreciation is generally considered allowable if reasonable and allocable.

Most of the engineering consultants under contract to State DOTs are not subject to full CAS coverage; therefore, the following would generally apply:

A. Depreciation Expense Presented Is Same for Both Financial and Income Tax Purposes

Costs are reasonable if the engineering consultant follows policies and procedures that are (a) consistent with those followed in the same cost center for business other than Government, and (b) reflected in the engineering consultant's books of accounts and financial statements. Thus, the firm is not using accelerated methods of depreciation in determining taxable income.

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B. Depreciation Expense Presented For Financial Purposes Differs From Income Tax Purposes

Reimbursement of fixed asset costs shall be based on the asset costs amortized over the estimated useful life of the fixed assets using depreciation methods acceptable for financial purposes (e.g., straight line, double-declining balance, or sum-of-the-years'-digits). Allowable depreciation shall not exceed the amounts used for book and statement purposes and shall be determined in a manner consistent with the depreciation policies and procedures followed in the same cost center on non-government business (FAR 31.205-11(c)). In addition, if the amounts used for book and financial statement purposes are not reasonable or equitable, costs should be questioned.

***Note**: Expenses computed based on special tax deduction methodologies (e.g., I.R.C. Section 179) are not allowable.*

For those engineering consultants that are required to follow CAS, the consultant must comply with the provisions of CAS 409, Depreciation of Tangible Capital Assets, and CAS 404, Capitalization of Tangible Assets. CAS 404 and CAS 409 are incorporated into FAR Part 31. (See Section 8.11 for a discussion of the treatment of gains and losses on sale of assets per FAR 31.205-16.)

8.8 – EMPLOYEE MORALE, HEALTH, AND WELFARE

[Reference: 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 FAR 31.205-13.

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

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

***Note**: Employee morale type expenses are often covered by the entertainment cost principle, FAR 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 FAR 31.205-14 overrides all other cost principles.*

Recreation expenses are expressly unallowable unless they meet the following criteria:

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

Taken together, the cost principles at FAR 31.205-13, Employee Morale, and FAR 31.205-14, Entertainment, expressly disallow certain costs that some engineering consultants may have considered allowable prior to the effective date of the current rule, October 1, 1995. Examples of unallowable costs include, but are not limited to:

- Entertainment provided as part of public relations, employee relations, or company celebrations;
- Gifts to the public;
- Gifts to employees which are not for performance or achievement or are not made according to an established plan or policy;

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- Travel tickets or tickets to shows or sporting events; and
- Recreational trips, shows, picnics, or parties.

Costs associated with the reimbursement of employee travel expenses are allowable, provided that the employee is in travel status for an official business purpose, the nature of the cost is allowable, and the cost does not exceed the per diem rates established in the Federal Travel Regulation. Reasonableness is considered in nature and amount both for the engineering consultant as a whole and for the employee(s) benefited by the expenditure.

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

8.9 – ENTERTAINMENT

[Reference: 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. Examples of unallowable company sponsored employee social events, include but are not limited to, outings to professional and college sporting events, company picnics, theme and holiday parties, and expo fairs.

8.10 – FINES AND PENALTIES

[Reference: 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.

8.11 – GAINS AND LOSSES ON DEPRECIABLE PROPERTY

[Reference: FAR 31.205-16]

Gains and losses from the sale, retirement, or other disposition (but see FAR 31.205-19) of depreciable property shall be included in the year in which they occur as credits or charges to the cost grouping(s) in which the depreciation or amortization applicable to those assets was included (but see last paragraph below). However, no gain or loss shall be recognized as a result of the transfer of assets in a business combination (see FAR 31.205-52).

Gains and losses on disposition of tangible capital assets, including those acquired under capital leases (see FAR 31.205-11(h)), shall be considered as adjustments of depreciation costs previously recognized. The gain or loss for each asset disposed of is the difference between the net amount realized, including insurance proceeds from involuntary conversions, and its undepreciated balance. The gain recognized shall be limited to the difference between the acquisition cost (or for assets acquired under a capital lease, the value at which the leased asset is capitalized) of the asset and its undepreciated balance.

Gains and losses on the disposition of depreciable property shall not be recognized as a separate charge or credit when either of the following conditions exists:

- Gains and losses are processed through the depreciation reserve account and reflected in the depreciation allowable under FAR 31.205-11; or
- The property is exchanged as part of the purchase price of a similar item, and the gain or loss is taken into consideration in the depreciation cost basis of the new item.

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8.12 – IDLE FACILITIES AND IDLE CAPACITY COSTS

[Reference: FAR 31.205-17]

The term *idle facilities* refers to completely unused facilities that exceed the engineering consultant's current needs. Costs of idle facilities must be excluded from overhead unless:

- The costs are necessary to meet fluctuations in workload, or
- The facilities, when acquired, were necessary but have become idle because of changes in requirements, production economies, reorganization, or other unforeseeable causes. Costs of idle facilities are allowable for a reasonable period, which generally may not exceed one year.

Costs of idle capacity are costs of doing business and are a factor in the normal fluctuations of usage or overhead rates from period to period. Such costs are allowable provided the capacity is necessary or was originally reasonable and is not subject to reduction or elimination by subletting, renting, or sale, in accordance with sound business, economics, or security practices. Widespread idle capacity throughout an entire plant, or among a group of assets having substantially the same function, may be idle facilities.

8.13 – BID AND PROPOSAL COSTS

[Reference: FAR 31.205-18]

The composition of bid and proposal (B&P) costs is frequently a key issue. Although marketing[14] and B&P activities can be similar in nature and frequently are performed by the same employees, there is an important distinction between the activities. That is, basic B&P costs are costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-government contracts. By contrast, marketing costs are more general in nature. Therefore, engineering consultants must establish procedures for segregating B&P costs from selling and marketing costs.

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

8.14 – PRECONTRACT COSTS

[Reference: FAR 31.205-32]

FAR 31.205-32 provides that (emphasis added):

> *Precontract costs* means costs incurred before the effective date of the contract directly pursuant to the negotiation and in anticipation of the contract award when such incurrence is necessary to comply with the proposed contract delivery schedule. These costs are allowable to the extent that they would have been allowable if incurred after the date of the contract.

Precontract costs are associated with specific contracts and therefore may not be included in the indirect cost pool. Precontract costs that meet the requirements of FAR 31.205-32 may be charged directly to projects; however, an advance agreement may be required (see FAR 31.109(h)). Precontract labor must remain as a direct cost regardless of whether it is billable to a client.

***Note**: Contracting agencies and engineering consultants should be aware that any project costs incurred prior to Federal authorization of that project, or phase of work within the project, are not eligible for reimbursement from Federal funds.*

[14] This Guide uses the word "marketing" to identify unallowable types of selling, advertising, corporate image enhancement, and market planning costs.

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8.15 – INSURANCE

[Reference: FAR 31.205-19]

A. Insurance on Lives of Key Personnel

Costs of insurance on the lives of key personnel, such as officers, partners, or proprietors are allowable only to the extent that (1) the insurance represents additional compensation, and (2) the amount paid is reasonable. However, if the company or its owners are beneficiaries, the costs are unallowable.

B. Professional Liability Insurance

Professional liability insurance (also referred to as *errors and omissions insurance*) protects against damages to clients or third parties resulting from professional errors or judgments. The cost of professional liability insurance is allowable, subject to tests of allocability and reasonableness.

Alternately, the costs incurred by an engineering consultant to correct its own defects, settle claims in lieu of correcting its own defects, or similar acts are unallowable costs as either a direct or indirect charge, however represented. Simply changing the label to "warranty" or "settlement" does not render the costs allowable.

C. Losses and Insurance Deductibles

Per FAR 31.205-19(d)(3), actual losses are unallowable unless expressly provided for in the contract, except :

> (i) Losses incurred under the nominal deductible provisions of purchased insurance, in keeping with sound business practice, are allowable; and
>
> (ii) Minor losses, such as spoilage, breakage, and disappearance of small hand tools that occur in the ordinary course of business and that are not covered by insurance, are allowable.

D. Self Insurance

Engineering consultants may elect to provide coverage for certain risks from their own resources under a program of self-insurance. The engineering consultant's decision to self-insure should be based on a determination that the coverage can be provided by self-insurance at a cost not greater than the cost of obtaining equivalent coverage from an insurance company or State fund. If purchased insurance is available, the charge for any self-insurance coverage plus insurance administrative expenses shall not exceed the cost of comparable purchased insurance plus associated insurance administrative expenses.

Generally, engineering consultants will rely on self-insurance to cover ordinary risks and losses and will maintain various forms of purchased insurance to cover major risks and catastrophic losses.

The self-insurance charge plus insurance administration expenses may be equal to, but must not exceed, the sum of comparable purchased insurance plus the associated insurance administration expenses. The engineering consultant's actual loss experience shall be evaluated regularly and self-insurance charges for subsequent periods shall reflect such experience in a similar manner as would purchased insurance.

As discussed in FAR 31.205-19(c)(2), the requirements of FAR 28.308 must be met. This requires self-insurance programs to be submitted for pre-approval when 50 percent or more of the self-insurance costs to be incurred at a segment will be allocated to negotiated Government contracts and the self-insurance costs at the segment are expected to be $200,000 or more annually.

8.16 – INTEREST COSTS

[Reference: 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, and costs of preparing and issuing stock rights are unallowable (but see FAR 31.205-28). However, interest assessed by State or local taxing authorities under the conditions specified in FAR 31.205-41(a)(3) is allowable.

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8.17 – LOBBYING COSTS

[Reference: 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, 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 providing technical and factual presentation of information through testimony, statements or letters in response to a document request on topics directly related to contracts, or lobbying activities that may directly reduce contract cost.

8.18 – LOSSES ON OTHER CONTRACTS

[Reference: FAR 31.205-23]

Any excess of costs over income under any other contract (including the engineering consultant's contributed portion under cost-sharing contracts) is unallowable. This would include costs applicable to direct project labor and/or expenses not being fully reimbursed due to contractual limitations.

8.19 – ORGANIZATION AND REORGANIZATION COSTS

[Reference: FAR 31.205-27]

All costs incurred 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.

8.20 – PATENT COSTS

[Reference: 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.

8.21 – RETAINER AGREEMENTS

[Reference: FAR 31.205-33]

Work performed by professionals and engineering consultants with special skills are allowable but must be supported by detailed evidence of the nature and scope of the work performed.

Engineering consultants may engage outside professionals and consultants on a retainer-fee basis. FAR 31.205-33(e) requires that allowable retainer fees be supported by evidence that:

- The services covered are necessary and customary,
- The fee is reasonable in comparison with maintaining an in-house capability, and
- The level of past services justifies the amount of the retainer fees.

The supporting evidential matter requirements also apply to retainer agreements, except retainer agreements are not required to (and generally do not) have specific statements of work.

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FAR 31.205-33(f) contains three specific documentation requirements that must be met for any professional and consultant service costs including those on retainer-fee basis to be allowable. These requirements are:

- Details of all agreements (e.g., work requirements, rate of compensation, and nature and amount of other expenses if any) and details of actual services performed.
- Invoices or billings submitted by consultants, including sufficient detail as to the time expended and nature of the actual services provided.
- Consultant work products and related documents, such as trip reports indicating persons visited and subjects discussed, minutes of meetings, and collateral memoranda and reports.

8.22 – RELOCATION COSTS

[Reference: FAR 31.205-35]

Certain costs of relocating permanent employees are allowable if numerous requirements are met. For more details see FAR 31.205-35(a). Limitations for considering costs allowable include the following criteria, as set forth in FAR 31.205-35(b):

> (1) The move must be for the benefit of the employer.
>
> (2) Reimbursement must be in accordance with an established policy or practice that is consistently followed by the employer and is designed to motivate employees to relocate promptly and economically.
>
> (3) The costs must not be otherwise unallowable under [FAR] Subpart 31.2.
>
> (4) Amounts to be reimbursed shall not exceed the employee's actual expenses, except as provided for in paragraphs (b)(5) and (b)(6) of this subsection.
>
> (5) For miscellaneous costs of the type discussed in paragraph (a)(5) of this subsection, a lump-sum amount, not to exceed $5,000, may be allowed in lieu of actual costs.
>
> (6) Reimbursement on a lump-sum basis may be allowed for any of the following relocation costs when adequately supported by data on the individual elements (e.g., transportation, lodging, and meals) comprising the build-up of the lump-sum amount to be paid based on the circumstances of the particular employee's relocation:
>
> (A) Costs of finding a new home, as discussed in paragraph (a)(2) of this subsection.
>
> (B) Costs of travel to the new location, as discussed in paragraph (a)(1) of this subsection (but not costs for the transportation of household goods).
>
> (C) Costs of temporary lodging, as discussed in paragraph (a)(2) of this subsection.
>
> When reimbursement on a lump-sum basis is used, any adjustments to reflect actual costs are unallowable.

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The following types of relocation costs are *unallowable*:

(1) Loss on the sale of a home.

(2) Costs incident to acquiring a home in the new location as follows:

(i) Real estate brokers' fees and commissions.

(ii) Costs of litigation.

(iii) Real and personal property insurance against damage or loss of property.

(iv) Mortgage life insurance.

(v) Owner's title policy insurance when such insurance was not previously carried by the employee on the old residence. (However, the cost of a mortgage title policy is allowable.)

(vi) Property taxes and operating or maintenance costs.

(3) Continuing mortgage principal payments on a residence being sold.

(4) Costs incident to furnishing equity or nonequity loans to employees or making arrangements with lenders for employees to obtain lower-than-market rate mortgage loans.

Some examples of the conditions which would cause the costs to be unallowable include the following:

- The claimed costs include mortgage-related costs, and the employees were not homeowners prior to the move.
- The move is for a period less than 12 months.
- The move does not benefit the employer.
- The employer does not have a consistent relocation policy for all employees.
- The claimed costs include a loss on the sale of a home.
- The claimed costs represent continuing mortgage principal payments on a sold residence.

8.23 – RENT/LEASE

[Reference: FAR 31.205-36]

An operating lease is the most common type of agreement used to lease realty or personal property. Under an operating lease, the engineering consultant pays rent to a third party at prevailing market rates. Operating lease payments generally are allowable in full, provided that the leased assets are allocable to, and used in, the engineering consultant's primary business activities. By contrast, special consideration is required for arrangements that are either structured as capital leases (a.k.a. "financing leases") or involve common control.

A. Capital Leases

In some cases, leased property is considered a purchased asset and must be accounted for as a capital lease. Accounting for capital leases requires the property acquired through the lease to be capitalized and amortized/depreciated over the property's useful life. The criteria for classifying leases are discussed in paragraph 7 of FASB Statement No. 13. 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 percent 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 percent 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.

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B. Common Control

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.

Per FASB Statement No. 57—Related Party Disclosures, *common control* is defined as "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an enterprise through ownership, by contract or otherwise." The key question is whether a party involved in the transaction has the ability to exercise control over the operating and financial policies of any related party. An individual does not need to have over 50 percent ownership to have control. The auditor needs to review the transactions that actually occurred to determine whether common control exists. A review of the actual decision-making process and the reasonableness of lease terms are required.

Sale and leaseback rental costs are allowable only up to the amount the engineering consultant would be allowed if the consultant retained title, computed based upon the net book value of the asset on the date the consultant becomes a lessee of the property adjusted for any gain or loss recognized in accordance with FAR 31.205-16(b). The gain or loss is the difference between the net amount realized and the net book value (the undepreciated balance) of the asset on the date of the sale and leaseback transaction. The annual lease cost limitation should reflect the amortization of the adjusted net book value and other costs of ownership which may include facilities capital cost of money, taxes, insurance, and/or similar types of costs.

For personal property (property other than real estate) under common control, rental costs are allowable to the extent that they do not exceed the normal costs of ownership as indicated above unless the same (or similar) property is also rented at the same price to unaffiliated organizations.

8.24 – SELLING COSTS

[Reference: FAR 31.205-38]

Generally. *Selling* is a generic term that includes efforts to market a company's goods and services. Selling costs usually are considered *necessary* for the overall operation of a business, but not all types of selling costs are allowable charges against Government contracts. Costs in the following categories should be reviewed for allowability:

- Advertising (FAR 31.205-1).
- Corporate image enhancement and public relations costs (FAR 31.205-1).
- Bid and Proposal costs (FAR 31.205-18).
- Entertainment costs (FAR 31.205-14).
- Long-range market planning costs (FAR 31.205-12).

Determining Allowability. Selling costs are allowable if they:

- Are reasonable and allocable in accordance with FAR 31.201-3 and FAR 31.201-4, respectively;
- Meet the criteria established in FAR 31.205-1(d) through (f), FAR 31.205-12, and FAR 31.205-18 (as applicable); and
- Are not specifically disallowed by other FAR cost principles (e.g., the FAR 31.205-14 Entertainment cost principle).

Note*: One example of allowable selling costs is* direct selling*, which involves person-to-person contact to induce a particular customer to purchase the engineering consultant's services.*

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Selling and marketing costs cannot be adequately identified by mere reference to account titles. Such a cursory 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.

Allocability. Any selling and marketing costs are subject to Government challenge if the costs can be considered unnecessary/unallocable to 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.

General Advertising. Costs of promotional material, brochures, handouts, magazines, or other media designed to call favorable attention to the company and its activities are unallowable. FAR 31.205-38 prohibits claiming these costs as selling expenses since FAR 31.205-1 specifically identifies these costs as unallowable advertising or public relations costs.

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8.25 – TAXES

[References: FAR 31.201-4, 31.205-20, 31.205-27, & 31.205-41]

Federal income taxes and excess profits taxes are unallowable, as are taxes in connection with financing, refinancing, refunding operations, or reorganizations. State and local taxes are allowable (e.g., property, franchise, income, and use taxes). However, if taxes are paid late or in error, any penalties or interest assessed by the Government (Federal, State, or local) are unallowable.

Engineering consultants that elect Subchapter S Corporation tax status are not taxed at the corporate level; accordingly, no payments or accruals for income taxes should be recorded in the consultant's financial records. S Corporation income passes through to the shareholders and is taxed on their personal income tax returns.

***Note**: Auditors should ensure that engineering consultants that have elected Subchapter S tax status[15] claim only the State or local taxes that are required to be paid by, or are otherwise accrued by, the engineering consultant at the corporate level. The State and local income taxes resulting from the individual shareholders' pass-through income are not allocable to Government contracts and must not be included in the engineering consultant's overhead rate .*

8.26 – TRAVEL EXPENSES

[Reference: FAR 31.205-46]

A. Generally

Depending on their nature and purpose, travel expenses may be allowable as either indirect or direct contract charges. 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, subject to any special limitations contained in said 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). In accordance with FAR 31.205-46(a)(2), lodging, meals, and incidental costs must be disallowed to the extent that, on a daily basis, they exceed the FTR per diem rates.

B. Substantiation of Travel Costs

As provided in FAR 31.205-46(a)(7), travel costs shall be allowable only if the following information is documented:

- Date and place of the expenses;
- Purpose of the trip; and
- Name of person on trip and that person's title or relationship to the contractor.

C. Aircraft Costs

Costs of travel in aircraft owned, leased, or chartered by the engineering consultant require additional substantiation and should be subject to additional audit scrutiny. Refer to FAR 31.205-46(c)(1) for additional information.

D. Vehicle Costs

In cases where transportation costs and consultant-owned or -leased vehicles are involved, only the portion of mileage incurred in connection with company business are allowable; accordingly, engineering consultants are encouraged to maintain mileage logs. Auto lease payments incurred without a

[15] The same applies for any other tax status in which taxes on the pass-through income of the corporation must be paid by the individual shareholders (e.g., limited liability companies).

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documented business purpose do not meet the criteria contained in FAR 31.206-46(d); therefore, these costs are unallowable in full. Related costs such as insurance, gasoline, and car repair also would be unallowable. Extra scrutiny should be applied to costs associated with luxury vehicles.

8.27 – LEGAL COSTS

[Reference: FAR 31.205-47]

In the reviewing the allowability of legal costs, the following must be considered:

- Costs incurred in connection with any proceeding brought by a Federal, State, or local government for violation of a law or regulation by the engineering consultant generally are unallowable. (Specific criteria appear in FAR 31.205-47.)
- Costs of legal, accounting, and other related costs that arise as a result of a dispute between engineering consultants that are partners in a joint venture, or similar shared interest arrangement, are unallowable. FAR 31.205-47 also requires for these costs, including directly associated costs, which may be unallowable, to be segregated in the accounting system.
- Legal costs pertaining to organization or reorganization activities are unallowable.
- In certain situations, significant legal costs may be incurred in one or more accounting periods and recoveries from settlements may be received in subsequent periods. A portion of the recoveries should be credited to the accounts where the legal costs were incurred.

