

For Audits of Transportation Consultants



UNIFORM AUDIT & ACCOUNTING GUIDE

September 2005



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*AASHTO Uniform Audit and Accounting Guide
for Transportation Consultants
September 2005 Update*

Uniform Audit and Accounting Guide

For Audits of Transportation Consultants'
Indirect Cost Rates



Prepared by the American Association of State Highway
and Transportation Officials (AASHTO),
Audit Subcommittee

September 2005 Update

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Committee

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Uniform Audit and Accounting Guide

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Chapter 1—Introduction, About This Guide

This guide has been developed by the American Association of State Highway and Transportation Officials (AASHTO) Audit Subcommittee with assistance from the American Council of Engineering Companies (ACEC) Transportation Committee and the Federal Highway Administration (FHWA) Atlanta Resource Center. The AASHTO Audit Subcommittee is comprised of the senior person representing the audit function for each state's transportation or highway department. This guide was developed over several years and initially approved by AASHTO at the organization's 2001 annual meeting and has been endorsed by the ACEC Transportation Committee. Input was solicited from all regions during 2004 for the 2005 update.

An electronic version of this guide can be found on the AASHTO home page:
<http://audit.transportation.org>

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

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

Note: Individual states may have specific limits and guidelines. Up-to-date contact information for all states can be found at the AASHTO web site.

Chapter 2—Background

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

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

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

Contract Engagements generally include the following:

INDIRECT COST RATES (COST INCURRED)

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

INDIRECT COST RATES (FORWARD PRICING)

This engagement is performed to render an opinion on the consultant's forward pricing indirect cost rate(s) used to prepare estimates of costs that will be incurred in future periods. Forward pricing rates are similar to cost incurred rates in that they have a **basis in historical costs**. However, forward pricing rates

are adjusted to reflect estimates of future costs and activity levels to project indirect cost rates for future periods. Auditors of forward pricing rates must evaluate the reasonableness of future projections as well as the accuracy of historical cost information used as the starting point for the rate development. While most contracts negotiated directly with the Federal government utilize forward pricing rates, **many SHAs will only negotiate contracts using indirect cost rates based on historical information.** Risk and materiality should be determined with consideration given to all contracts, which may be priced using the indirect cost rate

CONTRACT PRE-AWARDS

Contract pre-awards are performed to evaluate the reasonableness and accuracy of a cost proposal for a specific contract. The auditor may examine the reasonableness of estimates used as well as the accuracy of estimate components that are based on current or historical costs. When conducting pre-awards, auditors often rely on work done by other auditors. If other reports do not exist, auditors performing the pre-awards may examine items like indirect cost rates, schedules, accounting system surveys, and financial capability reviews. Risk and materiality should be determined with consideration only to the contract being covered by the pre-award. Auditors may be required to perform additional work for very large contracts.

CONTRACT COSTS

These engagements are performed to determine actual costs incurred under contracts. The auditor should consider both direct and indirect costs to determine whether costs invoiced were **allowable** under applicable cost principles and treated consistently with cost accounting practices used to develop the consultant's indirect cost rate(s). When conducting such engagements, auditors often rely on opinions rendered by indirect cost rate auditors. In addition to using the indirect cost rate, the auditor may be able to rely on evaluation and testing of accounting systems that were performed during indirect cost rate engagements. Risk and materiality should be determined with consideration only to the contract(s) being covered.

Auditing Standards

Auditing procedures and responsibilities may vary depending on the nature of the audit or attestation engagement procedures performed by the auditor. Several regulatory bodies may influence the types of procedures that will apply to planning, performing, and reporting on the results.

Government Auditing Standards ("**Yellow Book**")

These standards, published by the Comptroller General of the United States of America, apply to audits of government entities and government assistance paid to contractors, non-profit organizations, and other non-governmental organizations. They are often referred to as **Generally Accepted Government Auditing Standards (GAGAS)**. The standards were revised and reissued in June 2003. Standards include the following:

- GAGAS may be used in conjunction with professional standards issued by other authoritative bodies. For example, the American Institute of Certified Public Accountants (AICPA) has issued professional standards that apply in financial audits and attestation engagements performed by certified public accountants (CPA). *GAGAS incorporate the AICPA's field work and reporting standards and the related statements on auditing standards for financial audits unless specifically excluded. 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. **GAGAS also prescribe requirements in addition to those provided by the AICPA to meet the needs of users of government audits and attestation engagements.** Auditors may also consider other standards depending on the purpose and requirements of the audit or engagement.

GAGAS categorizes government audits and attestation engagements into three types for determining the appropriate standards. More than one type may apply to an audit engagement depending on the audit objectives.

- **Financial Audits** are 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 a Schedule of Indirect Costs (considered a financial statement) in compliance with Part 31 of the Federal Acquisition Regulations. Financial audits may also include other objectives that provide different levels of assurance and entail various scopes of work.
- **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 non-financial subjects and can be part of a financial audit or performance audit. Examples include 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.
- **Performance Audits** entail an objective and systematic examination of evidence to provide an independent assessment of the performance and management of a program. These audits are generally performed to improve program operations and may encompass a wide variety of objectives. Examples include whether legislative, regulatory, or organizational goals are being achieved, the relative cost and benefits of a program and the validity and reliability of performance measures.

The following page provides a summary matrix of applicable standards for audits of Schedules of Indirect Costs.

Matrix of Generally Accepted Government Auditing Standards (GAGAS)

Note: The standards to be used vary depending on the type of audit or engagement. GAGAS standards generally include AICPA standards as well as additional GAGAS required standards. The following chart may be used as a guideline to determine the applicable standards. The Yellow Book should be consulted for the complete text of the standards.