***Note**: In determining whether retainer fees are allowable, see Section 8.21 and the criteria established by FAR 31.205-33.*

8.28 – GOODWILL AND BUSINESS COMBINATION COSTS

[Reference: FAR 31.205-49 & -52]

Generally. A business combination occurs when a corporation and one or more other businesses are combined into a single accounting entity. These combinations are classified as mergers or consolidations and historically were accounted for as purchases or pooling of interests. However, on July 5, 2001, the Financial Accounting Standards Board (FASB) issued Statement 141, which eliminated the pooling of interests accounting method. FASB 141 requires the purchase method of accounting to be used for all business combinations initiated after June 30, 2001.

The Purchase Method and Goodwill. Under the purchase method, a business combination is accounted for as the acquisition of one company by another (a merger). Goodwill may result in these transactions and is computed as the difference between:

- The purchase price of the acquired company (acquiree), and
- The sum of the book values of the acquiree's net assets (total tangible and identifiable intangible assets less liabilities).

Allowability of Business Combination Costs. When the purchase method is used, allowable costs for depreciation and cost of money are limited to the amounts that would have been allowable if the combination had not occurred. Costs for amortization, expensing, or write-down of goodwill (including costs that arise from the impairment[16] of goodwill) are unallowable. Engineering consultants must maintain detailed records to identify and track elements of costs for future reporting periods.

[16] FASB Statement 142 changed the accounting for goodwill from an amortization approach to an impairment-only approach. Thus, the amortization of goodwill, including goodwill recorded in past business combinations, ceased upon adoption of FASB 142 on January 1, 2002. FAR 31.205-49 has not been updated to recognize this distinction and therefore continues to make reference to "amortization."

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8.29 – ALCOHOLIC BEVERAGES

[Reference: FAR 31.205-51]

Costs of alcoholic beverages are unallowable, and the engineering consultant's records should clearly segregate these costs, which must be excluded from the indirect cost schedule. Additionally, these costs must be excluded from any direct billings to Government contracts.

8.30 – LISTING OF COMMON UNALLOWABLE COSTS

The table on the following page lists expenses that generally are ineligible for cost reimbursement on Government contracts (either as direct or indirect costs). The list is not all inclusive, but it identifies many types of costs commonly incurred by engineering consultants.

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TABLE 8-1: LISTING OF COMMON UNALLOWABLE COSTS

FAR Reference	Unallowable Costs
31.205-1 & 31.205-38(b)(1)	Advertising
31.205-1(f)(2)	Trade Show Expenses
31.205-1(f)(2)	Trade Show Labor
31.205-1(f)(5)	Brochures and Other Promotional Material
31.205-1(d)(2)	Souvenirs/Imprinted Clothing Provided to Public
31.205-1(f)(7)	Membership in Civic and Community Organizations
31.205-3	Bad Debts
31.205-3	Collection Costs
31.205-6(m)(2)	Personal Use of Company Vehicles
31.205-8 & 31.205-1(e)(3)	Contributions or Donations
31.205-13(b)	Employee Gifts and Recreation
31.205-14	Membership in Social, Dining, and Country Clubs
31.205-14	Social Activities
31.205-15(a)	Fines, Penalties, and Mischarging Costs Related to Violation of Laws
31.205-19(e)(2)(v)	Life Insurance on Key Employees
31.205-19	Costs to Correct Defects in Materials and Workmanship
31.205-20	Interest Expense
31.205-22	Lobbying and Political Activity Costs.
31.205-27	Organization/Reorganization Legal Fees
31.205-27	Organization/Reorganization Accounting Fees
31.205-27	Organization/Reorganization Incorporation Fees
31.205-27	Organization/Reorganization Labor
31.205-27	Capital Raising (Equity or Long-Term Debt) Legal Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Accounting Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Lender Fees
31.205-30(c)	Patent Costs
31.205-33(e)	Retainer Agreements (unless properly supported)
31.205-35	Relocation Costs (in certain circumstances)
31.205-46	Travel Costs in Excess of FTR Rates
31.205-49	Goodwill
31.205-51	Alcoholic Beverages

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9

Chapter 9 – General Audit Considerations

9.1 – Background

Auditors must exercise significant judgment in planning and performing engagements and must consider both the environment in which the engineering consultant operates and the adequacy of the consultant's accounting systems and procedures to comply with Federal requirements. Auditors must consider specific Government regulations and individual contract provisions when designing, performing, and evaluating audit procedures. A wide variety of tools and publications is available to provide guidance in determining the appropriate procedures, testing methods, and reporting formats (see Appendix D – Listing of Resource Materials). The following are some publications that may be helpful:

- Government Auditing Standards (also referred to "Generally Accepted Government Auditing Standards," "GAGAS," or "Yellow Book Standards") by U.S. Government Accountability Office.
- Generally Accepted Auditing Standards, related Statements on Auditing Standards (SASs) and Statements on Standards for Attestation Engagements (SSAEs) by American Institute of Certified Public Accountants (AICPA).
- DCAA Contract Audit Manual (CAM) by the Department of Defense Contract Audit Agency.
- Internal Control–Integrated Framework by Committee of Sponsoring Organizations (COSO) of the Treadway Commission.
- OMB Circular A-123 Revised, Management's Responsibility for Internal Control, by the U.S. Office of Management and Budget (OMB).
- Auditing Standards promulgated by the Public Company Accounting Oversight Board (PCAOB) by SEC as a result of the Sarbanes-Oxley Act of 2002.
- Cost Accounting Standards (CAS), 48 CFR, Chapter 99, by Cost Accounting Standards Board (CASB), an independent board located administratively within the Office of Federal Procurement Policy (OFPP).

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9.2 – COMPLIANCE REQUIREMENTS

In performing audits of engineering consultants that provide services on projects funded by the Federal Government, auditors must assess the consultant's compliance with Government regulations (e.g., FAR Part 31 and relevant sections of the Cost Accounting Standards (CAS)) and contract terms. This is an important objective; accordingly, auditors should obtain reasonable assurance that management has met its obligations, including:

- Developing a system of internal controls to ensure compliance with applicable laws and regulations;
- Ensuring that employees are made aware of compliance policies; and
- Ensuring that procedures are enforced and are updated in accordance with changes in applicable laws, regulations, and interpretive guidance.

9.3 – INTERNAL CONTROL

A. Generally

Management is responsible for maintaining an effective internal control structure. In recent years, a significant amount of guidance has been issued regarding appropriate internal control assessment procedures. For example, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has established a common internal control model, which is discussed in detail below in subsection B. The unique requirements of cost-based Government contracting require the evaluation of cycles and elements of internal control as part of the engagement. The following important elements should be considered during the auditor's evaluation of internal control of an engineering consultant—

- Systems for monitoring compliance with Government regulations.
- Estimating systems and proposal preparation practices.
- Contract cost accounting practices, including:
  - Systems for tracking and allocating labor cost,
  - Systems for allocating non-labor direct costs, and
  - Systems for allocating costs through cost centers.
- Billing procedures and controls.
- Processes for accounting for miscellaneous revenues and credits.
- Change order identification, pricing, and reporting.
- Cost aspects of related-party and inter-organizational transactions.

B. COSO Internal Control Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued an integrated internal control framework[17] designed to provide businesses with guidance in meeting the three primary objectives of internal control: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. The COSO framework consists of five interrelated components derived from common business operations. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization. The five components include the following:

[17] Available on the Internet at http://www.coso.org/IC-IntegratedFramework-summary.htm.

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1. Control Environment

The control environment sets the tone of an organization/entity by influencing the control consciousness of its managers and employees. The control environment provides discipline and structure and is the foundation for all other components of internal control. Control environment factors include integrity, ethical values, management's operating style, systems used to delegate authority, and the processes used to develop and manage employees.

2. Risk Assessment

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment requires the establishment of objectives; accordingly, risk assessment is the identification and analysis of relevant risks in relation to the achievement of an entity's assigned objectives. Risk assessment is a prerequisite for determining how risks should be managed.

3. Control Activities

Control activities are composed of policies and procedures that help ensure that management directives are achieved. Control activities help ensure that appropriate actions are taken to address risks that may hinder the achievement of the entity's objectives. Control activities occur throughout the organization, at all levels and in all functions, and include a range of activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, as well as procedures for safeguarding assets and maintaining adequate segregation of duties.

4. Information and Communication

Information systems play a key role in internal control systems, as these systems are used to compile and report on operational, financial, and compliance-related information used to run and control a business entity. In a broader sense, effective communication procedures should be developed to ensure that information is disseminated appropriately within the organization. For example, formalized procedures should exist for employees to report suspected fraud. Effective communication procedures also should be developed to ensure adequate communication with external parties, such as customers, suppliers, regulators, and shareholders.

5. Monitoring

Internal control systems must be monitored—a process that assesses the quality of the systems' performance over time. This is accomplished through ongoing monitoring activities or separate evaluations. Internal control deficiencies detected through these monitoring activities should be reported upstream, and corrective actions should be taken to ensure continuous improvement of the system.

9.4 – ESTIMATING AND PROPOSAL SYSTEMS

Controls over estimating systems and proposal preparation are important to minimize the risk of contract losses. Management must establish these controls to ensure that reliable cost estimates support contract proposals, that the cost data are accurate, current and complete, and that the source of cost data is well documented. The controls should be documented in written policies and procedures, and auditors should perform procedures to determine whether (a) the estimating process is consistent and (b) whether management adequately monitors the estimating/proposal system to ensure compliance with the written policies.

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9.5 – COST ACCOUNTING SYSTEMS

A. Generally

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. Auditors should perform testing of the engineering consultant's control systems to obtain reasonable assurance that:

- Costs are accurately distributed to cost objectives,
- Costs are reasonable and in accordance with contract provisions,
- Unallocable or other otherwise unallowable costs are segregated from allowable costs,
- Cost-allocation practices are reasonable and in conformity with applicable Cost Accounting Standards and GAAP, and
- Costs incurred on all projects are periodically reconciled to the financial accounting system.

B. Labor Tracking

Accurately accounting for labor 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. Auditors should ensure that the combined total cost of direct and indirect labor displayed in the general ledger reconcile to the overall labor recorded in the payroll system for the accounting period under audit.[18]

C. Other Considerations

The engineering consultant's management is responsible for ensuring the accuracy of recorded financial data; accordingly, management must establish controls to ensure that transactions are reviewed and approved and that errors are promptly corrected. Management also must maintain records to support the transactions and to provide an audit trail. When integrated accounting systems are in place, management must implement procedures to ensure accuracy in the manner in which transactions are recorded, summarized, and transferred through the systems.

Auditors should perform testing to assess the adequacy of the engineering consultant's controls over disbursements and expenditures, allocations of other direct costs, billing procedures, related-party transactions, and inter-organizational transfers. Auditors frequently use internal control questionnaires (ICQs) to document the existing controls.[19] The ICQs should be used in conjunction with additional procedures (see Chapter 10) to determine whether the engineering consultant's controls are adequately designed and function properly.

9.6 – UNDERSTANDING THE ENGINEERING CONSULTANT'S BUSINESS

A. Risk Assessment

To perform effective risk assessments, it is crucial for auditors to obtain an understanding of the engineering consultant's business. Risk assessments provide an understanding of the engineering consultant and its environment, including the internal control structure. The risk assessment process allows auditors to gather appropriate evidence related to the likelihood of the occurrence of a material misstatement in the engineering consultant's financial statements regarding the classes of transactions and the operation, and effectiveness of, the consultant's internal control structure.

[18] See Chapter 10 for additional details regarding minimum recommended audit procedures.

[19] Appendix B contains the standard internal control questionnaire used by State departments of transportation.

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B. Types of Audit Risk

Audit risk includes inherent risk, control risk, and detection risk. During the planning phase of an audit engagement, auditors should obtain the following types of information for use in establishing materiality levels for high-risk cost items—

- The engineering 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 engineering consultant's operations;
- Mix of Government and commercial business;
- Competition in the industry;
- Types of contracts (e.g., lump sum, cost plus fixed fee, and time and materials);
- The engineering 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 or loss recognized to date
  - Incentive, escalation, or other relevant contract provisions;
- Government regulations affecting contract accounting, such as FAR cost principles and State laws;
- Key changes in operations, systems, or segments of the business;
- CAS Disclosure Statement and revisions, if applicable;
- Key information-processing systems;
- Related party and inter-organizational transactions;
- Litigation, claims and disputes;
- Prior audited indirect cost rates;
- Prior filings with the SEC such as Form 10-K; and
- Minutes from board of directors' meetings.

***Note**: The majority of the above items will be disclosed in the engineering consultant's responses to the standard* AASHTO Internal Control Questionnaire for Consulting Engineers*. See Appendix B.*

9.7 –OTHER AUDITS AS A RESOURCE

In planning for an audit, auditors may obtain information from the engineering consultant pertaining to other audits. Such audits may include FAR audits performed by independent CPAs, other State DOTs, local government agencies, or Federal Government agencies (e.g., the Defense Contract Audit Agency, U.S. Department of Transportation, or Army Audit Agency), as well as general-purpose financial statement audits, compilations, and/or attestations performed by CPA firms.

9.8 – COMPUTERIZED ACCOUNTING INFORMATION SYSTEMS

Considering the prevalence of technology and its rapid rate of change, auditors should carefully assess the impact of technology on the control environment. Accounting records may be stored in a wide range of internal information systems, including large host-based systems, networked environments, and stand-alone desktop computer applications. Many engineering consultants also use outside service providers for payroll, benefits, and related tax services. Additionally, the Internet commonly is used for transmitting

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data or for accessing regulations and other information involved in Government contracting.

Auditors should apply the same standards for evaluation of controls to highly automated environments and manual systems. However, the audit tests may vary significantly depending on the level of automation and integration of management information systems. In certain instances, auditors may need to employ experts to conduct a proper assessment of internal controls. Particular attention should be focused on the engineering consultant's internal controls as new automated accounting systems are implemented or significant upgrades are applied to legacy systems. Engineering consultant personnel must be adequately trained on new systems and must be knowledgeable of the interrelationship between these systems and the overall internal control environment.

9.9 – AUDIT RISK AND MATERIALITY

A. Audit Risk

Audit risk involves the possibility that the auditor's testing and review may not detect material misstatements, mischarging, or violations of Government regulations. Accordingly, risk assessment is crucial to planning and conducting any audit engagement.

If the auditor assesses a firm's internal control risk as low, then the auditor may decide to accept a higher level of "detection risk" by limiting the audit procedures. Conversely, when internal control risk is assessed as high, the auditor should perform a greater amount of testing to reduce the detection risk. When determining control risk, the auditor should consider all factors that may identify risk areas, such as the engineering consultant's:

- Size, business volume, and types of accounting systems;
- Familiarity with the Federal Acquisition Regulation and applicable Cost Accounting Standards;
- Employee labor classifications;
- Structure of cost/profit centers and departments;
- Performance metrics tied to meeting budgets or other project-related financial measures;
- Changes in procedures and practices for direct/indirect time charging; and
- Contract/cost objectives where the potential for labor mischarging is high (see further discussion below in Section 9.10).

B. Materiality

[References: GAGAS 4.26, 4.27, 4.28]

When performing risk assessments, auditors must consider materiality. Under GAGAS, the terms "material" and "significant" are used synonymously. The auditors' responsibility when assessing materiality in financial audits is best stated in GAGAS 4.26:

> Under both AICPA standards and GAGAS, the auditors' responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected. The concept of materiality recognizes that some matters, either individually or in aggregate, are important for fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important. In performing the audit, matters that, either individually or in aggregate, could be material to the financial statements are a primary consideration. Additional considerations may apply to GAGAS financial audits of government entity or entities that receive governmental awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of governmental programs.

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***Note**: See Section 10.2 for a discussion of audit sampling as applied to overhead audits.*

9.10 – TYPE AND VOLUME OF CONTRACTS

The level of risk related to an engineering consultant audit varies depending on the types of contracts employed by the consultant as well as the mix of contract types (i.e., fixed-price or cost-plus contracts[20]). If the engineering consultant uses primarily fixed-price (lump sum or unit rate) contracts, then the auditor should place more emphasis on the consultant's estimating procedures and controls designed to ensure that all direct costs are excluded from indirect cost pools. Conversely, if the engineering consultant primarily enters into cost-plus contracts, then the audit emphasis should be on allowability and should focus on determining whether the costs recorded in the cost accounting system reflect actual costs, regardless of whether such costs are billable. Engineering consultants with a mix of fixed-price and cost-plus type contracts require special emphasis on consistent allocation of costs regardless of whether contract revenues are based on costs incurred.

The relationship of an engineering consultant's cost-plus Government contracts to total contracts and the mix of Government and commercial work also will affect the auditor's assessment of audit risk and planning materiality and will have a significant influence the design of appropriate audit procedures. Accordingly, these considerations will impact audit procedures and may have a significant impact on the control environment and management's commitment to internal control aspects unique to Government contracting.

[20] These contracts are generally structured as cost plus fixed fee contracts. Such agreements provide that all the cost factors, except the fixed fee, are based on the engineering consultant's actual allowable costs. The fixed fee is a specific, predetermined amount, as identified in the agreement.

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Chapter 10 – Guidance for Developing Audit Procedures

Before accepting a FAR audit report or examination-level attestation report, the home State DOT or other reviewing State DOT must determine whether the auditor has adequately complied with the procedures described in Chapter 9 (General Audit Considerations) and performed adequate testing in compliance with the recommended minimum audit testing procedures discussed in the following sections.[21]

When employing a CPA firm (or other service provider/auditor) to audit[22] a proposed overhead rate, the engineering consultant must inform the CPA that:

- The audit should comply with AASHTO's minimum recommended audit procedures, as discussed in the following sections.
- All CPA workpapers used as the basis to establish an audited overhead rate must be made available to the home State DOT, or surrogate/agent, for review at a location of mutual agreement, as determined by the State DOT and engineering consultant. (Audit documentation also may be subject to review by the Federal Highway Administration, the U.S. DOT OIG, and/or the U.S. Comptroller General.)
- A sufficient audit trail of the sampling performed by the CPA, or other auditor, must be maintained by the engineering consultant and made available for review as stated above.
- The CPA should consider meeting with representatives of the reviewing State DOT to discuss the audit process. This is especially important in cases where the auditee is a new client of the CPA or in cases where the CPA has limited experience in performing FAR overhead audits. Any such meetings should occur during the planning phase of the CPA's audit, with subsequent follow-up meetings, if deemed necessary.

10.1 – Planning and General Procedures

[References: SAS No. 108, DCAA CAM Appendix B-102.c]

Audit work must meet professional standards (Government Auditing Standards and either Generally Accepted Auditing Standards or Attestation Standards), and the audit must be planned and performed to provide reasonable assurance that the overhead rate presented on the overhead schedule complies with the Cost Principles of FAR Part 31.2.[23]

[21] Note: As further discussed in this chapter, deviations from the recommended minimum audit procedures may be allowable, provided that these deviations are documented and adequately justified in the CPA's audit workpapers.

[22] For the sake of brevity, in this chapter the term "audit" is used to encompass both audits *and* examination-level attestation engagements.

[23] See Sections 2.5.B and 2.5.C for further discussion regarding auditors' responsibilities and factors that should be considered when selecting a CPA to perform an overhead audit.

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The auditor should begin this process by gaining familiarity with the auditee, as described in Statement on Auditing Standards (SAS) No. 108:

> Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning and performing an audit in accordance with generally accepted auditing standards. The auditor must plan the audit so that it is responsive to the assessment of the risk of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control.

***Note**: As a practice aid, auditors are encouraged to obtain a completed copy of the* AASHTO Internal Control Questionnaire for Consulting Engineers *from the engineering consultant/auditee (see Appendix B).*

After gaining an understanding of the consultant's business and evaluating the client's internal control structure, the auditor should develop a plan for substantive testing. This plan may include both statistical and non-statistical sampling techniques which, when combined with other audit procedures, must be designed to provide sufficient, appropriate audit evidence to support the auditor's opinion on the compliance of the overhead schedule with the Cost Principles of FAR 31.2. The auditor may obtain audit evidence through a variety of procedures, including planning and performing risk assessments, analytical procedures (e.g., comparisons with historical cost patterns using comparative, ratio, and/or trend analysis), directed inquiries, tests of transactions, and other procedures described in the professional standards. An auditor often considers the combined evidence obtained from various types of procedures to determine whether there is sufficient audit evidence.

As discussed in DCAA CAM Appendix B-102.c, it should be noted that:

> Although the extent of the auditor's examination of records can be minimized by other sources of reliance, it seldom can be eliminated when substantial dollar values or sensitive issues are involved. In all audits, a certain amount of record examination is required to ascertain that controls are actually effective and that procedures and practices, which were satisfactory in the past, have not changed. Furthermore, the auditor must consider the objectives as well as the effectiveness of internal controls. For example, controls designed to assure that costs are properly recorded from purchase orders and vouchers to appropriate accounts would influence a sample selection that is designed to determine if those costs were assigned to appropriate contracts.

Additionally, auditors should be aware of the following:

- The overhead schedule should be prepared based on cost data from the engineering consultant's general ledger, after the adjusting entries have been posted to the accounts and reconciled with any published financial statements.
- The overhead schedule must be reconciled to the post-closing trial balance or general ledger.
- All unallowable costs uncovered through audit testing must be removed from the overhead schedule, regardless of amount. Accordingly, any type of planning materiality level established by the auditor for use in determining large-dollar items[24] may *not* be used as a minimum tolerance level, or "floor," to allow expressly unallowable costs to remain in the indirect cost pool. Examples of expressly unallowable costs include, but are not limited to, interest expense, bad debts, donations, and advertising.[25]

[24] See the following sections for recommended testing procedures to be applied to large-dollar or sensitive (LDS) items.

[25] See Section 8.30 for additional cost items that are ineligible for reimbursement.

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10.2 – AUDIT SAMPLING

[References: DCAA CAM Appendix B-302.a, B-302.g, B-303.a, B-304, B-402, B-502, B-503.1.b; GAGAS 4.26]

Decisions related to sample selection are dependent on the audit objectives. When a representative sample is required, the use of statistical sampling approaches generally yields better results than those obtained from non-statistical techniques. However, when a representative sample is not required, a targeted, judgmental selection may be effective if the auditors have isolated certain risk factors or other criteria to isolate the selection.

This chapter presents some basic issues to be considered in designing an audit sample. For further guidance, auditors are encouraged to consult *DCAA CAM Appendix B: Statistical Sampling Techniques*, which presents essential principles and methods of statistical sampling as applied to overhead audits.

A. Audit Objectives and Sampling Methods

Appendix B of the DCAA CAM provides the following guidance:

> **B-302.a**: A prerequisite to the application of any sampling process is the need to identify the specific audit objectives to be attained by examination of the area under evaluation. Prior to initiation of the sampling process, the auditor should definitively set forth in the sampling plan the characteristics and values to be examined during the audit. The auditor's sampling objective should satisfy the audit objectives of the area being audited.
>
> **B-302.g**: When the auditor has reason to believe that a cost category includes a significant amount of unallowable expenses, the purpose in taking a sample will generally be to estimate the total amount of unallowable expenses. On the other hand, if the auditor has no reason to believe the costs being audited include unallowable amounts, the purpose will generally be to obtain additional assurance that the costs do not, in fact, include a significant amount of unallowable expenses. In either case, the auditor should seek to develop a sampling plan that will provide maximum support for conclusions in return for the time spent in the selection, examination, and evaluation of the sample. In addition, the sample size should provide a reasonable balance between: (1) the amount of support the sample will provide for audit conclusions and (2) the expenditure of auditor resources the sample will require.

Depending on the audit objectives, acceptable sampling methods may include any one or more of the following, among others:

- ***Judgmental Sampling***. A method in which items are selected based on auditor judgment, without regard to the parameters of a statistical model.
- ***Block Sampling***. A judgmental method in which items are grouped and selected in sequential order; once an initial item in a group is chosen, the rest of the group also is selected.
- ***Haphazard Sampling***. A judgmental method based on the arbitrary selection of items.
- ***Statistical Sampling***. A collection of procedures and methods that allow for the proper application of statistical procedures, such as the extrapolation of an audit finding to all the cost elements within a defined test stratum.
- ***Random Sampling***. A statistical sampling technique in which each member of the population has an equal chance of being selected.
- ***Systematic Sampling (Nth Record Sampling)***. A statistical sampling technique involving the selection of items from an ordered sampling frame. After the required sample size has been calculated, every Nth record is selected from a list of population members.

B. Sampling for Attributes and Sampling for Variables

Based on the sampling objective and purpose of the test, it is critical for the auditor to consider when it is

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most appropriate to use attribute sampling, variable sampling, or some combination of the two methods. DCAA CAM Appendix B provides the following guidance—

> **B-303.a**: The sampling of characteristics may be divided into two broad categories of *sampling for attributes* and *sampling for variables* [emphasis added]. When sampling to determine the rate or proportion of errors in the records or to obtain assurance that an error rate is not excessive, the auditor is sampling for attributes. Sampling for variables is performed when a sample is selected in order to estimate an amount such as the dollar value of unallowable costs contained in the total dollar value of material invoices charged to a Government contract. The distinction is important because the methods used to evaluate sample results differ.
>
> **B-402: Use of Sampling for Attributes.**
>
> a. Attribute sampling can be classified into two approaches of acceptance and estimation sampling. Their use depends on audit objectives. With acceptance sampling, the goal is to either accept or reject the universe. With estimation sampling, the goal is to estimate the actual error rate in the universe.
>
> b. Attribute sampling is performed when there are only two possible outcomes from the evaluation of a sample item: the sampled item either is or is not in compliance with the control being tested. An audit can be built around questions answerable by either "yes" or "no", a feature that distinguishes sampling for attributes from sampling for variables.
>
> **B-502**: **Use of Sampling for Variables**.
>
> Variable sampling is generally used to verify account balances or cost elements and note any differences. This type of sampling is substantive testing (as opposed to compliance testing) whereby sample items are evaluated for error amounts or variables (as opposed to attributes). The audit sampling universe (e.g., accounts, vouchers, or bill of material) is the entire grouping of items from which a sample will be drawn. Variable sampling can be applied to proposals, incurred costs, progress payments, forward pricing rates, and defective pricing.
>
> An important objective of variable sampling is to estimate a particular universe characteristic such as total unallowable costs (or questioned cost). The estimated questioned cost is commonly known as the "point estimate." A point estimate strikes a balance between potential understatement (considering both likelihood and amount) and potential overstatement of the true universe amount. In statistical sampling, "confidence level" and "precision" are used to measure the reliability of the point estimate. The confidence level deals with "sureness" (or assurance) while precision deals with "closeness" (or accuracy). Auditors must establish desired levels of reliability (discussed in B-504)[26] [footnote added] in order to properly evaluate the sample results.

[26] DCAA CAM Appendix B-504 discusses precision and confidence level, two interrelated parameters used to develop reliability parameters for variable sampling.

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***Note**: Consistent with DCAA CAM Appendix B-304, before selecting a statistical audit sample using variable sampling techniques to test for unallowable cost items, auditors are expected to scan the engineering consultant's general ledger so that large dollar or sensitive (LDS) transactions can be removed/stratified[27] for complete examination, including verification to source documents. Accordingly, the sampling universe should be limited to the group of items that remain after the LDS items have been removed.*

C. Determining Sample Size

The auditor should determine an appropriate sample size after considering the size of the firm, the auditor's previous experience with the firm, the number of transactions and high-risk accounts in the indirect cost pool, and the assessed level of control risk. The test sample of an account balance or line item must be sufficient to comply with GAGAS 4.26. Additionally, in accordance with SAS No. 111, the auditor should document the sampling plan, including factors used in the determination of sample sizes.

Auditors are encouraged to consult the AICPA's *Audit Sampling* guide,[28] an interpretive publication designed to assist practitioners in the application of the guidance found in SAS No. 111. The *Audit Sampling* guide includes detailed information and tables for determining sample sizes based on the facts and circumstances of an engagement, assessed risks, expected deviation, reliability of controls, and the type of sampling being used. Additionally, the DCAA's EZ-Quant statistical analysis software program is useful for determining and analyzing audit samples using either attribute sampling or variable sampling techniques. EZ-Quant is a free program available for download at http://www.dcaa.mil/ezquant.htm.[29]

***Note**: Although there is no single optimal sample size for use on all engagements, auditors are encouraged to apply sampling methods using a 95-percent confidence level with a precision level in the range of 2 to 5 percent.[30] Additionally, as stated previously, all unallowable costs uncovered through audit testing must be removed from the overhead schedule, regardless of amount, as FAR Part 31 does not establish a tolerance level to permit any amount of unallowable costs to remain in the indirect cost pool.*

[27] Per DCAA CAM Appendix B-503.1.b: "Stratification of the universe into several dollar ranges or strata can be used to improve audit reliability and reduce the overall number of items evaluated. Normally, the universe is stratified into a high-dollar stratum (for 100 percent evaluation) and several other strata from which samples are selected for evaluation. Audit effort is concentrated on the high-dollar items where the risk is greater. Samples are statistically selected from each of the other strata, which are used as the basis for projecting individual stratum sample results to the corresponding universe."

[28] See https://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/TopicSpecificGuidance/PRDOVR~PC-012530/PC-012530.jsp.

[29] If auditors have any questions or concerns regarding the adequacy of a sampling plan, they are encouraged to discuss the sampling plan with the cognizant State DOT.

[30] Precision level, also known as "sampling error," is the range in which the true value of the population is estimated to be found. When using *variable sampling*, precision often is expressed as a dollar amount (materiality threshold); accordingly, when establishing a precision amount for a given account or line item of cost, the auditor should apply judgment based on the results of the risk assessment and internal control testing procedures described in Chapter 9 and in other sections of this chapter.

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Isolated Errors Versus Systemic Errors. When an unallowable cost (error) is uncovered during audit testing, the auditor must determine if the error is isolated or instead is due to a systemic internal control deficiency or other problem. If determined to be an isolated error, the auditor should document the basis for this determination and should remove the unallowable cost from the overhead pool. However, if the error is systemic, then, in addition to removing the unallowable cost from the overhead pool, the auditor must determine the effect of the error on the overhead rate and must perform additional testing of the account or line item, as deemed necessary.

Note*: The auditor and consulting engineer should discuss all errors uncovered during the audit process, regardless of type or amount. Material, systemic errors may require enhanced internal controls over the costs in question.*

10.3 – TESTING LABOR COSTS

A. Generally

For the majority of engineering consultant contracts, labor is the largest single component of cost. Labor costs are composed of direct labor assigned to contracts (regardless of whether the labor is billable) and indirect labor charges allocated to contracts through an overhead rate. Verification of labor costs should begin with the examination of the engineering consultant's internal control structure and testing of those controls, as discussed in Section 9.2. Based on the assessed level of control risk, the auditor should determine an appropriate labor sample with a *minimum of 26 timesheets* chosen for testing across an appropriate mix of direct-charge employees,[31] including supervisors and/or project managers. The following examples are presented for illustrative purposes only and are not meant to encompass the full range of acceptable labor testing. The sample size should increase appropriately based on the size of the labor population and conclusions drawn from the risk assessment for labor testing.

EXAMPLE 10-1:

The auditor is planning labor testing for a firm with 200 full-time employees. Assume that the auditor assessed control risk as ***low****, as the auditor's initial procedures revealed that the firm's controls over labor were well designed, fully documented, and properly administered. The firm pays employees biweekly but requires each employee to submit timesheets at the end of each workweek. The auditor could randomly select 26 unique employees and test a single weekly timesheet for each employee across separate and discrete weeks, resulting in the review of timesheets covering 26 unique weeks within the audit period. Alternatively, the auditor could randomly select 13 employees and test two weekly timesheets from randomly selected pay periods for each employee (or perform similar testing that would provide adequate coverage).*

EXAMPLE 10-2:

Assume the same facts as above, except that the auditor assessed control risk as ***high****, based on the firm's lack of consistent written controls over labor charging practices. The auditor conducted preliminary interviews with several managers and employees, several of whom had different understandings of the proper methods for labor approval and charging. In this instance, it would be appropriate to increase the audit sample beyond the 26 minimum timesheets, and the auditor would be advised to consider stratifying the sample based on his or her expectation of areas that would be most prone for risk.*

[31] In this context, "direct-charge employees" means any employees, supervisors, and/or principals who spend a portion of their time working on A/E projects.

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B. Recommended Testing Procedures

After the timesheet sample is selected, the auditor should apply the following minimum procedures:

1. The sample should be traced from employee time records to:
    - The payroll records, to ensure hours are recorded and properly allocated.
    - The cost system, to ensure hours are posted properly to jobs.
    - The general ledger, to ensure that the total posted is recorded in the financial accounting system.
2. The timesheets also should be reviewed for compliance with the model time-charging practices established by DCAAP 7641.90 Chapter 2-302, as referenced in FAR 31.002. For example, auditors should determine whether individual employees prepared and signed their own timecards, whether supervisors approved the timecards, and how labor movement was documented and approved. (See Section 6.4 for further discussion of the DCAAP 7641.90 factors.)
3. The overall labor costs recorded in the general ledger accounts must be reconciled to:
    - The job cost system.
    - The payroll reports submitted to the Internal Revenue Service (i.e., Form 941s—Employer's Quarterly Federal Tax Return).
4. Audit procedures also must be performed to determine if the labor accounts and individual time card entries sufficiently screen labor to:
    - Determine the allowability of payroll cost. Do the timecards identify time spent on unallowable activities?
    - Determine the proper allocation of labor. 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. If the base is direct labor costs excluding premium overtime, do the records accumulate direct labor and direct premium overtime?

***Note**: An auditor who selects a smaller sample size than that recommended above must include an adequate explanation in the workpapers to justify the deviation. If the State DOT conducting the review determines that the deviation is not properly justified, the State DOT may reject the overhead rate determined through the audit.*

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10.4 – TESTING INDIRECT COSTS

A. Generally

Indirect cost accounts must be examined for compliance with the cost principles of FAR 31.2 and the general financial statement assertions: occurrence, completeness, accuracy, authorization, cutoff, and classification. Auditors may use a combination of analytical testing and detailed transaction testing to obtain reasonable assurance that the indirect costs accounts substantially comply with applicable laws and regulations; however, auditors should structure audit testing in a manner consistent with the following discussion.

Based on the risk assessment process previously described, the auditor should determine high-risk accounts or line items and should perform adequate detailed testing of these accounts. In this testing—

- Large-dollar[32] or sensitive (LDS) transactions should be removed/stratified for complete examination, including verification (vouching) to source documents. The auditor should prioritize the LDS items in terms of risk and materiality to determine whether the LDS items constitute adequate audit coverage of the aggregate account balance. If this coverage is deemed adequate, then no further examination of the account may be required.
- In situations where the auditor determines that additional testing beyond the LDS items is required, the remaining indirect costs in the high-risk accounts (the sampling universe) should be tested on a sample basis, using the sampling parameters recommended above in Section 10.2.[33] A minimum random sample in the range of **2 to 20 transactions** is recommended for each high-risk account. This requires transactions to have been verified from the overhead schedule back to the general ledger and requires that the transactions be vouched from the general ledger to source documents.

***Note**: The auditor should increase the sample size appropriately based on the results of the risk analysis and assessment, when the population size would so justify, or when unallowable activity is found in an account. Recurring transactions, such as monthly rent, should be counted as only one transaction toward the minimum sample.*

B. Baseline for Determining Risk

Although the following cost items will not necessarily constitute high-risk areas in all engagements, the auditor should consider the following factors in deciding which accounts to examine in detail. The auditor should expand or reduce the list, as appropriate for each engagement:

1. ***Printing/Reproduction***. Were direct costs consistently handled and all direct costs removed from the indirect cost pool?
2. ***Dues and Subscriptions***. Review for civil/country club dues, Political Action Committee (PAC) contributions and other lobbying costs, scholarship donations, and non-business purchases.
3. ***Travel***.
    - Were entertainment costs, alcoholic beverages, and personal charges removed from the indirect cost pool? (FAR 31.205-15 and FAR 31.205-51)
    - Were costs for personal use of company vehicles removed from the indirect cost pool?
    - Were travel costs in compliance with the Federal Travel Regulation? (FAR 31.205-46)
    - Were direct travel costs treated consistently, and were all direct costs removed from the indirect cost pool?
4. ***Seminars and Conventions***. Review registration forms for allowability/business purpose, sponsorships, golf fees, door prize donations, and booth rental costs.

[32] Large-dollar items should be selected based on a planning materiality level (PML) determined by the auditor. The PML will vary based on the facts and circumstances of each unique engagement, and auditors are advised to fully document their PML computations in the audit workpapers.

[33] A 95-percent confidence level with a precision level (materiality threshold) in the range of 2 to 5 percent.

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5. ***Insurance***. Did the premiums cover only the audit period? (Review for prepayments related to future periods and late payments for coverage provided in prior periods.) If the company is self insured, were the associated costs in compliance with FAR 31.205-19?
6. ***Professional and Consultant Service Costs***. Review for organization and reorganization costs (FAR 31.205-27), bad debt collections (FAR 31.205-3), direct project costs, and other unallowable activities. Examine retainer fees for reasonableness and adequate support (FAR 31.205-33(d)).
7. ***Rent***. Review costs for facilities and other property, including personal property, to determine if common control exists (FAR 31.205-36).
8. ***Depreciation***. Compare claimed depreciation to tax return and review for systematic and rational allocation method. Ensure the amount is based on GAAP methods (AICPA). Ensure that assets are ordinary and necessary business assets and that their associated costs are reasonable in amount. No Internal Revenue Code (I.R.C.) Section 179 write-offs are permitted (FAR 31.205-11(a) & (c)).
9. ***Employee Morale***. Review for unallowable entertainment costs per FAR 31.205-14 (including employee parties). See also DCAA CAM Sections 7-2103(e)(3) & (4).
10. ***Accounts Titled "Other Indirect Costs," "General Office," or Similar Titles***. Review for overall allocability and allowability in accordance with FAR Part 31 and applicable Cost Accounting Standards. (See Section 8.30 for a list of common unallowable costs.)
11. ***Subconsultants/Outside Consultants***. Ensure proper segregation of direct and indirect cost, business purpose of activities performed, and reasonableness.
12. ***Miscellaneous Income and Expense Accounts***. Review for overall allocability and allowability in accordance with FAR Part 31 and applicable Cost Accounting Standards.
13. ***Gains on Sale of Assets***. Ensure proper credit on gains on sales of assets originally included as part of the depreciation expense cost.
14. ***Loss on Sale of Assets***. Ensure proper reporting within the year the transaction occurred, appropriate calculation, appropriate application of credit or charge to the cost groupings in which the depreciation or amortization was originally posted, and appropriate posting of cash awards.

Note*: The auditor should fully document the identification of high-risk accounts, based on a risk assessment and the application of professional judgment. If the auditor's procedures vary significantly from those listed above, the auditor must provide an adequate explanation to justify the deviation. If the State DOT conducting the review determines that the deviation is not properly justified, the State DOT may reject the overhead rate determined through the audit.*

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10.5 – ALLOCATED COSTS

A general discussion of allocated costs (cost centers) appears in Section 5.3 of this Guide. With respect to FAR overhead audits, auditors should consider the following issues when performing risk assessments of cost centers and allocated costs:

- ***Allocability***. Are costs posted to the cost center properly allocated? Do the costs belong to the function being priced?
- ***Allowability***. Are costs posted to the cost center allowable? Do the costs exclude interest, profit, and/or other costs expressly unallowable per FAR Part 31?
- ***Consistency***. Do the unit charge records indicate the consistent assignment of all similar charges to projects.

Note*: The third item (consistency) is the most commonly overlooked issue and can result in substantial audit adjustments.*

State DOTs must review and approve overhead rates submitted by engineering consultants. The engineering consultant bears the burden of establishing the accuracy of the overhead rates and that direct costs were properly removed from the indirect cost pool. The overhead audit report should include disclosure notes regarding the audited direct cost rates and a listing of cost categories that the engineering consultant charges directly to contracts.

Some firms choose not to create cost centers. These firms estimate the cost of providing certain services by extracting certain cost elements from ledger accounts (e.g., 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.

10.6 – OTHER DIRECT COSTS (ODCS)

Invoices received from vendors and/or employee expense reports support ODCs. ODCs are processed through the cost accounting system and must be assigned directly to the appropriate cost objectives (projects). To ensure that ODCs are properly excluded from the overhead cost pool, the engineering consultant should establish dedicated accounts in the general ledger to accumulate the various types of ODCs. Examples of common ODCs include project travel, vendor printing, employee mileage, rented vehicles and equipment, and costs of subcontractors.

Note: *Auditors should be aware that, instead of establishing dedicated ODC accounts as recommended above, some engineering consultants capture both ODCs and indirect costs in summary accounts that appear on the overhead schedule.*[34] *Accordingly, auditors should examine indirect expense accounts to determine whether—*

- *The indirect cost pool was properly reduced for the ODCs that were billed to projects,*
- *Costs were allocated consistently to projects when such costs were incurred for similar purposes, and*
- *Costs were priced consistently to direct and indirect cost objectives.*

[34] For example, the consultant might use single *Travel* account for both direct and indirect costs.

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10.7 – FAILURE TO MEET MINIMUM AUDIT PROCEDURES

[Reference: AICPA Code of Professional Conduct Section 501-5]

In cases where a CPA fails to meet the minimum audit procedures, the reviewing State DOT may consider referring the CPA to the appropriate Board of Accountancy for review under the AICPA Code of Professional Conduct, which provides the following in *Section 501-5–Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies in Performing Attest or Similar Services*:

> Many governmental bodies, commissions or other regulatory agencies have established requirements such as audit standards, guides, rules, and regulations that members are required to follow in the preparation of financial statements or related information, or in performing attest or similar services for entities subject to their jurisdiction. For example, the Securities and Exchange Commission, Federal Communications Commission, state insurance commissions, and other regulatory agencies, such as the Public Company Accounting Oversight Board, have established such requirements.
>
> If a member prepares financial statements or related information (for example, management's discussion and analysis) for purposes of reporting to such bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to generally accepted accounting principles. If a member agrees to perform an attest or similar service for the purpose of reporting to such bodies, commissions, or regulatory agencies, the member should follow such requirements, in addition to generally accepted auditing standards (where applicable). A material departure from such requirements is an act discreditable to the profession, unless the member discloses in the financial statement or his or her report, as applicable, that such requirements were not followed and the reason therefore.

When reviewing a CPA's workpapers, if the reviewing DOT determines that the CPA auditor has failed to follow the minimum audit procedures presented in this Guide, then:

- The submitted/audited overhead rate will be rejected by the reviewing DOT, and the rate will not be considered cognizant.
- If the reviewing DOT rejects the audited overhead rate, the engineering consultant will be afforded the opportunity to correct the defects in the audit. Generally, this will require more extensive testing by the auditor.
- Before the engineering consultant resubmits the audited overhead schedule to the reviewing DOT, the engineering consultant must ensure that the auditor performs additional audit procedures in compliance with the minimum testing procedures.
- If the follow-up submittal still does not meet the minimum procedures, then the reviewing DOT may disallow all audit fees associated with the overhead audit that were included in the submitted overhead rate. The reviewing DOT may be required to perform additional audit procedures before an acceptable overhead rate can be established.

***Note**: State DOTs generally will deem an overhead audit insufficient due to an auditor's failure to comply with the recommended minimum testing procedures as established in this chapter (unless deviations from the minimum testing requirements are adequately identified and justified in the auditor's workpapers), failure to apply properly the FAR Subpart 31.2 cost principles, and/or failure of a CPA or other audit group to provide access to all audit workpapers used to determine the audited overhead rate. For additional guidance, see Chapter 11 and the CPA Workpaper Review Program in Appendix A.*

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11

Chapter 11 – Audit Reports and Minimum Disclosures

11.1 – GENERALLY

[Reference: GAGAS Reporting Standards for Financial Audits or Attestation Engagements]

Although auditors' reports may be presented in a variety of formats and styles, in all cases these reports must meet the GAGAS Reporting Standards for Financial Audits or Attestation Engagements. Accordingly, CPAs must perform appropriate examination procedures before they opine on, or attest to, the reliability of the engineering consultant's overhead rate.

GAGAS reporting standards first incorporate the AICPA reporting standards for each type and then require additional GAGAS standards. There are ten standards for financial audits and nine standards for attestation engagements. See Chapter 2 of this Guide for a summary matrix of the standards. The complete text of the standards is available in the Yellow Book.

This chapter provides basic guidelines for reporting and minimum disclosures that must be made by the engineering consultant's management and included in auditors' reports. A typical report package contains the following:

- Independent Auditor's Report on overhead schedule.
- Overhead schedule.
- Listing of unallowable account adjustments with FAR References.
- Notes to the overhead schedule including minimum disclosures.
- Independent Auditor's Report on Internal Control.

***Note**: The AASHTO Audit Subcommittee and the ACEC Transportation Committee have approved the report formats.*

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11.2 – SAMPLE AUDIT REPORT ON OVERHEAD SCHEDULE

The following is an example of a typical audit report that would be issued by a CPA firm or a State or Federal agency on the overhead schedule for a consulting engineering firm. If the auditor performed an "attestation engagement examination," then the report wording would be modified, but in both cases an auditor's opinion is required. The complete report would include the overhead schedule and footnote disclosures (see following pages).

INDEPENDENT AUDITOR'S REPORT ON THE
STATEMENT OF DIRECT LABOR, FRINGE BENEFITS, AND GENERAL OVERHEAD

Board of Directors
The Company

We have audited the Statement of Direct Labor, Fringe Benefits, and General Overhead (hereinafter referred to as "overhead schedule" or "the Schedule") for the fiscal year ended December 31, 2XXX. The Schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on the Schedule 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 Schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Indirect Cost Schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Schedule. We believe that our audit provides a reasonable basis for our opinion.

The accompanying overhead schedule was prepared on a basis of accounting practices prescribed by Part 31 of the Federal Acquisition Regulation (FAR) 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 overhead schedule 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, 2XXX on the basis of accounting described in Note 2.

In accordance with the *Government Auditing Standards* we have issued a report dated April 4, 2XXX 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 Regulation and should not be used for any other purpose.

(Signature of Official Representative/CPA Firm)

DATE, 2XXX

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Firm X, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead (with Field Rate)
For the year ended December 31, 201x

Description	General Ledger Balance	Portion Unallowable	FAR Ref.	Total Proposed	Allocations: Home Office Costs	Allocations: Field Office Costs
Direct Labor	$ 12,500,000	$ 12,000	(1)	$12,512,000	$12,011,520	$ 500,480
Fringe Benefits						
Vacation/Holiday/Paid Leave	$ 1,700,000			$ 1,700,000	$ 1,632,000	$ 68,000
Payroll Taxes	1,550,000			1,550,000	1,488,000	62,000
Group Insurance	1,100,000			1,100,000	1,056,000	44,000
Pension and Profit Sharing	1,016,000	(500,000)	(2)	516,000	495,360	20,640
Incentive Payments	1,550,000			1,550,000	1,488,000	62,000
Seminars/Education	400,000			400,000	384,000	16,000
Employee Welfare	10,000	(4,000)	(3)	6,000	5,760	240
Total Fringe Benefits	$ 7,326,000	$ (504,000)		$ 6,822,000	$ 6,549,120	$ 272,880
General Overhead						
Non-Project Labor	$ 4,900,000	$ (12,000)	(1)	$ 4,888,000	$ 4,808,000	$ 80,000
Recruiting	190,000			$ 190,000	189,126	874
Building Costs (Rent)	1,400,000	(20,000)	(4)	$ 1,380,000	1,380,000	-
Other Occupancy Costs	464,000			$ 464,000	464,000	-
Supplies	380,000			$ 380,000	380,000	-
Field Supplies and Equipment	100,000			$ 100,000	-	100,000
Postage and Shipping	78,000			$ 78,000	77,641	359
Equipment Rent/Maintenance	386,000			$ 386,000	384,225	1,775
Interest	20,000	(20,000)	(5)	$ -	-	-
Telephone	290,000			$ 290,000	288,667	1,333
Business Insurance	194,000			$ 194,000	193,108	892
Legal & Other Professional Fees	376,000	(25,000)	(6)	$ 351,000	349,386	1,614
Administrative Travel	597,000	(30,000)	(7)	$ 567,000	564,393	2,607
Dues, Memberships, and Registrations	173,000			$ 173,000	172,205	795
Subscriptions and Publications	41,000			$ 41,000	40,811	189
Depreciation and Amortization	628,000	(10,000)	(8)	$ 618,000	615,159	2,841
Outside Payroll Service	45,000			$ 45,000	44,793	207
State Income & Personal Property Taxes	27,000			$ 27,000	26,876	124
Direct Cost Credit	(833,000)	-		$ (833,000)	(829,170)	(3,830)
Total General Overhead	$ 9,456,000	$ (117,000)		$ 9,339,000	$ 9,149,221	$ 189,779
Total Indirect Costs				$16,161,000	$15,698,341	$ 462,659
Percentage of Direct Labor				**129.2%**	**130.7%**	**92.4%**

FAR References:

(1) 31.202 - Uncompensated overtime for salaried employees considered to be direct labor and removed from indirect labor costs.
(2) 31.205-6(a)(6)(ii)(B) - Compensation paid to owners in excess of reasonable amount and considered distribution of profits.
(3) 31.205-14 - Costs of dues for social clubs are unallowable and considered entertainment.
(4) 31.205-36 - Adjusted rental costs to actual costs incurred to eliminate markups between subsidiaries under common control.
(5) 31.205-20 - Interest and other financial costs not allowable.
(6) 31.205-27 - Accounting and legal fees considered as organization costs are not allowable.
(7) 31.205-6(m)(2) - Portion of the cost of company-furnished automobiles that relates to personal use by employees.
(8) 31.205-49 - Amortization of acquisition intangibles (goodwill).

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11.3 – SAMPLE REPORT ON INTERNAL CONTROL AND COMPLIANCE

The following is an example of a report on internal control with no reportable conditions, which is a GAGAS requirement for financial audits (see Chapter 2). For both financial audits and attestation engagements, auditors' reports should disclose deficiencies in internal control, fraud, illegal acts, violations of contracts or grant agreements, and abuse. (See the Yellow Book for specific reporting requirements)

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

Board of Directors
The Company

We have audited the overhead schedule of the Company for the fiscal year ended December 31, 2XXX, and have issued our report thereon dated (DATE, 2XXX). We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits (or examination level attestation engagements) contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the schedule, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's 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 controls 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 Part 31 of the Federal Acquisition Regulation. 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.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process, or report financial data reliably in accordance with Part 31 of the Federal Acquisition Regulation such that there is more than a remote likelihood that a misstatement of the Company's overhead schedule that is more than inconsequential will not be prevented or detected by the Company's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Company's overhead schedule will not be prevented or detected, and corrected, on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's overhead schedule is free from material misstatement, we performed tests of the Company's compliance with certain provisions of laws, regulations, contracts, and grant agreements, including provisions of the applicable sections of Part 31 of the Federal Acquisitions Regulation, noncompliance with which could have a direct and material effect on the determination of the amounts reported on the overhead schedule. 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 or other matters that are required to be reported under Government Auditing Standards.

We noted certain matters that we reported to management of the Company in a separate letter dated (DATE, 2XXX).

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 Regulation. This report should not be used for any other purpose.

(Signature of Official Representative of Firm)

(DATE, 2XXX)

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11.4 – MINIMUM AUDIT REPORT DISCLOSURES

The following subsections describe disclosures that should be included with audit reports, regardless of whether the audits reports are generated from financial audits or attestation engagements. In cases where examples are included, they are for illustrative and explanatory purposes only and are not intended to be comprehensive regarding rules and regulations. Some of the recommended disclosures may not be appropriate or necessary for certain firms. Conversely, additional disclosures may be required for firms with unusual or complex issues. Disclosures should be included with the overhead audit report for each fiscal year and may either be included in the notes to the overhead schedule or as a separate section within the report.

A. Description of the Company

Provide an overview of the company including when the company was formed, type of organization (e.g., corporation, LLC, or LLP), major business activities, primary customer groups, type of ownership (e.g., subsidiary of corporation, division of another company, privately held firm) and any other pertinent general company information.

B. Basis of Accounting

The basis of accounting practices should be clearly stated, as described below.

> EXAMPLE 11-1: The Company's overhead schedule was prepared on the basis of accounting practices prescribed in Part 31 of the Federal Acquisition Regulation (FAR). Accordingly, the overhead schedule is not intended to present the results of operations of the Company in conformity with accounting principles generally accepted in the United States of America.

C. Description of Accounting Policies

Describe the financial accounting system (i.e., cash, accrual, or hybrid) and job cost accounting system (e.g., job order, modified job order, standard, or hybrid). Include a description of accounting policies and procedures governing the classification of costs as direct or indirect. Describe how project costs are accumulated and assigned to projects.

D. Description of Overhead Rate Structure

Disclosures should include language to—

- Identify the *reporting unit*. (e.g., company wide; business segment; or technical specialty such as design, construction administration, geotechnical, or environmental; and/or geographical location pertaining to the overhead rate or rates).
- Identify the company's overall rate structure in terms of the base(s) for allocation. Describe if more than one base is used, depending on the customer (e.g., different bases used for Federal and State projects).

  EXAMPLE 11-2:

  Single Base
  - All costs are allocated based on Direct Labor cost.

  Multiple Bases
  - Fringe benefits costs allocated based on Direct + Indirect Labor.
  - Office overhead costs allocated based on Direct Labor + Fringe Benefits.
  - General and administrative costs allocated based on Value Added Costs (all company costs, excluding subconsultants).
- Identify whether a dual rate structure exists for field office projects and home office projects. Specify the allocation methods used.
- Identify that Nonsalary Direct Project Costs, sometimes referred to as Other Direct Costs (ODCs) are consistently charged to all projects, and not just projects that reimburse for ODCs (e.g., computer costs, reproduction, equipment charges, and vehicle usage). Include a listing of cost items generally charged directly to projects.

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- Identify cost allocation practices between related business entities (e.g., parent company allocating costs to subsidiaries or divisions, allocations between subsidiaries or divisions, and/or allocations to specific product lines).

E. Description of Labor-Related Costs

The disclosures associated with labor costs must include details regarding—

1. ***Project Labor***. Describe how the company charges labor to all projects (i.e., actual, average, or standard hourly rates).
2. ***Variances***. Describe how and when variances are recorded if using other than actual labor costs.
3. ***Paid Time Off***. Explain the company's policy and accounting practice as to paid vacation, sick leave and comp time. Include the engineering consultant's policy as to accounting for accrued sick leave upon termination.
4. ***Paid Overtime and Uncompensated Overtime***. Indicate where the premium portion of overtime pay is recorded in the cost accounting system. Detail the procedures for recording uncompensated overtime incurred by employees charging direct project time.

   EXAMPLE 11-3:

   Premium 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.

5. ***Highly Compensated Employees/Officers/Owners***. 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." Other bases (such as independent salary surveys) may be used to determine reasonable compensation levels. The reasonable compensation limit or range that was used by the auditor should be disclosed in the notes to the audit report. Distributions of profits to owners are unallowable as direct or indirect labor costs.

   EXAMPLE 11-4: The Company paid compensation to senior executives in excess of the FAR 31.205-6(p) limit of $XXX,XXX per person. The total, which was adjusted to the overhead schedule, amounted to $XXX,XXX.

6. ***Pension Plans, Deferred Compensation Plans, and ESOPs***. If pension and/or deferred compensation costs (as defined by FAR 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 engineering consultant, or 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). Identify any other significant impacts from market valuations.

   EXAMPLE 11-5: The Company operates a 401(k) pension plan, meeting the requirements of FAR 31.205-6(j), to which it makes a cash contribution of 2 percent of participating employees' salaries 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. The amount of the company's share of ESOP expense included in the overhead pool for the year is $xxx,xxx.

7. ***Contract/Purchased Labor***. Provide the methodology used by the engineering consultant to account for contract labor (not sub-contracts). In some cases this labor will be considered to be a direct cost item invoiced to the project, but in other cases the firm may choose to have this labor treated the same as employee labor, and therefore it would be included in the direct labor base.

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EXAMPLE 11-6: 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.

F. Description of Depreciation and Leasing Policies

Policies regarding costs related to acquisition and disposition of assets should be clearly identified along with the related depreciation methods. Costs and accounting treatment for capital and operating leases should be disclosed.

EXAMPLE 11-7: Certain assets are purchased and depreciated, while others are leased and considered operating leases, and the annual lease costs are included in the overhead pool. The depreciation reflected on the Company's financial statements differs from the acceptable depreciation for Federal income tax purposes. Since the financial statement amounts included in the overhead pool are lower than the amounts used for Federal purposes, the amounts included on the Overhead Schedule are allowable under FAR 31.205-11(e).

G. Description of Related Party Transactions

Identify any related parties, who are considered to have common control, to the extent that audit adjustments are required, and the amounts of required adjustments per FAR 31.205-36.

EXAMPLE 11-8: The Company rents one of its two offices from a Limited Liability Partnership (LLP) partially owned by a company shareholder. The actual occupancy costs of $350,000 include interest expense of $140,500. The rent expense recorded in the Company's financial statements includes a $400,000 charge from the related party LLP. The calculation to determine the allowable portion of the rent follows:

Total rent expense recorded (from related LLP)	$400,000
Less: Profit included in rent charges	(50,000)
Less: Unallowable interest expense	(140,500)
Allowable portion of related party rent	$ 209,500

Consequently, rental expense has been reduced by $190,500 ($400,000 rent expense less $209,500 allowable portion) in accordance with FAR 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.

H. Facilities Capital Cost of Money (FCCM)

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

EXAMPLE 11-9: 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:

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

***Note**: When calculating FCCM, the net book value of the related party building may be included in the total net book value of tangible assets for the company.*

I. List of Direct Cost Accounts

Provide a listing of the types of costs that were charged directly to contracts, along with a description of the control procedures used to ensure that these costs were not also included in the indirect cost pool.

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12

Chapter 12 – Cognizance and Oversight

To avoid duplication of audit work, it is common practice for auditors to rely on the work of others. GAGAS 4.23 states:

> Underlying GAGAS audits is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform a financial audit in accordance with GAGAS cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplication of efforts. Subject to applicable laws and regulations, auditors should make appropriate individuals, as well as audit documentation available, upon request and in a timely manner to other auditors or reviewers to satisfy these objectives. The use of auditors' work by other auditors may be facilitated by contractual arrangements for GAGAS audits that provide for full and timely access to appropriate individuals, as well as audit documentation.

***Note**: Additional guidance is provided in GAGAS 7.41, 7.42, and 7.43.*

12.1 – National Highway System Designation Act Section 307

In 1995, Congress passed the latest version of the National Highway System Designation Act (hereinafter referred to as "the NHSD Act"). The focus of Section 307 of the NHSD Act was to remove the ceilings on overhead rates and indirect salaries that had been established by some states, to avoid duplicate indirect cost audits of the same firm by multiple audit entities, and to reinforce the need for all auditors to use the FAR for the purpose of determining cost eligibility.

This legislation impacted how some states paid consulting engineers for the overhead portion of their costs on Federally-participating contracts. Heretofore, approximately one-half of the State DOTS had self-imposed ceilings on overhead limits and/or maximum hourly rates associated with indirect labor. Section 307 of the NHSD Act prohibited the use of such limitations on Federal-aid contracts.

The NHSD Act, however, provided 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 were referred to as "opt-out States," and included the following: Connecticut, Delaware, Florida, Kentucky, Louisiana, Maine, Maryland, Minnesota, New York, North Carolina, Utah, Tennessee, and West Virginia.

In 2006, the Transportation Appropriations Act (SAFETEA-LU) contained language that eliminated the concept of opt-out States, thereby promoting greater uniformity. Of the thirteen opt-out States, alternative processes were repealed for all states except Minnesota and West Virginia.

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12.2 – SECTION 174 OF THE 2006 TRANSPORTATION APPROPRIATIONS ACT

The underlying guidance concerning cognizant audits is contained in 23 CFR 172 and 23 U.S.C. 112 and supporting documents published by FHWA. Section 174 of the 2006 Transportation Appropriations Act and the implementation guidance issued by FHWA served to re-emphasize the importance of cognizant audits, while not actually changing the underlying regulations specific to issuance or acceptance of cognizant audits.

23 U.S.C. 112 provides definitive guidance on indirect rates and the acceptance of cognizant audits. 23 U.S.C. 112 (b)(2), Contracting for engineering and design services, provides the following:

> (A) General Rule – Subject to paragraph (3), each contract for program management, construction management, feasibility studies, preliminary engineering, design, engineering, surveying, mapping, or architectural related services with respect to a project . . . shall be awarded in the same manner as a contract for architectural and engineering services is negotiated under Chapter 11 of Title 40.
>
> (B) Performance and audits – Any contract or subcontract awarded in accordance with subparagraph (A), whether funded in whole or in part with Federal-aid highway funds, shall be performed and audited in compliance with cost principles contained in the Federal Acquisition Regulation of part 31 of title 48, Code of Federal Regulations.
>
> (C) Indirect cost rates – Instead of performing its own audits, a recipient of funds under a contract or subcontract awarded in accordance with subparagraph (A) shall accept indirect cost rates established in accordance with the Federal Acquisition Regulation for 1-year applicable accounting periods by a cognizant Federal or State government agency, if such rates are not currently under dispute.
>
> (D) Application of rates – Once a firm's indirect cost rates are accepted under this paragraph, the recipient of the funds shall apply such rates for the purposes of contract estimation, negotiation, administration, reporting and contract payment and shall not be limited by administrative or de facto ceilings of any kind.

The AASHTO Audit Subcommittee and ACEC Transportation Committee worked together to develop the following guidance, which was later incorporated by FHWA into the *Administration of Engineering and Design Related Services Contracts–Questions and Answers* prepared by the FHWA and available on the Internet at http://www.fhwa.dot.gov/programadmin/172qa.cfm#r39.

12.3 – WHAT IS A COGNIZANT AGENCY?

A cognizant agency can be any of the following:

- A Federal agency,
- The Home State Transportation or Highway Department (the State where the consulting firm's accounting and financial records are located), or
- 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 consulting firm.

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12.4 – HOW IS A COGNIZANT APPROVED INDIRECT COST RATE ESTABLISHED?

Cognizant approved rates may be established by any one of the following methods:

- A Cognizant Agency either: (a) performs an indirect cost rate audit, or (b) contracts with and directs the work of a CPA who performs this work.
- A Non-Home State auditor or CPA working under the State's direction issues an audit report, and the Home State issues a cognizant letter of concurrence. If the Home State does not accept the indirect cost rate audit performed by another State, the Home State will have 180 days from receipt of the audit report to issue a cognizant approved rate; otherwise, the Non-Home State audit report will be used to establish a cognizant approved rate for the one-year applicable accounting period.
- An indirect cost audit performed by an independent CPA (not part of the engineering consultant's organization) hired by the consulting firm will be used to establish a cognizant approved rate if one of the following conditions is met:

  (a) The Home State reviews the CPA's audit report and related workpapers, and the Home State issues a cognizant letter of concurrence with the audit report.

  (b) A Non-Home State reviews the CPA's audit report and related workpapers 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 used to establish the cognizant approved rate for the one year applicable accounting period.

12.5 – GUIDELINES FOR REVIEWING CPA INDIRECT COST AUDITS

A CPA Workpaper Review Program appears in Appendix A of this Guide. Government auditors should use the Program when performing overhead audits or when reviewing the workpapers of others, to determine whether is it appropriate to issue a cognizant letter of concurrence. The workpaper review program is a tool to assist in determining whether: (a) the CPA's audit was conducted in accordance with GAGAS, (b) the CPA adequately considered the auditee's compliance with FAR Part 31 and related laws and regulations, and (c) and the audit report format is acceptable. Chapter 9 of this Audit Guide includes a recommended format for the audit report and required disclosures.

12.6 – ATTESTATIONS ENGAGEMENTS

Examination level engagements following GAGAS (Yellow Book) requirements are acceptable. This Uniform Audit and Accounting Guide also should be followed when performing these engagements.

12.7 – RISK ANALYSIS: ACCEPTING OVERHEAD RATES WITHOUT A WORKPAPER REVIEW

For many State DOTs, it will not be feasible to perform comprehensive CPA workpaper reviews for all engineering firms that perform work and are located in their home states; however, the onus remains on State DOTs to obtain reasonable assurance that the rates submitted by engineering consultants are FAR compliant. Accordingly, to accept rates without performing a comprehensive workpaper review, the State DOTs should perform a risk analysis.

The Internal Control Questionnaire provided in Appendix B of this Guide provides a framework for assessing engineering consultants' internal control structures. Additional steps also may be required, including a site visit; further desk review, including correlation analysis using data from prior years; or making additional inquiries of management and/or the provider of the overhead computation (e.g., a CPA or in-house accountant).

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Risk factors to be considered should include, if applicable:

- The dollar volume of contracts with the State DOT.
- The engineering consultant's overall experience in working with State DOT contracts.
- The history and professional reputation of the engineering consultant.
- The number of States in which the firm operates.
- The date of the last audit.
- The type and complexity of the accounting system used by engineering consultant.
- The size (number of employees and annual revenues) of the engineering consultant.
- The relevant professional experience of the CPA who audited the overhead rate.
- The engineering consultant's responses to the Internal Control Questionnaire.
- Changes in the engineering consultant's organizational structure.

***Note**: Each State DOT may develop its own risk analysis, but documentation should be maintained to support any decision involving the acceptance of an overhead computation.*

12.8 – QUESTIONS AND ANSWERS REGARDING COGNIZANCE

The following Q&A section provides additional clarification of the cognizant audit requirements. Answers are shown in italic text, below.

1. May State DOTs employ a risk management framework in ensuring compliance with Federal requirements for consulting firm indirect cost rates?

   Yes. The primary objective in providing oversight related to design and engineering firm indirect costs is to ensure such rates are developed in compliance with the FAR cost principles. In providing that assurance, a risk management framework in conjunction with an appropriate internal control structure may be employed that includes the following mix of tools and risk criteria:

   - FAR compliant audits (which may result in cognizant approved indirect cost rates), desk reviews, other alternate procedures that provide effective assurance of compliance with the FAR cost principles for the firms doing business within their States
   - Dollar thresholds
   - History/reputation of the firm
   - The number of states in which the firm does business
   - Audit frequency (date of the firm's last FAR compliant audit)
   - Experience of the CPA firm performing audits on the firm's indirect cost rate
   - Responses to the firm's internal control questionnaire
   - Other risk criteria, as deemed appropriate

2. Can a local government or an agency or some other sub-recipient of Federal-aid funds be a cognizant agency?

   No. The law requires the cognizant agency to be either a Federal or State government agency.

3. For an indirect cost rate audited by a CPA firm to be accepted as a cognizant approved rate, is it necessary for the audit to be performed using Generally Accepted Government Auditing Standards (GAGAS or "Yellow Book")?

   Yes. In defining minimum standards for cognizant audits, AASHTO and ACEC agree that to be cognizant, an audit must be performed to test compliance with the FAR cost principles, in accordance with the Yellow Book.

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4. For an audit performed by a State DOT to be cognizant, must the same Yellow Book standards be followed?

   Yes, the same standards should be applied if the audit is performed by a State, rather than by a CPA firm.

5. What work must be performed by a State DOT to accept an audit performed by a CPA firm and issue a cognizant letter of concurrence making the indirect cost rate "cognizant approved"? Do the requirements change depending on whether the CPA firm was hired by the consulting firm or was working under the State's direction?

   In either case, the State DOT must perform a review of the CPA's workpapers, using the CPA QCR Work Program, in order to issue a cognizant letter of concurrence and make the rate "cognizant approved." Inquiries, discussions or other information provided by the CPA firm may be useful, but is not an acceptable substitute to a review of the CPA's workpapers.

6. What may potentially trigger a request for a cognizant rate approval?

   A consulting engineering firm that has had an indirect cost rate audit performed by a CPA firm requests one.

7. Are States required to perform cognizant approvals of indirect cost rates?

   No. In addressing cognizant audits, 23 U.S.C. 112(b)(2) states that recipients of Federal-aid Highway funds must accept the indirect cost rates established by a cognizant Federal or State agency, if such rates are not in dispute. There is no legislative direction in 23 U.S.C. 112 or 23 CFR 172 stating that the issuance of a cognizant approved rate is required of any State. The interpretation of existing regulations accepted by both AASHTO and ACEC is that, while beneficial, the issuance of a cognizant approved rate is not required of any State or Federal agency.

8. May a State DOT accept and use an indirect cost rate submitted by an engineering consultant if such rate has not received cognizant approval?

   Yes. Contracts funded in whole or in part with Federal-aid highway funds are required to be performed and audited in compliance with FAR cost principles. States may accept [adopt] an audit performed by a CPA firm or another State, if a cognizant approved rate does not exist. The contracting State DOT should take appropriate steps to ensure the indirect cost rate was calculated in compliance with FAR cost principles; Government Audit Standards (the Yellow Book), as applicable; and the AASHTO Audit Guide. Each reviewing State DOT will perform a risk assessment to determine the appropriate required level of review.

9. When a cognizant approved rate exists, may a contracting agency use an indirect cost rate other than the one established by the cognizant agency?

   Not unless the rate is under dispute. The regulations clearly provide that if an indirect cost rate has been established by a cognizant Federal or State agency, the contracting agency must accept that rate. Such cognizant rate must be applied for the purposes of contract estimation, negotiation, administration, reporting, and contract payment and shall not be limited by administrative or de facto ceilings of any kind.

10. May a contracting agency request a lower indirect cost rate than what has been established by a cognizant audit?

    No. The contracting agency may not request or start negotiations for a lower rate. However, as either part of the original cost proposal or as part of a negotiation point, the consultant may offer a rate lower than their FAR audited rate, and the contracting State DOT may accept that rate. The consultant's offer of a lower indirect cost rate may not be a condition of contract award. It should be noted that in accordance with the Brooks Act declaration of policy, a contracting agency may select the next qualified candidate if the contracting agency determines that the total contract would not be awarded at a fair and reasonable price.

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11. What if no cognizant approved indirect cost rate has been established?

    A State may conduct its own indirect cost audit or negotiate a provisional indirect cost rate until an audit is performed. (See also question No. 1, regarding the use of a risk management framework.)

12. What parties may dispute a cognizant approved indirect cost rate, and under what conditions may a rate be disputed?

    Except in the case of error or the failure to follow Government Audit Standards, in which case the contracting agency may raise concerns (see #13 below), only the consultant may dispute an established indirect cost rate. If either an error is discovered in the established indirect cost rate, or if Government Audit Standards were not followed in the establishment of the rate, any contracting agency may dispute the rate. The term "error" does not refer to differing and legitimate interpretations of the FAR cost principles. Errors may consist of complete misinterpretation or misapplication of the FAR cost principles or simple mathematical errors of calculation.

13. What steps may be included in a dispute resolution process?

    In general, States should work to develop a level of trust in the audit work performed by other States. In the case where a contracting agency believes that there are obvious errors in the indirect cost rate, or that Government Audit Standards may not have been followed, that contracting agency should contact the cognizant agency to discuss its concerns. The contracting agency's objection to the cognizant approved rate must be based upon objective criteria and must not be speculative or without a reasonable factual basis. The cognizant agency, consulting firm and its FAR auditor/CPA, as applicable, should work together to resolve any issues. Involvement of the FHWA Division Office in discussions with the parties to a dispute may be a final step in dispute resolution, if necessary. In resolving such disputes, the FHWA Division Office may, at times, consult with FHWA Headquarters, as deemed necessary. States may choose to employ either formal or informal dispute resolution policies and procedures to establish the dispute resolution processes within their respective jurisdictions. Such processes likely will include provisions for appeal within the State DOT audit organization, within the State DOT chain of command, and, as stated, to the local FHWA Division Administrator. Those policies and procedures may either be referenced or specifically cited within the provisions of a State's procurement processes, and/or they may be referenced specifically within the contract document itself.

14. How may an indirect cost rate be obtained if the cognizant approved rate is under dispute?

    If a cognizant approved indirect cost rate is under dispute, for the reasons stated in Question 10, the contracting agency does not have to accept the rate. The contracting State DOT can conduct its own indirect cost rate audit or negotiate a provisional indirect cost rate.

15. May a firm elect to develop a national (corporate-wide) rate, a State DOT rate, or business segment indirect cost rate?

    Yes. The firm is responsible for proposing an indirect cost rate, and the firm may choose the portion of its business it wants the rate to cover. There may be multiple rates for a single firm. Once the firm develops this rate (or rates), it should be consistently and fairly applied.

16. How long is an audited indirect cost rate valid?

    One year. The one-year applicable accounting period is defined in 23 CFR 172 to mean the annual accounting period for which financial statements are regularly prepared for the consultant.

17. What happens if a cognizant approved cost rate expires during the contract period?

    In general and in accordance with the FAR cost principles (48 CFR 31.203(e)), a new indirect cost rate should be established by a cognizant agency. However, 23 CFR 172.7(b) allows an indirect cost rate established for a contract to be extended beyond the one year applicable accounting period provided all concerned parties agree. This extension is only on a contract-by-contract basis where all concerned parties agree and such an agreement shall not be a requirement of the contract.

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18. May a cognizant approved indirect cost rate be modified by subsequent contracting agencies?

    Generally no. The regulations are clear that a cognizant approved indirect cost rate must be accepted and applied for purposes of contract estimation, negotiation, administration, reporting, and contract payment. Applying additional limitations or reducing the indirect cost rate established in a cognizant audit would constitute a violation of 23 U.S.C. 112(b)(2). However, States with unique laws may request supplemental information from the consulting firm, in order to make adjustments to fit its specific statutory requirements, as long as they are in accordance with the FAR cost principles. Other Federal agencies can and do perform cognizant agency audits for indirect cost rates and may not share their audit background information. In these cases they normally give several rates depending on the type of use. This still results in a cognizant approved indirect cost rate and must be used, as long as the audit was performed in accordance with the Yellow Book to test compliance with the FAR cost principles.

19. Do the cognizant audit requirements apply to sub-consultant indirect cost rates?

    No. Sub-consultants hired by the prime contractor do not fall under the requirements of Section 23 U.S.C. 112(b)(2)(C-D) and as such, their rates would not be subject to establishment via cognizant agency audit. However, as stated in 23 U.S.C.(b)(2)(B), subcontracts must comply with the FAR Cost Principles contained in 48 CFR 31.

20. In what situations is it appropriate to cap or negotiate overhead?

    Section 174 of the 2006 Transportation Appropriations Act removed the ability to cap or negotiate indirect cost rates on Federal-aid funded A&E activities carried out under 23 U.S.C. 112(b)(2). Two states received an exemption from this legislation: Minnesota and West Virginia. If a contract involves any Federal-Aid Highway funds, it is not appropriate to cap or negotiate indirect cost rates.

    Contracting agencies are free to cap indirect cost rates on contracts for Preliminary Engineering project activities/phases not funded with Federal-aid funds Since such a cap does not comply with Federal law, however, the project costs borne by the grantee or subgrantee cannot be applied toward the non Federal share (in-kind match) on Federally funded projects or phases of work.

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Note: The following letter is an example only, actual wording may differ.

EXAMPLE OF COGNIZANT LETTER FOR CPA WORKPAPER REVIEW

[Use State Letterhead]

Date

(Firm name)
(Firm Address)

Dear:

We have performed a cognizant review of the examination, and supporting workpapers, of the Indirect Cost Rate(s) of (_ENGINEERING CONSULTANT NAME_) for the year ended [Month dd, 20XX] in accordance with our role as Cognizant Agency as defined in 23 U.S.C. 112(b)(2)(c) and 23 CFR 172.3 and 172.7. The examination was performed by the independent CPA firm of [Name of CPA firm]. The CPA represented that the examination was conducted in accordance with Government Auditing Standards as promulgated by the Comptroller General of the United States of America, and the examination was designed to determine that the indirect cost rate(s) was(were) established in accordance with Cost Principles contained in the Federal Acquisition Regulation, 48 CFR Part 31. Our cognizant review was performed in accordance with the AASHTO Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates.

[Option 1: unqualified language]

In connection with our cognizant review, nothing came to our attention that caused us to believe that the examination, and supporting workpapers for the Indirect Cost Rate(s), and the related Accountant's Report(s), we reviewed did not conform in all material respects to the aforementioned regulations and auditing standards.

[Option 2: qualified language]

In connection with our cognizant review, except for the effect of the deficiency(ies) described below, nothing came to our attention that caused us to believe that the examination and supporting workpapers for the Indirect Cost Rate(s), and the related Accountant's Report(s), we reviewed did not conform in all material respects to the aforementioned regulations and auditing standards.

Our cognizant review revealed that the CPA failed to…

We recommend acceptance of the following rate(s):

Combined/Corporate:
Home Office:
Field/Project Office:
Facilities Capital Cost of Money (FCCM):

[STATE DOT AUDIT OFFICIAL]
[TITLE]

c: [As identified]

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Appendix

A

Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates

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Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates

Name of Consultant (A/E Firm): _____

Name of CPA Firm/Auditor: _____

Name of DOT Reviewer: _____

Date of DOT Review: _____

I. Purpose and Objectives

A. Purpose

The primary purpose of this CPA Workpaper Review Program is to allow State DOTs to obtain reasonable assurance that independent CPAs have conducted overhead audits in accordance with Government Auditing Standards (also known as "GAGAS" or "Yellowbook" standards) and Generally Accepted Auditing Standards (GAAS); to ensure compliance with Generally Accepted Accounting Principles (GAAP), FAR Part 31 and, to the extent applicable, the Cost Accounting Standards (CAS) of 48 CFR subpart 9900.

The audit/examination will evaluate compliance with GAAS and Government Auditing Standards, applicable Cost Accounting Standards, FAR Part 31, and the *AASHTO Uniform Audit and Accounting Guide* (hereinafter "AASHTO Audit Guide"). To ensure the objectives listed below are met, the following program steps have been developed to provide the auditor with a flexible outline to ensure that sufficient evidence is gathered to support audit conclusions.

B. Objectives

This Program was designed to provide State Department of Transportation (State DOT) auditors with a framework to—

- Evaluate the CPA's familiarity with the GAGAS, GAAS, GAAP, 23 U.S.C. 112(b)(2), 23 CFR 172, FAR Part 31, and interpretive guidance such as the DCAA Contract Audit Manual (CAM) and the AASHTO Audit Guide.
- Assess the adequacy of the CPA's audit planning procedures.
- Determine whether the CPA's workpapers support the opinions stated in the report regarding the engineering consultant's—
  - job-cost accounting and estimating systems;
  - overhead schedule;
  - internal control structure;
  - compliance with the applicable laws, regulations, and guidance; and
  - identification and segregation of field office costs.
- Verify the adequacy of the sampling procedures used by the CPA to determine audit findings.
- Ensure the CPA presented the audit findings and the Audit Report to the engineering consultant.
- Ensure that the CPA's audit adjustments agree to the adjustments listed on the final, audited overhead schedule submitted to State DOTs.
- Evaluate and report on the quality of the CPA's workpapers and audit procedures.

Note: The foregoing list of objectives was designed to determine whether the CPA's workpapers support various elements of the engineering consultant's financial systems, such as the job-cost accounting and estimating systems. However, it should be noted that the CPA only is required to provide an opinion on the overhead schedule and to issue a report on internal controls over financial reporting and compliance as required by GAGAS.

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Name of Consultant: _____ **DOT Reviewer:** _____
Audit Period: _____ **Review Date:** _____
CPA Firm/Auditor: _____

II. Preparatory Work		Workpaper Reference or Comment
II.A.	Obtain current year overhead schedule.	
II.B.	Obtain previous year(s) overhead schedule(s).	
II.C.	Compare overhead schedules for consistency of amounts, rates, and allocations to home office and field offices.	
II.D.	Obtain copy of financial statements for the period being reviewed, if available, and/or Form 10K for publicly-traded companies (many times this can be obtained from the company's website). Review of the financial statements may provide additional information regarding related party transactions, acquisition of another firm(s) or other organizational changes, and other information that could be used during the review of the CPA's audit report.	
II.E.	Evaluate the length of time there has been a business relationship between the CPA and engineering consultant. If there is a lengthy and close relationship between the CPA and consultant, the CPA should incorporate additional analysis/evaluation steps for such within the work program.	

III. General Standards (GAGAS Chapter 3)		Attribute Met?	Workpaper Reference (or Comment)
III.A.	Review the CPA's most recent Peer Review report and Letter of Comments, if applicable (GAGAS 3.63). Did the CPA receive an unqualified peer review opinion? If not, document the comments of the peer reviewer(s), obtain a copy of the corrective action plan, and note any possible impairment(s) to the audit work performed.	☐ Yes ☐ No	
III.B.	Did the CPA meet the minimum Yellow Book requirements for CPE credit per GAGAS 3.46? Review the earned CPE hours and course listing for each individual CPA who worked on the assignment: • 80 hours CPE over 2 years • 24 hours in government auditing or government environment	☐ Yes ☐ No	
III.C.	Did it appear that the CPA was free from personal, external, and organizational impairments to independence, and did the CPA avoid the appearance of such impairments to independence (GAGAS 3.02 through 3.30)?	☐ Yes ☐ No	
III.D.	(Answer "yes" or "no," based on overall conclusion.) Did it appear that the staff assigned to conduct the audit collectively possessed adequate professional competence for the tasks required (GAGAS 3.40)? Determine the sufficiency of CPA firm's knowledge of applicable audit criteria, such as the following: • Was staff assigned to the audit proficient with the FAR? • Was assigned staff knowledgeable of the AASHTO Guide and other relevant guidance (e.g., the DCAA CAM and/or supplemental materials issued by State DOTs?) • Have assigned staff members received specific training in relevant subjects? • Has the firm had recent experience in conducting FAR audits? • Have any State DOTs already reviewed any of the CPA's audits of other consulting firms? If "yes," contact those states to see if they identified any problems with the CPA's work.	☐ Yes ☐ No	

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Name of Consultant: _____ **DOT Reviewer:** _____
Audit Period: _____ **Review Date:** _____
CPA Firm/Auditor: _____

IV. Review of Audit Field Work (GAGAS Chapter 4)		Attribute Met?	Workpaper Reference (or Comment)
IV.A.	(Answer "yes" or "no," based on overall conclusion.) Is there evidence that the audit work was properly planned to: • Determine the nature timing and extent of auditing procedures; • Consider fraud and illegal acts; • Consider materiality; • Evaluate previous audits; and • Assess risk?	☐Yes ☐No	
IV.B.	Did the audit contract, engagement letter, or agreement include the following? (Answer "yes" or "no," based on overall conclusion.) • The period to be covered, • The cost pools to be audited, • The reports to be prepared, • That representatives of State agencies and other applicable government audit staff shall have access to the audit documentation upon request and in a timely manner (GAGAS 4.23), • That working papers be maintained for at least three years after the date of the report, • Any restrictions or special conditions, and • Citations to the Audit Guide and other relevant standards and/or regulations to be followed (e.g., GAGAS, GAAS, Far Part 31)?	☐Yes ☐No ☐N/A	
IV.C.	Did the CPA follow up on known material findings and recommendations from prior audits (GAGAS 4.09)?	☐Yes ☐No ☐N/A	
IV.D.	Did the audit documentation (GAGAS 4.19 and 4.20) provide adequate evidence of the following? • Overall, there was sufficient detail to provide a clear understanding of the CPA's work (additional detail, supplementary, or oral explanations should not be necessary); • The audit evidence obtained included its source, descriptions of transactions and records examined, and the conclusions reached; • The documentation provided sufficient detail to enable an experienced auditor, having no previous connection to the audit, to understand— – the nature, timing, and extent of auditing procedures performed to comply with Yellow Book and other applicable standards and requirements; – the results of the audit procedures performed and the audit evidence obtained; – the conclusions reached on significant matters; and – that the accounting records agree or reconcile with the audited financial statements or other audited information. • The documentation provided evidence of supervisory review of the work performed.	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No	

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V. Review of Audit Report (GAGAS Chapter 5)		Attribute Met?	Workpaper Reference (or Comment)
V.A.	Did the report contain an opinion stating that the audited overhead schedule was fairly presented in accordance with applicable Federal laws and regulations?	☐Yes ☐No	
V.B.	Did the report contain a scope paragraph stating that the audit was performed in accordance with Yellow Book standards?	☐Yes ☐No	
V.C.	Did the scope paragraph state that the CPA used FAR Part 31 as the primary basis for determining costs eligible for reimbursement under Government contracts?	☐Yes ☐No ☐N/A	
V.D.	Did the CPA issue a report on the Internal Control and Compliance with Laws, Regulations, and Provisions of Contracts or Grant Agreements as required by Government Auditing Standards? – If "yes," were all significant deficiencies and material weaknesses in the internal control that were found by the auditor disclosed in the auditor's report? (GAGAS 5.10 - 5.16)	☐Yes ☐No ☐Yes ☐No ☐N/A	
V.E.	Review the procedures used by the CPA to communicate the results of the audit and deficiencies in internal controls to the engineering consultant (GAGAS 5.10-5.22). Were the procedures adequate?	☐Yes ☐No	
V.F.	(Answer "yes" or "no," based on overall conclusion.) Were the Disclosure Notes to the Report Adequate? (See AASHTO Guide, Chapter 11, which discusses Audit Reports and Minimum Disclosures.) At a minimum, the following should have been disclosed (if applicable): • Description of the Company • Basis of Accounting • Description of Accounting Policies • Description of Overhead Rate Structure • Single or Multiple Base • Multiple rates for field, home office, and corporate level? • Other Direct Costs (ODCs) consistently charged? (ODCs should be listed.) • Cost Allocation Policies • Description of Labor Related Costs • Project Labor • Variances • Paid Time Off • Paid Overtime and Uncompensated Overtime • Employee Compensation Analysis • Pension/Deferred Compensation/Employee Stock Option Plans • Contract Labor • Description of Depreciation/Leasing Policies • Related Party Transactions • Facilities Capital Cost of Money (FCCM) • List of Direct Cost Accounts	☐Yes ☐No	
V.G.	Did the CPA's Audit Report contain a list of costs submitted by the engineering consultant, adjustments and allowed costs per audit, explanations of the adjustments, and FAR references for the adjustments made?	☐Yes ☐No	

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VI. Review of CPA's Workpapers (GAGAS Chapter 4, FAR Part 31, and Cost Accounting Standards (48 CFR Chapter 99))		Attribute Met?	Workpaper Reference (or Comment)
VI.A.1	General Ledger. (Answer "yes" or "no," based on overall conclusion.) Did the CPA review the accounting system to determine if the system was adequate to segregate and accumulate reasonable, allocable, and allowable costs? • Evaluate the testing used by the CPA to verify the accuracy of costs in the general ledger, associated subsidiary ledgers, and related documents or systems. (Assess if testing was sufficient to support the CPA's conclusions—consider additional sample testing, if necessary). • Was there evidence that costs in the general ledger were properly classified? • Did the general ledger contain separate accounts for segregating FAR-unallowable costs? • If not, were unallowable costs otherwise identified or estimated? Review, evaluate, and document how the unallowable costs were determined. Review the CPA's documentation of tests and conclusions.	☐Yes ☐No	
VI.A.2	General Ledger (continued). (Answer "yes" or "no," based on overall conclusion.) If the engineering consultant used statistical sampling as a basis to estimate unallowable costs, was a proper statistical sampling method used as required by FAR 31.201-6(c)(2)? Specifically: • The sampling method must result in an unbiased sample that is a reasonable representation of the sampling universe; • Any large dollar value or high risk transaction must be separately reviewed for unallowable costs and must be excluded from the sampling process; and • The sampling method must permit audit verification. • Did the engineering consultant enter into an appropriate advance agreement with its cognizant state DOT to allow for such sampling and estimation as discussed in FAR 31.201-6(c)(4)?	☐Yes ☐No ☐N/A	

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VI. Review of CPA's Workpapers (cont.) (GAGAS Chapter 4, FAR Part 31, and Cost Accounting Standards (48 CFR Chapter 99))		Attribute Met?	Workpaper Reference (or Comment)
VI.B.	Labor Accounting System. (See AASHTO Guide, Chapters 6 and 10.) Did the CPA's workpapers contain evidence that the engineering consultant's labor-charging/timekeeping system was determined to be complete and sufficiently detailed to allow for a proper determination of the consultant's direct labor base and indirect labor costs, including the allowability of such costs? Specifically—		
	• Was there evidence that the consultant accounted for all hours worked by all employees, including salaried employees and principals?	☐Yes ☐No	
	• Was there evidence that indirect labor was recorded on timesheets in sufficient detail to allow for a determination of labor relating to FAR-governed costs, including marketing/promotional, direct selling, bid and proposal, training, reorganization, and other administrative tasks?	☐Yes ☐No	
	• Were the labor costs per the overhead schedule reconciled to total labor costs per payroll tax returns (941s), the general ledger/financial statement, and the labor distribution system/summary?	☐Yes ☐No	
	• Was there a labor distribution analysis—a review of hours and rates per the labor distribution reports and comparison to employee timesheets and payroll register or other payroll records?	☐Yes ☐No	
	• Was there a review of uncompensated overtime? (FAR 52.237-10 defines uncompensated overtime as "hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act. Compensated personal absences such as holidays, vacations, and sick leave must be included in the normal work week for purposes of computing uncompensated overtime hours.")	☐Yes ☐No	
	• If the consultant used a standard costing system, was there evidence that the consultant properly accumulated and disposed of variances?	☐Yes ☐No	
	• Was there evidence that the consultant accounted for the premium portion of overtime on a consistent basis?	☐Yes ☐No	
	• Was there evidence that the consultant consistently and properly accounted for project-related purchased/temporary labor?	☐Yes ☐No	
	• Did the CPA's workpapers contain evidence that a minimum labor sample size of 26 timesheets were chosen for testing across an appropriate mix of direct-charge employees, including supervisors and/or project managers? Alternatively, did the CPA's workpapers for labor testing document the size of the labor population and the conclusions drawn from the risk assessment to determine if a larger sample size was warranted beyond the minimum sample size?	☐Yes ☐No	

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VI.C.	Project (Job) Costing System. Was there evidence that the project costing system accounted for all direct costs (direct labor and other costs that can be identified specifically with a project or final cost objective), on a proper, complete, and consistent basis?		
	• Did costs contained in the project costing system integrate with, or otherwise reconcile to, financial accounting system control accounts (general ledger accounts)?	☐Yes ☐No	
	• Was there evidence that the consultant properly recorded all direct labor to projects, including non-billable labor identified with projects?	☐Yes ☐No	
	• Was there evidence that the consultant recorded labor costs at properly developed labor rates for both salaried and non-salaried employees? For example, did the CPA pay specific attention to the accuracy of labor rates for salaried employees who incur overtime and work in both direct and indirect functions?	☐Yes ☐No	
	• Was there evidence that the consultant recorded all Other Direct Costs, whether billable or not, to projects on a consistent basis? Were the components of such costs segregated from general overhead?	☐Yes ☐No	
	• Did the workpapers address costs that the consultant treated as direct costs and billed, but also included in the indirect cost pool? If so:	☐Yes ☐No ☐N/A	
	– Were recoveries associated with these costs credited to the indirect cost pool in accordance with FAR 31.201-5?	☐Yes ☐No ☐N/A	
	– The netting of direct costs included in the indirect cost pool and billed amounts (on a basis other than cost) in this instance may yield an inaccurate representation of costs. Did the workpapers address the acceptability of this alternative methodology?	☐Yes ☐No ☐N/A	
VI.D.	Direct Costs/Verification of Company In-House Rates and Direct Billings. Did the CPA's workpapers include evidence of the following?		
	• The consultant submitted a list of direct cost accounts and amounts for the CPA's review.	☐Yes ☐No	
	• The CPA reviewed the consultant's direct cost accounts for consistency.	☐Yes ☐No	
	• The CPA ensured that all direct costs were removed from the indirect cost pool.	☐Yes ☐No	
	• The CPA reviewed the consultant's in-house billing rates to ensure that:		
	– Total usage (direct and indirect) was included in the denominator?	☐Yes ☐No	
	– If expenses associated with the development of the rate(s) were accumulated in the indirect cost pool, the indirect cost pool was reduced by the amount of direct usage?	☐Yes ☐No	
	– If the expenses were accumulated in separate clearing account(s), the indirect cost pool included only indirect usage?	☐Yes ☐No	
	• Did the CPA audit the in-house billing rates, compare the audited in-house rates to the billing rates, and revise as necessary (e.g., CADD and in-house reproductions)?	☐Yes ☐No	

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	• Did the CPA verify billings on other projects on a sample basis? (If a State project was tested, note project number and amount for information.) Did the CPA performed reconciliations of: – Hours charged on billings to timesheets, – Hourly rates billed to actual rates, and – Hourly rates billed to contract maximums?	☐Yes ☐No	
VI.E.	Cost Pooling and Allocation Methodologies. (Answer "yes" or "no," based on overall conclusion.) Did the CPA's workpapers include evidence that costs were properly and consistently pooled and allocated to intermediate and final cost objectives? • Was there evidence that the CPA addressed the propriety of the methodology used by the engineering consultant in allocating costs contained in intermediate cost pools (e.g., corporate expenses, fringe benefits, general and administrative, and service specific overheads) to the final indirect cost rate(s)? • Specifically, did the CPA firm evaluate the homogeneity of the cost pools and the relationship to the allocators used? Did the CPA conclude that the methodology resulted in an allocation of costs in relation to the benefits accrued by the cost objectives? • If the consultant developed indirect costs rates for more than one region, reporting unit, or engineering discipline, did the CPA address the propriety of the cost pooling and cost allocation methodologies used? • For Other Direct Costs that were internally-generated, did the CPA determine that related costs were properly segregated from the general cost pool and allocated to projects on a consistent basis? • For Other Direct Costs that were internally-generated and were accumulated in separate cost pools, did the CPA determine that material year end variances, which resulted from over- or under-allocation of pooled costs, were properly disposed of? • For internally-generated costs, such as company-owned vehicles, were such costs accumulated in separate cost pools when such costs were material in amount and had a material impact on the firm's indirect cost rates (specifically when the firm has more than one overhead rate involving differentials in the amounts of service-specific vehicle usage)?	☐Yes ☐No	
VI.F.	Elements of Cost in the Overhead Schedule: Generally. • Did the workpapers include evidence that the CPA determined that costs contained in the overhead schedule were supported by the underlying books and records, as summarized by financial statements, trial balances, tax returns (IRS Form 941s), and related schedules? • Did the workpapers document the identification of *large-dollar or sensitive* (LDS) transactions that were removed/stratified for complete examination, including verification (vouching) to source documents? (AASHTO Guide Chapter 10). • Did the workpapers document the additional sampling parameters used by the CPA if additional testing beyond the LDS was warranted? (AASHTO Guide Chapter 10).	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No	

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VI.G.	Elements of Cost in the Overhead Schedule: Specific Cost Elements. Did the workpapers include evidence that the CPA paid particular attention to evaluating the allowability (including reasonableness) of types or groups of costs that have the greatest potential impact on the overhead rate? These costs include the following: (1) salary, (2) bonus/incentive compensation costs, (3) fringe benefits costs, (4) indirect labor, and (5) other indirect costs. See the following subsections for a detailed discussion.		
Complete Section VI.G.1.A **(shaded)** if the engineering consultant performed an analysis of executive compensation; otherwise, complete Section VI.G.1.B **(National Compensation Matrix analysis)**.			
VI.G.1.A	Salary, Bonus/Incentive Compensation, Fringe Benefits, and Indirect Labor Costs – **Using the Engineering Consultant's analysis.** • Did the workpapers include evidence that the Consultant prepared an executive compensation schedule in compliance with Chapter 7 of the AASHTO Guide? Specifically, did the NCM schedule disclose the following? (1) Employee/owner/officer first and last name or employee ID, (2) Position title. (3) Employee's responsibility for sales. (4) Total wages/salaries paid including taxable fringe benefits. (5) Total bonuses paid. (6) Total employer contributions to defined contribution pension plans (whether paid, earned, or otherwise accrued). (7) Total of items 4 through 6 above. (8) The reasonable compensation amount from the NCM. (9) The excess compensation required to be disallowed from the indirect labor or bonus line item.	☐Yes ☐No	
	• Did the workpapers include evidence that: – The CPA verified that the wages paid were for work performed in the current year and did not constitute a retroactive adjustment of prior years' salaries or wages?	☐Yes ☐No	
	– The CPA verified that the Consultant's analysis complied with the procedures and criteria established in Chapter 7 of the AASHTO Guide?	☐Yes ☐No	
	– The CPA verified that specific elements of compensation costs were allocable, allowable and reasonable in compliance with FAR part 31?	☐Yes ☐No	
	– The CPA reviewed the Consultant's written bonus/incentive compensation plan to ensure that objective, performance-based criteria were established, communicated to staff, and used in determining bonus amounts?	☐Yes ☐No	
	– The CPA reviewed the Consultant's written		

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	bonus/incentive compensation plan to determine if any portion of the bonus paid was a constructive dividend or other distribution of profits?	☐Yes ☐No	
VI.G.1.B	Salary, Bonus/Incentive Compensation, Fringe Benefits, and Indirect Labor Costs – **Using the National Compensation Matrix.** • Did the workpapers include evidence that the engineering consultant prepared an executive compensation analysis in compliance with Chapter 7 of the AASHTO Guide? Specifically, did the consultant's analysis disclose the following? (1) Employee/owner/officer first and last name or employee ID, (2) Position title. (3) Employee's responsibility for sales. (4) Total wages/salaries paid including taxable fringe benefits. (5) Total bonuses paid. (6) Total employer contributions to defined contribution pension plans (whether paid, earned, or otherwise accrued). (7) Total of items 4 through 6 above. (8) The applicable amount from the consultant's analysis or NCM. (9) The excess compensation required to be disallowed from the indirect labor or bonus line item.	☐Yes ☐No	
	• Did the workpapers include evidence that: – The CPA verified that the wages paid were for work performed in the current year and did not constitute a retroactive adjustment of prior years' salaries or wages?	☐Yes ☐No	
	– The CPA verified that specific elements of compensation costs were allocable, allowable and reasonable in compliance with FAR part 31?	☐Yes ☐No	
	– The CPA verified that the Consultant complied with the National Compensation Matrix to determine reasonable compensation?	☐Yes ☐No	
	– The CPA verified that the Consultant used nationally-published salary survey data to prepare the analysis?	☐Yes ☐No	
	– The CPA reviewed the Consultant's written bonus/incentive compensation plan to ensure that objective, performance-based criteria were established, communicated to staff, and used in determining bonus amounts?	☐Yes ☐No	
	– The CPA reviewed the Consultant's written bonus/incentive compensation plan to determine if any portion of the bonus paid was a constructive dividend or other distribution of profits?	☐Yes ☐No	
	• If the Consultant claimed superior performance, did the consultant's analysis disclose the following? – Did the consultant apply three (or more) financial performance measures as detailed in Chapter 7 of the AASHTO Guide?	☐Yes ☐No	
	– Did the consultant consistently use the same criteria	☐Yes ☐No	

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	from a prior year (if superior performance was claimed in the prior year)? – Did the consultant use proxy data available from valid sources using the prescribed criteria in Chapter 7 of the AASHTO Guide? – Did the consultant limit superior performance so as not to exceed the 75th percentile or the Federal Benchmark Compensation Amount (BCA)? • Did the workpapers include evidence that the CPA verified that the Consultant's performance analysis complied with the procedures established in Chapter 7 of the AASHTO Guide?	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No	
VI.G.2	Indirect Cost Accounts. (See AASHTO Guide, Chapters 4, 5, 8, and 10.) (1) Did the workpapers include a list of accounts the CPA deemed immaterial and therefore did not review? (2) Did the workpapers adequately address the *allowability* (including *reasonableness*) of indirect costs in accordance with the FAR 31.205 Selected Costs? Specifically, did the CPA perform the following procedures? • Payroll taxes reconciled with applicable tax returns. • Printing/reproductions direct costs were consistently handled by the Consultant, and all direct costs were removed from the indirect cost pool. • Travel. – All entertainment costs, alcoholic beverages, and personal charges were removed from the indirect cost pool (FAR 31.205-14 & -51). – Costs for personal usage of company cars, regardless of whether the costs were reported as taxable income to the employee, were removed from the indirect cost pool (FAR 31.205-6(m)(2). – Travel costs were reviewed for compliance with the Federal Travel Regulation (FAR 31.205-46). – Direct travel costs were treated consistently by the Consultant, and all direct costs were removed from the indirect cost pool (FAR 31.202(a) & 31.203(b)). • Insurance. – Premiums covered the audit period. – Group insurance was reviewed in accordance with FAR 31.205-19. – Self-insurance was reviewed for compliance with FAR 31.205-19. • Professional Fees. Reviewed for organization and reorganization costs (FAR 31.205-27), bad debt collections (FAR 31.205-3), and other unallowable activities. • Rent. Facilities and other, including personal property, was reviewed for common control, and the Consultant properly limited expenses for controlled assets to the allowable *cost of ownership* as discussed in FAR 31.205-36.	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐N/A ☐Yes ☐No ☐Yes ☐No	

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	• Depreciation. Amount was compared to tax return and reviewed for reasonable depreciation method. Determine whether the CPA ensured the amount was based on GAAP methods. No section 179 write-offs, and no luxury vehicles on depreciation schedule. Review IRS regulations or CPA analysis to ensure proper treatment (FAR 31.205-11). • Employee Morale and Related Costs. Reviewed for unallowable entertainment costs per FAR 31.205-14 and other allowable costs per FAR 31.205-13. • Accounts titled "Other Indirect Costs," "General Office," or similar titles. Reviewed for allowability. • Subcontractors/ Outside Consultants. Reviewed for proper segregation between direct and indirect. • Other/Miscellaneous Income. Reviewed for any amounts that should be credited to an indirect cost account. • Gains on Sale of Assets. Reviewed for proper credit on gains on sale of assets originally presented as part of the depreciation expense cost. • Losses on Sale of Assets. Reviewed to ensure reporting within the year the transaction occurred, appropriate calculation, appropriate application of credit or charge to the cost grouping(s) in which the depreciation or amortization was originally posted, and appropriate posting of cash awards.	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A	
VI.H.	Elements of the Overhead Rate Calculation. Did the cost base used to compute the overhead rate consist only of direct labor (e.g., the base excluded fringe benefits, and/or general and administrative costs)?	☐Yes ☐No	
VI.I.	Field Rate Accounting. Did the Overhead Schedule include the calculation of a field rate? (See Chapter 5 of the AASHTO Guide.) If so, ensure that the Consultant considered the following factors in computing the field rate: • Were costs that were allocable to one cost pool properly included in that cost pool? • Were the following field allocation percentages properly computed? – Direct field labor to total direct labor. – Allocation of supportive service "space costs."	☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A	
VI.J.	Elements of the CPA Workpapers/Workprogram. • Was the CPA's audit program sufficiently detailed to support the audit conclusion? • Did the audit program contain references to the applicable Federal and state laws, regulations, guidance and standards (e.g., FAR Part 31, Government Auditing Standards, and Cost Accounting Standards)? • Were the summary or lead workpapers adequately indexed and cross-referenced to supporting workpapers (i.e., were the workpapers easy to follow)? • Did the CPA include narratives/notes in the workpapers that, when reviewed together with the audit program, adequately described the work performed?	☐Yes ☐No ☐Yes ☐No ☐Yes ☐No ☐Yes ☐No	

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	(Answer "yes" or "no," based on overall conclusion.) • Did the workpapers include evidence that the CPA evaluated internal controls? Specifically— – What procedures did the CPA use to evaluate Internal Controls? – Did the CPA evaluate the adequacy of the controls over the accounting system (e.g., Payroll, Other Direct Costs, and posting)? – Did the CPA evaluate the adequacy of the controls over the computer systems (e.g. Information Technology System policies around: hardware/software, security protocol, activation/deactivation of employees; completion of risk assessment; electronic data retention)? – Did the CPA evaluate the following: (1) Control Environment (management attitude), (2) Risk Assessment, (3) Control Methods (policies and procedures), (4) Communications, and (5) Monitoring? • Did the CPA, in conformance with GAGAS 4.10-4.13, 5.27, 6.13-6.14; and SAS 99, adequately consider factors related to fraud? _____	☐Yes ☐No ☐Yes ☐No	
VI.K.	Compliance with Cost Accounting Standards (CAS). Aside from the measurement, assignment, and allocability rules of selected Cost Accounting Standards (CAS) incorporated through reference in FAR Part 31— • Did the workpapers address the extent of CAS coverage with which the consultant must comply; that is: – Full CAS coverage, or – Modified CAS coverage? • If modified CAS-coverage applied, did the CPA's workpapers address compliance with the following four standards from CAS 9904.400, as follows: – 9904.401: Consistency in estimating, accumulating and reporting of costs; – 9904.402: Consistency in allocating costs incurred for the same purposes; – 9904.405: Accounting for unallowable costs; and – 9904.406: Cost accounting period? • If full CAS coverage applied, did the CPA's workpapers address compliance with all applicable 9904 standards (Subparts 9904.401 through 9904.20)?	☐Yes ☐No ☐Yes ☐No ☐N/A ☐Yes ☐No ☐N/A	

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VII. Final Results	
VII.A.	Exit Conference: Discuss the results of the audit/review with the Consultant and the CPA. Obtain their concurrence and/or identify areas of disagreement. Ensure that the Consultant understands the results are preliminary and are subject to review. Document the Consultant and CPA conference thoroughly. State DOT Workpaper Reference: _____
VII.B.	Complete the following Conclusion Statement: Based upon the application and performance of the steps within this work program: (1) The CPA's work demonstrated an ☐ Acceptable level of compliance with FAR Part 31 and the AASHTO Audit Guide. ☐ Unacceptable (2) Should follow-up audit work be considered? ☐ Yes ☐ No If "yes," then describe any issues that warrant additional audit work: _____ _____ _____ _____ _____ _____ _____ _____
VII.C.	Issue review memorandum to Consultant incorporating above conclusion statement, observations, and recommendations. State DOT Workpaper Reference: _____
VII.D.	This CPA workpaper review program was completed and approved by— State DOT Reviewer and Title: _____ Signature: _____ Date: _____ State DOT Supervisor and Title: _____ Signature: _____ Date: _____

Clear Form Data

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Appendix

B

Internal Control Questionnaire

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Internal Control Questionnaire (ICQ) for Consulting Engineers

Name of Engineering Consultant: _____

TIN (Taxpayer Identification Number): _____

Headquarters Address: _____

_____

Company Website: _____

Fiscal Year End: _____

This ICQ was prepared for (agency name): _____

Time Period Covered: _____

Location of Accounting Records: _____

- Please include the following items as attachments to this ICQ:

- FAR Part 31 Overhead Audit Report for most recent fiscal year, including audited Statement of Direct Labor, Fringe Benefits, and General Overhead (hereinafter "Overhead Schedule") and related reconciliation to the financial statements.
- Cognizant audit report or cognizant letter of concurrence from the cognizant Government agency. *Check here if not applicable*: ☐
- Post-closing trial balance and financial statements (balance sheet, income statement, and statement of cash flows) for the most recent fiscal year.
- Current chart of accounts that ties to financial statements and overhead schedule.
- Independent Auditor's Report on financial statements and accompanying management letter. *Check here if not applicable*: ☐
- Sample timesheet.
- The company's policies for vacation and sick leave.
- The company's bonus policy.
- Other written policies, as requested throughout this ICQ.

Note: Throughout this ICQ, all references to "AASHTO Guide" pertain to the 2010 Edition of the *AASHTO Uniform Audit & Accounting Guide*.

- Who is the company's primary contact person for accounting questions?

Name: _____

Title: _____

Phone Number: _____

E-mail Address: _____

Mailing address (if different than headquarters address listed above): _____

A. Background Information

1. When was the company formed? _____

2. What form of business entity is the company?

☐ Sole Proprietorship ☐ Partnership ☐ C Corporation ☐ S Corporation

☐ Other _____

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3. Is the company a subsidiary of another company?

☐ Yes If yes, please explain: _____

☐ No

4. Does the company own or control any other company through common ownership? (See AASHTO Guide Section 8.23.B for details.)

☐ Yes If "yes," please explain: _____

☐ No

5. List the major stockholders, partners, or other owners with greater than five percent ownership of the company and their respective percentages of ownership.

Name:	**Title:**	**Ownership Percentage:**

6. What types of services does the company provide? (e.g., consultant–Architectural and Engineering Design)

_____

7. How many offices does the company operate, and where are these offices located?

_____

_____

_____

8. How many employees (including managers and principals) does the company currently employ?

a. Full time: _____ b. Part time: _____

9. For most recent fiscal year, what percentage of the company's revenue was generated from each of the following?

a. State government: _____% c. Local government: _____%

b. Federal government: _____% d. Commercial/private: _____%

10. What percentage of the company's revenue was generated from each of the following contract types?

a. Lump sum: _____% c. Cost plus (time and materials): _____%

b. Cost plus fixed fee: _____% d. Other: _____% (Explain "Other" below.)

_____

B. Accounting: General Background

1. Has the company used the same fiscal reporting period for the past two years? ☐ Yes ☐ No

2. What basis of accounting does the company use to prepare general purpose financial statements?

☐ Cash ☐ Accrual ☐ Hybrid. Explain: _____

- Was the same basis of accounting also used to prepare the firm's overhead schedule?

☐ Yes ☐ No. Explain: _____

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3. Does the company have written accounting policies that address the following topics?

(If "yes," please provide a copy.)

		Yes	No
a.	Accounting system	☐	☐
b.	Billing	☐	☐
c.	Cost estimating/allowability	☐	☐
d.	Bonus policy	☐	☐
e.	Recording time worked/timesheet preparation	☐	☐
f.	Fringe benefits/leave time	☐	☐
g.	Recording overtime	☐	☐
h.	Compliance with FAR Part 31[†] and applicable CAS	☐	☐
i.	Recording direct and indirect costs	☐	☐
j.	Overhead/indirect cost rate development	☐	☐
k.	Billing rate development	☐	☐

[†] FAR Part 31 is codified at 48 CFR Part 31, which is available at **www.arnet.gov/far**.

4. How frequently does the company prepare an overhead schedule to determine costs eligible for reimbursement per FAR Part 31?

☐ Annually ☐ Other (specify): _____

- Is the schedule prepared by the company or by another entity instead (e.g., CPA firm)?

Prepared by: ☐ Internal staff ☐ External party (specify):_____

- Period covered by most recent overhead schedule:

_____

(e.g., "one-year fiscal period ended December 31, 20xx")

5. Is management aware of any material instances of fraud, illegal acts, abuse, or violations of contracts provisions or grant agreements?

☐ No ☐ Yes. If "yes," please explain below:

_____

6. Are appropriate personnel within the company familiar with FAR Part 31?

☐ Yes ☐ No. If "no," please explain below:

_____

7. Within the past three years, has a CPA or governmental agency performed an independent audit, review, attestation, or compilation of the company's financial data or any phase of the company's operations?

☐ No ☐ Yes. If "yes," complete the following (if applicable):

a. **Financial Statements**: ☐ Audit ☐ Review ☐ Compilation ☐ Other _____

Name of CPA or Agency:

_____

Contact:

_____

Period Covered:

_____

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b. **Overhead Rate**: ☐ Audit ☐ Review ☐ Compilation ☐ Other _____

- Was the overhead rate calculated in accordance with FAR Part 31? ☐ Yes ☐ No

Name of CPA or Agency:

_____

Contact:

_____

Period Covered:

_____

c. **Project Audits**: ☐ Audit ☐ Review ☐ Compilation ☐ Other _____

Name of CPA or Agency:

_____

Contact:

_____

Period Covered:

_____

C. Accounting System(s)

1. What type of accounting software does the company use?

☐ Internally developed ☐ Commercial system: _____

Please describe any significant manual procedures used outside of the automated accounting system to record transactions:

_____

2. Does the company have a job-cost accounting system? ☐ Yes ☐ No

If no, explain what type of system is used: _____

3. Does the general ledger interface with the job-cost ledger?

☐ Yes ☐ No ☐ N/A (no job-cost ledger used)

4. Which of the following types of records does the company maintain to support financial transactions?

	Yes	No
a. General ledger	☐	☐
b. Cash disbursements journal	☐	☐
c. Cash receipts journal	☐	☐
d. Job/Project-cost ledger	☐	☐
e. Labor distribution reports	☐	☐
f. Employee expense reports	☐	☐
g. Payroll registers	☐	☐

5. Does the general ledger contain separate direct and indirect accounts for the following?

a. Labor costs ☐ Yes ☐ No
b. Non-labor expenses ☐ Yes ☐ No

If no, please explain: _____

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6. Does the company have a system in place to identify and remove from the indirect cost pools all unallowable costs, in accordance with per FAR Part 31 and applicable Cost Accounting Standards? (See AASHTO Guide, Sections 2.2, 4.4, 5.2, 5.5, and 6.3.)

☐ No ☐ Yes. If "yes," please answer (a) through (c), below.

(a) Please provide details about the system.

_____

_____

(b) How are appropriate personnel trained to distinguish between allowable and unallowable costs?

_____

_____

(c) When does the review for allowability occur—at time the transaction is recorded, or later?

_____

7. Does the company have more than one division/cost center?

☐ No ☐ Yes. If "yes," are separate ledgers maintained for each? ☐ Yes ☐ No

Comment: _____

8. Does the company reconcile the financial accounting system to the job-cost system?

☐ N/A (no job-cost ledger used)

☐ No. Please explain. _____

Check here if systems are integrated: ☐

☐ Yes. If "yes," how often? (Check all that apply.) ☐ Monthly ☐ Quarterly ☐ Semi-annually ☐ Annually

Comment: _____

9. How frequently are bank statements reconciled? Who performs this process?

_____

10. Does the company use a budgeting system for project planning and oversight?

☐ Yes ☐ No

Comment: _____

11. Does the company prepare variance reports to compare budgeted amounts to actual amounts on projects, and are the reports distributed to appropriate management personnel?

☐ Yes ☐ No. Please explain: _____

_____

12. Does the company use cost allocation methods consistently for all State and Federal government contracts? (See AASHTO Guide, Sections 5.3 and 10.5.)

☐ Yes ☐ No. Please explain: _____

_____

13. When computing overhead rates, the company uses—

☐ a single base for cost allocation. Description of base: _____

☐ multiple bases for cost allocation. Description of bases: _____

(See AASHTO Guide Section 4.7 for a discussion of common allocation bases for indirect costs.)

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14. Does the company have field offices? (See AASHTO Guide Section 5.6.)

☐ No ☐ Yes. If "yes," are separate overhead rates used for the home office and field offices?

_____

D. Information Technology Systems (ITS)

1. Does the firm have written ITS policies concerning the following topics (if "yes," please provide a copy):

	Yes	No
a. Hardware/Software		
• Purchasing	☐	☐
• Inventory	☐	☐
• Maintenance	☐	☐
• Access	☐	☐
• Use of In-house and off-site	☐	☐
• Addition and removal/retirement/disposition of	☐	☐
b. Business Continuation Plan	☐	☐
c. Security Protocol	☐	☐
d. Activation and deactivation of employees upon arrival or departure	☐	☐

2. Has an ITS risk assessment been conducted within the past three years? ☐ Yes ☐ No

3. Are system security and application access logs enabled and reviewed periodically?

☐ Yes ☐ No

Comment: _____

4. If documents are retained in electronic format, are they stored in a format that cannot easily be modified, removed, or replaced, and does a mechanism/audit trail exist to track all such events?

☐ Yes ☐ No

Comment: _____

E. Accounting – Payroll

1. Does the company use an external payroll service? ☐ No ☐ Yes. Please specify: _____

2. What is the company's standard pay cycles?

☐ Bi-weekly ☐ Monthly ☐ 1st & 15th ☐ Other _____

If the company uses more than one pay cycle, please explain:

_____

3. Does the payroll register include the following data?

	Yes	No
a. Gross pay	☐	☐
b. Payroll deductions	☐	☐
c. Net pay	☐	☐
d. Check amount	☐	☐
e. Hourly rate	☐	☐
f. Pay period	☐	☐
g. Normal hours for pay period	☐	☐

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4. Does the company use an electronic timekeeping system?

☐ Yes ☐ No

If "yes," please provide an explanation of its operation, or provide system documentation:

_____

5. Are all employees responsible for signing their own timesheets? ☐ Yes ☐ No

If "no," please explain below:

_____

6. Are all employee timesheets approved by supervisors? ☐ Yes ☐ No

If "no," please explain below:

_____

7. Is there a certification and approval process required for all time worked by owners and principals?

☐ Yes ☐ No

If "no," then how is time accounted for and billed to projects?

_____

F. Labor Cost Accumulation

1. Does the company maintain timesheets, with reporting codes for both direct and indirect hours? (See AASHTO Guide, Chapter 6.)

☐ Yes ☐ No

- If "yes," do all employees, including principals and managers, code direct and indirect time on their timesheets?

_____

- If "no," then explain the method used to segregate direct and indirect labor hours.

_____

2. What are the company's normal hours of business operation (normal work week)?

_____

3. Do principals and other salaried personnel record all hours worked, including hours worked in excess of the normal week?

☐ Yes ☐ No. If "no," then please explain below:

_____

4. Uncompensated Overtime (see AASHTO Guide, Section 5.4):

(a) How does the company account for *uncompensated overtime*—the hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt from the Fair Labor Standards Act?

_____

(b) What is the effect of uncompensated overtime on direct and indirect labor rates?

_____

5. How does the company segregate work performed under a basic agreement/contract from work charged for contract changes/modifications?

_____

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AASHTO Internal Control Questionnaire for Consulting Engineers

G. Labor Billings

1. Please either describe how billing rates are determined, or attach the company's billing-rate policy.

_____

2. Does the company pay overtime at a premium? ☐ Yes ☐ No

   If "yes," what premium rate is paid, and who is eligible for this rate?

   _____

3. Is overtime premium ever billed directly to a job? ☐ Yes ☐ No

   Comment: _____

4. Are overtime costs charged consistently, regardless of the type of contract (lump sum versus actual cost) or customer (government versus commercial)?

   ☐ Yes ☐ No. If "no," then please explain below:

   _____

5. If the company pays a principal or an employee at a rate in excess of a contract's maximum hourly labor rate, where will the excess be assigned/charged?

_____

6. Does the company bill contract labor to projects? ☐ Yes ☐ No

   - If "yes," complete the following: Contract labor is billed—

   ☐ as part of direct labor, and overhead is applied.

   ☐ as an other direct cost (no overhead applied).

   ☐ Other. Please explain below:

_____

H. Expense Accumulation and Billing

1. Besides labor, what type of costs does the company normally bill as direct expenses?

_____

2. Is the indirect cost pool relieved/reduced for credits/reimbursements received for indirect costs?

   ☐ Yes ☐ No. If "no," then please explain below:

   _____

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3. Explain the accounting and billing for the in-house items listed below (check both "D" and "I," if applicable):

(D = Direct; I = Indirect; N/A = not applicable)	**D**	**I**	**N/A**
a. Vehicles	☐	☐	☐
b. Computer Assisted Design and Drafting (CADD)	☐	☐	☐
c. Computer (non-CADD)	☐	☐	☐
d. Telephone	☐	☐	☐
e. Printing / reproduction	☐	☐	☐
f. Postage	☐	☐	☐
g. Lab	☐	☐	☐
h. Drilling	☐	☐	☐
i. Travel and Subsistence	☐	☐	☐
j. GPS and/or Nuclear Density Meters	☐	☐	☐
k. Other (list if significant)	☐	☐	☐

4. Describe the accounting treatment for direct costs not billable to clients.

_____

5. **Vehicle Expenses**. Does the company provide vehicles to employees for business purposes?

☐ Yes ☐ No

a. If "yes," are the vehicles leased or owned?
☐ Leased ☐ Owned

b. Identify the total number of vehicles owned or leased by your firm.
_____ Leased _____ Owned

c. Are mileage logs maintained for all vehicles? If "no," please explain.
☐ Yes ☐ No

Explanation: _____

d. Is mileage separated by direct and indirect classifications, and is mileage incurred in connection with unallowable activities tracked? ☐ Yes ☐ No

Explanation: _____

e. What recovery/billing rate does the company use for company vehicle mileage reimbursement?
$_____ per mile.

Explanation: _____

f. How was the rate developed?

_____

6. **Computer Expenses**. Are the company's computer expenses incurred as a result of: (select one)

a. ☐ Outside Services? ☐ Company ownership? ☐ Both?

b. Does the company compute a charge rate for computers? ☐ Yes ☐ No

- If "yes," what is the rate? _____
- How was the rate developed?

_____

c. Is computer usage segregated by direct and indirect classifications? ☐ Yes ☐ No

d. Are computer usage logs maintained and coded by job/project? ☐ Yes ☐ No

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7. **Printing and Reproduction Costs**. How are printing and reproduction expenses treated?

- In House: ☐ Direct cost ☐ Indirect cost ☐ Combination of direct and indirect
- Outside vendor: ☐ Direct cost ☐ Indirect cost ☐ Combination of direct and indirect

If you marked "combination of both," please explain below:

_____

a. For in-house services, are usage logs maintained and coded by job/project?

☐ Yes ☐ No

b. Is usage segregated by direct and indirect classifications?

☐ Yes ☐ No

c. If these costs are incurred through the use of an outside vendor, are the invoices coded by job/project when received?

☐ Yes ☐ No

8. **Telephone Costs**. How is the telephone service expense billed?

☐ Direct cost ☐ Indirect cost ☐ Combination of direct and indirect

If you marked "combination of both," please explain below:

_____

- Does the company maintain a telephone log to record toll calls? ☐ Yes ☐ No
- Are the calls job coded by direct and indirect classifications? ☐ Yes ☐ No

I. Other - General

1. Did the company pay bonuses during the period covered by the latest overhead schedule?

☐ Yes ☐ No

- If "yes," were the bonuses included in the submitted overhead rate? ☐ Yes ☐ No
- Was any portion of these bonuses excluded from the submitted overhead rate? ☐ Yes ☐ No

Comment: _____

2. Does the company have a written bonus plan? ☐ Yes ☐ No. If "yes," please provide a copy.
3. Are all employees eligible for the bonuses? ☐ Yes ☐ No. If "no," please explain below.

_____

4. Has the company, an independent CPA, or compensation consultant performed an evaluation of compensation for *reasonableness* in accordance with FAR 31.205-6? (See AASHTO Guide Section 7.5.)

☐ Yes ☐ No

- If "yes," please describe how this process has been documented:

_____

5. If the company rents facilities from another organization, are any of the company's owners/stockholders, or members of their immediate family, also owners/stockholders in the other organization?

☐ Yes ☐ No

- If "yes," please explain:

_____

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6. Does the company pay life insurance for officers/principals of the company?

☐ Yes ☐ No

- If "yes," please identify the beneficiary of the life insurance:

_____

7. Has the company, its parent, subsidiary, or any owner, stockholder, officer, partner, or employee of the company been suspended or debarred from doing business by any State or the Federal government?

☐ Yes ☐ No

- If "yes," please provide complete details :

_____

8. Does the company have an existing process designed to provide timely updates to company procedures to accommodate changes in the FAR Subpart 31.2 cost principles?

☐ Yes ☐ No

Description:_____

9. Does the company have a process for assessing risks that may result from changes in cost accounting systems or processes?

☐ Yes ☐ No

- If "yes," please describe the process. How are risks identified and addressed?

_____

10. How does information flow from the FHWA/State DOT to appropriate management personnel?

_____

I certify that to the best of my knowledge and belief this ICQ is a complete and accurate representation of the above-named company's cost accounting and billing practices.

_____
Typed or Printed Name

_____ _____ _____
Signature **Title** **Date Completed**

Note: The representations on this ICQ were made by, and are the responsibility of, the company's management.

Clear Form Data

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Appendix

C

Keyword Index of 48 CFR Part 31

(Federal Acquisition Regulation, Part 31)

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Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(d)(1)	Accrual of Compensation Expenses (allowable).	YES†
31.201-2(d)	Adequate Recordkeeping (requirement for, and authority to disallow unsupported costs).	--
31.109	Advance Agreements: defined and requirements of (in writing, executed by both parties, stated duration).	--
31.205-1(b)	Advertising defined (generally, allowability is limited to recruitment costs)	YES - help wanted
31.205-1(d)	Advertising (allowable types of).	YES
31.205-1(f)	Advertising (unallowable types of).	NO
31.205-38(b)(1)	Advertising as a part of selling costs.	NO
31.205-51	Alcoholic Beverages.	NO
31.205-46(b)	Airfare, generally.	YES
31.205-46(c)	Aircraft owned by consultants.	YES†
31.201-4	Allocability (Allowability, Reasonableness, and Allocability).	--
31.201-2 & 31.204	Allowability (Reasonable, Allocable, CAS Compliant, meets Terms of K, & not otherwise unallowable).	--
31.205-52	Asset Valuations Resulting from Business Combinations.	--
31.201-6(a)	Associated Costs, defined (costs associated with unallowables). See also CAS 405.	NO
31.205-46(a)(1)	Automobile--Mileage Costs.	YES
31.205-6(m)(2)	Automobile--Personal Use of (see also 31.205-46(d)). Includes commuting and other personal costs.	NO
31.205-6(f)(1)	Awards to Employees (Performance-Based Awards--bonus and incentive compensation).	YES
31.205-18(c)	B&P: Bid and Proposal Costs (allowability of).	YES
31.205-18	B&P: Bid and Proposal Costs (generally).	YES
31.205-6(h)	Back pay (backpay). Generally unallowable.	NO
31.205-3	Bad Debts (and directly-associated costs).	NO
31.205-6(p)	BCA (Benchmark Compensation Amount).	YES
31.205-6(p)	Benchmark Compensation Amount for Executives (adoption of).	--
31.205-4	Bonding Costs (e.g., bid, performance, payment, infringement, and fidelity).	YES
31.205-6(f)	Bonuses and Incentive Pay.	YES
31.205-6(f)(1)(ii)	Bonus: Basis and Support For.	YES
31.205-1(f)(5)	Brochures and Promotional Materials.	NO

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KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.201-3(a)	Burden of Proof on Consultant (Determining Reasonableness).	--
31.205-52	Business Combinations (Asset Valuations Resulting from).	LIMITED DEPR.
31.205-16(a)	Business Combinations (Gains and Losses Related to).	NO
31.205-11(h)	Capital Leases (full payment not allowable--limited to depreciation of property capitalized under the lease).	LIMITED DEPR.
31.205-11(h)(2)	Capital Leases: Related Parties.	LIMITED DEPR.
31.205-43(a)	Chambers of Commerce, Dues (but disallow portion of dues attributable to lobbying).	YES†
31.103	Commercial Organizations (contracts with).	--
31.205-36(b)(3)	Common Control of Leased Properties (e.g., between sub. and parent: limited to normal costs of ownership).	YES†
31.205-6(p)	Compensation Amount.	YES
31.205-44(f)	College Savings Plans for Dependents of Company Employees.	NO
31.205-6	Compensation for Personal Services.	YES
31.105	Construction and Architect-Engineer Contracts.	--
31.201-7	Construction and Architect-Engineer Contracts.	--
31.205-33	Consultant Service Cost and Professional Fees (outside accountants, lawyers, actuaries, and marketing consultants). AKA Professional and Consultant Service fees (PCS costs). See Retainer fees at 31.205-33(e).	YES†
31.205-7	Contingencies.	NO
31.205-42	Contract-Termination Costs.	VARIES
31.205-8	Contributions or Donations.	NO
31.205-1(e)(3)	Contributions or Donations: Community Service Activities.	YES
31.205-10	Cost of Money.	YES
31.205-14	Country Club Memberships.	NO
31.201-5	Credits.	OFFSET
31.205-47	Defense of Fraud (False Claims Act, Anti-Kickback Act, etc.).	NO†
31.205-18(d)	Deferred IR&D Costs: Allowability.	NO†
31.001	Definitions.	--
31.205-44(f)	Dependents: Employee-dependent education plans	NO
31.205-11	Depreciation.	YES

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KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-11(c)	Depreciation: May not exceed amount used for financial accounting.	NO
31.205-11(a)	Depreciation: Salvage Value (only applicable if >10%; not applicable to DB or MACRS)	--
31.202	Direct Costs.	YES
31.205-38(b)(5)	Direct Selling Costs.	YES
31.201-6(a) & CAS 405-40	Directly-Associated Costs, defined (costs associated with unallowables).	NO
31.205-28(f)	Directors' Meetings	YES
31.205-6(a)(6)(ii)(B)	Distribution of Profits to Owners (unallowable).	NO
31.205-8	Donations	NO
31.205-13	Dormitory Costs and Credits.	YES
31.202(a) & 31.203(b)	Double-Counted Costs (unallowable).	NO
31.205-43	Dues and Subscriptions.	YES
31.205-12	Economic Planning Costs.	YES
31.205-44	Education Costs (vocational training, part-time college, full-time college)	YES
31.205-6(f)	Employee Performance Awards (bonuses and incentive).	YES
31.205-6(n)	Employee Rebate and Purchase-Discount Plans.	NO
31.205-6(q)	Employee Stock Ownership Plans (ESOPs).	YES
31.205-14	Entertainment Costs (overrides all other cost principles).	NO
31.205-6(q)	ESOPs.	YES
31.205-6(q)(2)(i)(B)	ESOP: Current Funding Requirement.	YES
31.205-41(b)(1)	Excess Profits Taxes.	NO
31.205-6(p)(1)	Executive Benchmark Compensation Amount (reference to). Note that these costs are further limited by reasonableness--see National Compensation Matrix (Audit Guide Section 6.4) for details.	YES†
31.205-41(b)(1)	Federal Income Taxes.	NO
31.205-15(a)	Fines, Penalties, and Mischarging Costs Related to Violation of Laws.	NO
31.205-15(b)	Fines, Penalties, and Mischarging Costs Related to Improper Charging or Recording of Costs.	NO
31.102	Fixed-Price Contracts.	--
31.205-13(d)	Food Service, and Dormitory Costs and Credits.	YES
31.205-47(b), (f)(4) & (g)	Fraud, Defense of (including requirement to segregate and account for these costs separately--see 31.205-47(g)).	SEGREGATE

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Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(m)	Fringe Benefits.	YES
31.205-16	Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets.	YES†
31.201-1	Generally Accepted Methods for Measuring Costs (requirement to use).	--
31.205-1(d)(2)	Gifts (to clients and the public as part of trade shows).	NO
31.205-13(b)	Gifts (to employees).	NO
31.205-6(l)(2)	Golden Handcuff Payments.	NO
31.205-6(l)(1)	Golden Parachute Payments.	NO
31.205-49	Goodwill.	NO
31.205-44(d)	Grants, Scholarships, and Fellowships to Educational or Training Institutions.	NO
31.205-13	Health, Welfare, Food Service, and Dormitory Costs and Credits.	YES
31.205-34(a)(1) & (b)	Help-Wanted Advertising Costs--Recruitment.	YES
31.205-35(a)(2)	House-Hunting Trip Costs (for employees with a permanent change of work location).	YES
31.205-17(b)	Idle Facilities Costs.	NO†
31.205-17(c)	Idle Capacity Costs.	YES
31.205-6(e)(1)	Income Tax Differential Pay (foreign assignments).	YES
31.205-6(e)(2)	Income Tax Differential Pay (domestic assignments).	NO
31.205-41(b)(1)	Income Taxes, Federal.	NO
31.205-41(a)(1)	Income Taxes, State and Local.	YES
31.205-18	Independent Research and Development and Bid and Proposal Costs.	YES
31.110	Indirect Cost Rate Certification and Penalties on Unallowable Costs.	--
31.203	Indirect Costs.	--
31.205-19	Insurance and Indemnification.	YES
31.205-20	Interest and Other Financial Costs.	NO
31.205-18	IR&D and B&P: Independent Research and Development and Bid and Proposal Costs.	YES
31.205-21	Labor Relations Costs.	YES
31.205-19(e)(2)(v)	Key-Man Life Insurance (allowable to extent that costs is included in compensation of officers--not allowable when company is beneficiary of policy)	LIMITED†

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Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-36(b)(1)	Leases (operating leases for real property and personal property)	YES
31.205-47	Legal and Other Proceedings.	YES
31.205-19(e)(2)(v)	Life Insurance	YES
31.205-22	Lobbying and Political Activity Costs.	NO
31.205-46	Lodging, Meals, and Incidental Expenses.	YES
31.205-35(c)(1)	Loss on Sale of Home (for employees with a permanent change of work location).	NO
31.205-23	Losses on Other Contracts.	NO
31.205-25	Manufacturing and Production Engineering Costs.	YES
31.205-1; 31.205-38	Marketing Costs. (Note: FAR Part 31 does not expressly use the term "marketing," but public relations, advertising costs, and selling costs are widely referred to as marketing by many individuals. Within the FAR, *selling costs* are the most analogous to marketing costs--see 31.205-38.)	NO
31.205-38(b)(4)	Market Planning.	YES
31.205-26	Material Costs (Direct Costs, primarily).	YES
31.205-46(a)(2)	Meals, Lodging, and Incidental Expenses.	YES
31.205-1(f)(7)	Memberships in Civic and Community Organizations.	NO
31.205-46(d)	Mileage Costs: Automobile.	YES
31.205-13	Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits.	YES
31.205-35	Moving Costs Paid to Employees.	YES
31.205-25	M&PE Costs (Manufacturing and Production Engineering Costs).	YES
31.205-19(e)(2)(v)	Officers' Life Insurance.	NO†
31.205-1(e)(4)	Open Houses.	YES
31.205-36	Operating Leases (real property and personal property).	YES
31.205-27(a)	Organization/Reorganization Costs.	NO
31.205-28	Other Business Expenses.	YES
31.205-30(c)	Patent Costs.	NO
31.205-15(a)	Penalties (costs associated with)	NO
31.205-6(j)	Pension Costs	YES
31.205-6(j)(1)(i)	Pension Costs: Current Funding Requirement	YES

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Key
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KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(j)(4)	Pension Costs: Defined Contribution Plans.	YES
31.205-6(j)(4)(i)	Pension Costs: Allowable Contribution Limited to	YES
31.205-6(f)	Performance Awards to Employees.	YES
31.205-6	Personal Services (compensation for).	YES
31.205-6(m)(2)	Personal Use of Automobiles.	NO
31.205-29	Plant Protection Costs.	YES
31.205-31	Plant Reconversion Costs.	NO
31.205-32	Precontract Costs (Direct Costs).	YES
31.205-43	Professional Activity Costs.	YES
31.205-33	Professional and Consultant Service Costs (outside accountants, lawyers, actuaries, and marketing consultants).	YES
31.205-19	Professional Liability and General Insurance	YES
31.205-6(a)(6)(ii)(B)	Profits to Owners, Distribution of (unallowable).	NO
31.205-1	Public Relations and Advertising Costs.	NO†
31.205-6(n)	Purchase-Discount Plans for Employees.	NO
31.205-1(f)(5)	Promotional Materials.	NO
31.205-35(a)(3)	Real Estate Brokers' Fees and Commissions (for employees with a permanent change of work location).	YES
31.201-3	Reasonableness. (No presumption of reasonableness exists.)	--
31.205-31	Reconversion Costs.	NO
31.201-2(d)	Record-keeping Requirements (Consultants' Responsibility to Maintain Adequate Records).	--
31.205-13(c)	Recreation for Employees.	NO†
31.205-34	Recruitment Costs.	YES
31.205-36(b)(3)	Common Control of Leased Properties (e.g., between sub. and parent).	YES†
31.201-6(a)	Related Costs (Costs Related to Unallowable Costs). See also CAS 405.	NO
31.205-36(b)(3)	Related Party Transactions: Rental Costs	YES†
31.205-35	Relocation Costs Paid to Employees.	YES
31.205-36	Rental Costs--Operating Leases.	YES

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Key
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KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-27	Reorganization Costs.	YES
31.205-48	Research and Development Costs.	YES
31.205-37(a)	Royalties and Other Costs for Use of Patents (Direct Costs).	YES
31.205-11(h)(1)	Sale and Leaseback.	YES†
31.205-38	Selling Costs (all marketing of the consultant's products or services)	LIMITED†
31.205-1(f)(3)	Seminars, Symposia, and Meetings-When to Disallow Costs.	NO
31.205-39	Service and Warranty Costs (Direct Costs).	YES
31.205-42	Settlement Costs Associated with Contract Terminations.	VARIES
31.205-6(g)	Severance Pay.	YES
31.205-14	Social and Dining Club Memberships (Entertainment).	NO
31.205-40	Special Tooling and Special Test Equipment Costs (Direct Costs).	YES†
31.205-41(a)(1)	State Income Taxes.	YES
31.201-6(c)(2)	Statistical Sampling for Unallowable Costs.	ONLY IF(*)
31.205-28(a)	Stock Issue Costs.	YES
31.205-43(b)	Subscriptions and Dues	YES
31.205-41	Taxes.	YES†
31.205-42	Termination Costs (Direct Costs).	VARIES
31.201-1(a)	Total Cost, Defined.	--
31.205-43	Trade, Business, Technical and Professional Activity Costs.	YES
31.205-1(f)(2)	Trade Shows.	NO
31.205-44	Training and Education Costs.	YES
31.205-46	Travel Costs.	YES
31.201-6	Unallowable Costs (and Related Costs)	--
31.201-4	Uncompensated Overtime.	NO
31.205-13	Welfare, Food Service, and Dormitory Costs and Credits.	YES

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Appendix

D

Appendix D – Listing of Resource Materials

This section provides a listing of resource materials commonly used by auditors who perform Government contract audits. The listing is not comprehensive; instead, it merely highlights the most frequently used materials. While paper copies are available, most of the publications also are available on CD ROM disks or the Internet. The electronic versions of these documents are especially useful because of the built-in search features that enable users quickly to find specific information.

Accounting Standards - Current Text

Published by:

Financial Accounting Standards Board

Format:

- Hard-copy 3 volume set
- Website address: http://www.fasb.org

Purpose:

The *Accounting Standards Current Text* 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.

American Institute of Certified Public Accountants (AICPA) Publications

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:

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

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Relevant Materials:

- AICPA Professional Standards (Two Volume Set)
- Audits of Federal Government Contractors - Audit and Accounting Guide
- Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments and Non-Profit Organizations
- Codification of Statements on Auditing Standards. See for example, *SAS 99: Consideration of Fraud in a Financial Statement Audit* (October 2002).
- Accounting Trends and Techniques -CD-ROM
- Audit Sampling - Auditing Practice Release
- Auditing in Common Computer Environments - Auditing Practice Release
- Codification of Statements on Standards for Attestation Engagements

Cost Accounting Standards (CAS)

Published by:

Cost Accounting Standards Board (CASB), a section of the Office of Federal Procurement Policy within the U.S. Office of Management and Budget. The CASB has the exclusive authority to issue and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts that involve Federal funds. The CAS are codified in 48 CFR Chapter 99.

Format:

Available in hard copy and electronic format. See the Code of Federal Regulations homepage: http://www.gpoaccess.gov/cfr/index.html.

Purpose:

The Board has the exclusive authority to make, promulgate, amend, and rescind cost accounting standards and regulations, including interpretations thereof, designed to achieve uniformity and consistency in the cost accounting practices governing measurement, assignment, and allocation of costs to contracts with the United States Government.

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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 via the Acquisition Knowledge Sharing System (AKSS) at: http://www.dcaa.mil/cam.htm.

Purpose:

Quote, per manual—

> This manual is issued to provide technical audit guidance, audit techniques, audit standards, and technical policies and procedures to be followed by DCAA personnel in the execution of the contract audit mission.

Federal Acquisition Regulation (FAR)

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 : http://www.arnet.gov/far. Another way to access the web site is at the Federal Government main home page : http://www.usa.gov, then search for "Federal Acquisition Regulation."

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.

Federal Travel Regulation

Provides information on travel guidelines for Federal government rates at: http://www.fedtraveler.com.

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Government Auditing Standards - 2007 Revision ("Yellow Book")

Published by:

United States Government Accountability Office (GAO), by the Comptroller General

Format:

Available in paper, CD ROM and on the Internet at http://www.gao.gov/govaud/ybk01.htm.

Purpose:

Quote from introduction—

The professional standards and guidance contained in this document, commonly referred to as generally accepted government auditing standards (GAGAS), provide a framework for conducting high quality government audits and attestation engagements with competence, integrity, objectivity, and independence. These standards are for use by auditors of government entities and entities that receive government awards and audit organizations performing GAGAS audits and attestation engagements. GAGAS contain requirements and guidance dealing with ethics, independence, auditors' professional competence and judgment, quality control, the performance of field work, and reporting. Audits and attestation engagements performed under GAGAS provide information used for oversight, accountability, and improvements of government programs and operations. GAGAS contain requirements and guidance to assist auditors in objectively acquiring and evaluating sufficient, appropriate evidence and reporting the results. When auditors perform their work in this manner and comply with GAGAS in reporting the results, their work can lead to improved government management, better decision making and oversight, effective and efficient operations, and accountability for resources and results.

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Appendix

E

Appendix E – Sample Management Representation Letters

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[Firm Letterhead]

Management Representation Letter – Contract Audit

[Insert Month Day, Year]

[AGENCY]
[ADDRESS]
[ADDRESS]
[ADDRESS]

We are providing this letter in connection with your examination of our job cost records for contract ***[insert contract number]***. We confirm that we are responsible for the fair presentation of job cost records in conformity with: generally accepted accounting principles; contractual provisions; and Federal Acquisition Regulation, Subparts 9900, 31.105 and 31.2. We are also responsible for adopting sound accounting policies, establishing and maintaining internal control, and preventing and detecting fraud.

We confirm to the best of our knowledge and belief, as of ***[insert date]***, the following representations made to you during your examination.

1. The financial information referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all the financial records requested and
   A. These records were prepared from ***[insert company name]*** official records.
   B. The job cost ledger provided for examination contains actual direct costs and quantities incurred for contract ***[insert contract number]***.
3. There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
4. There are no material transactions that have not been properly reported in the accounting records underlying the job cost accounting system.
5. There has been no:
   A. Fraud involving management or employees who have significant roles in internal control.
   B. Fraud involving others that could have a material effect on the financial statements.
6. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
7. The following have been properly recorded or disclosed in the financial job cost records:
   A. Related party transactions and related accounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.
   B. Guarantees, whether written or oral, under which the company is contingently liable.
8. There are no:
   A. Violations or possible violations of laws or regulation whose effect should be considered for disclosure in the financial statements or as a basis for recording a contingency loss.

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B. Unasserted claims or assessments that our legal staff has advised us are probable of assertion and must be disclosed in accordance with *Statement on Financial Accounting Standards No. 5*.

C. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by *Statement of Financial Accounting Standards No. 5*.

9. The company has satisfactory title to all owned assets, there are no liens or encumbrances on such assets, and no asset has been pledged as collateral.

10. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

No events have occurred subsequent to the job cost ledger date and through the date of this letter that would require adjustment to our contract costs or require any further disclosure.

Printed or Typed Name: _____

Signature: _____

Title: _____

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[Firm Letterhead]

[DATE]

[AGENCY]
[ADDRESS]
[ADDRESS]
[ADDRESS]

Dear [AGENCY REPRESENTATIVE]

We are providing this letter in connection with your audit of [FIRM NAME] Statement of Direct Labor, Fringe Benefits and General Overhead (hereinafter "Statement") for the period [MONTH, DATE] through [MONTH, DATE, YEAR]. We confirm that we are responsible for the Statement.

Certain representations in this letter are described as being limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

As of the above date, we confirm, to the best of our knowledge and belief, the accuracy of the following representations made to you during your audit.

1. The aforementioned Statement is a fair and accurate representation of our firm's costs for year [YEAR]; furthermore, the Statement was prepared on a basis of accounting prescribed in Part 31 of the *Federal Acquisition Regulation*.
2. We have made available to you all financial records and related data. We are not aware of any accounts, transactions, or material agreements not fairly described or properly recorded in the financial accounting records underlying the computations used in the preparation of the Statement.
3. We have received no communications from regulatory or enforcement agencies concerning either of the following: (a) noncompliance with applicable laws or regulations or (b) deficiencies in financial reporting practices.
4. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
5. There has been neither—
    a. Fraud involving our firm's management or employees who have significant roles in internal control; nor
    b. Fraud involving others who could have a material effect on the Statements.
6. All related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees have been properly recorded or disclosed in the financial statements.
7. To the best of our knowledge, the computation and appended notes include all disclosures necessary for a fair presentation of the overhead rates shown in the Statement in accordance with Part 31 of the *Federal Acquisition Regulation*.

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8. There are no:
   A. Violations or possible violations of laws or regulation whose effect should be considered for disclosure in the financial statements or as a basis for recording a contingency loss.
   B. Unasserted claims or assessments that our legal staff has advised us are probable of assertion and must be disclosed in accordance with *Statement on Financial Accounting Standards No. 5*.
   C. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by *Statement of Financial Accounting Standards No. 5*.
9. The company has satisfactory title to all owned assets, there are no liens or encumbrances on such assets, and no asset has been pledged as collateral.
10. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
11. To the best of our knowledge and belief, no events have occurred as of the date of this letter that would require adjustment to or disclosure in the aforementioned statement.

Respectfully,

[INSERT PRINTED OR TYPED NAME AND TITLE] Date

Signature Date

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