Standard Category	Source	Financial Audit Standards	Examination Level Attestation Engagement Standards
General	AICPA	None	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	Audit Documentation	Similar to Financial
Reporting	AICPA	GAAP or Not GAAP	None
	AICPA	Consistent Between Periods	None
	AICPA	Informative Disclosures	None
	AICPA	Opinion or Expression of Non-Opinion	None
	AICPA	None	Engagement Subject Matter
	AICPA	None	Practitioner's Conclusion
	AICPA	None	Practitioner's Reservations
	AICPA	None	Report Distribution Restrictions
	GAGAS	In Accordance with GAGAS	Same as Financial
	GAGAS	Internal Control Report	None
	GAGAS	Reporting Deficiencies	Same as Financial
	GAGAS	Responsible Officials Views	Same as Financial
	GAGAS	Privileged and Confidential Info	Same as Financial
	GAGAS	Report Distribution	Same as Financial

- 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 adequacy of controls for publicly traded consulting firms.
- Other audit standards and procedures may be considered depending on the circumstances (e.g., Institute of Internal Auditors, Federal Agencies, etc.).

Chapter 3—Cost Principles

Federal Acquisition Regulations (FARs)

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

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

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

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

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

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

1. Any limitations set forth in Subpart 31.2 of the FARs.
2. Allocability;
3. Standards promulgated by the Cost Accounting Standards Board (CAS); if applicable, otherwise, Generally Accepted Accounting Principles and practices appropriate to the particular circumstances;

4. Terms of the contract; and
5. Reasonableness.

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

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

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

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

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

Costs that are expressly or mutually agreed to be **unallowable**, including directly associated costs, must be identified and excluded from any billing, claim, or proposal applicable to a government contract. A directly associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an **unallowable** cost is incurred, its directly associated costs are also **unallowable**. The practices to account for and present **unallowable** costs are described in 48 CFR 9904.405, Accounting for **Unallowable** Costs.

In evaluating a consultant's overhead, an auditor must consider direct as well as indirect costs. A **direct cost** is any cost that can be identified specifically with a particular contract or project. Costs identified

specifically with a contract or project are direct costs and are to be charged directly to the contract or project. All costs specifically identified with a project are direct costs of that project and cannot be charged to another project, either directly or indirectly. Finally, a cost cannot be charged as direct and also be

included in any indirect cost pool. For reasons of practicality, small dollar direct cost items 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. 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 consultant's method of allocating overhead costs should be in accordance with generally accepted accounting principles, and are consistently applied.

Contracts may be subject to Cost Accounting Standards (CAS), which are promulgated by the Cost Accounting Standards Board (CASB), an independent board that reports to the Office of Federal Procurement Policy, within the OMB. All Federal contracts in excess of \$500,000 are subject to CAS regulations, unless specifically exempted.

A **distribution base** common to all cost objectives or projects is selected for allocation of an overhead or indirect cost pool. **Many consultants use direct labor as the base for developing overhead rates.** However, many large Federal contractors have rate structures that are more complex and utilize more than a single base for allocating costs. A typical example follows:

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

* In this scenario all costs are in the base for G&A expenses including direct labor, indirect labor, fringes, OH, unallowables, sub-consultants, etc.

Once a base or bases have been established, they should not be adjusted by removing individual components such as establishing individual segment rates, whose costs are already included in the overall rates. Rate structures and cost allocation methods must be consistent for all Federal and State government contracts. See Chapter 4 for additional information.

The **base period** for most consultants' overheads will normally be the firm's fiscal year, when a contract is performed over an extended period, as many base periods shall be used as are required to represent the period of contract performance. In certain instances an agreed upon rate may be used over the duration of the contract.

Chapter 4—Cost Accounting

Allocation Bases

An allocation base is the means by which certain overhead or indirect costs are distributed to final cost objectives. There are a variety of allocation bases which are commonly used in cost accounting systems for allocating indirect costs, however, for State Highway Agency (SHA) administered engineering contracts **direct labor cost** is the most frequently used base. Whatever base is used for cost allocation, it should be consistent for all government contracts. Some of the common methods include:

Direct Labor Cost

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

Direct Labor Hours

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

Total Labor Hours (Total Hours Worked)

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

Total Costs

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

Total Cost Value Added

This basis is similar to the Total Cost base shown above to allocate G&A costs. However, the value-added basis excludes materials (used primarily in production only) and subcontract costs. Distortion in allocations may occur due to a disproportionate amount of subcontract costs or materials in the pool.

Usage

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

Cost Centers

Cost centers are established to accumulate and segregate costs.

Functional Cost Centers

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

Subsidiaries, Affiliates, Divisions, and Geographic Locations

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

Allocated Costs

Fringe Benefits

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

Overhead

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

General & Administrative

This expense generally is all costs associated with the entire business' operation, which cannot be specifically identified with a smaller unit of business activities. Example, certain management or administration costs that are incurred for an entire business unit may be considered G&A, but other accounting or legal costs benefiting a segment of the business may be considered part of the overhead pool of that specific segment.

Computer/CADD Costs

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

Fleet or Company Vehicles

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

Equipment

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

Printing/Copying/Plan Reproduction

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

Direct Labor

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

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

An adequate labor accounting system, manual or electronic, will create an audit trail whenever an employee creates a timesheet entry. A system that allows an audit trail to be destroyed is inadequate because the integrity of the system can be easily compromised. Access to timesheets should be controlled and preprinted, if possible, with the employee's name, number, and fiscal week. An inadequate system would allow employees to erase prior entries without recording the adjustment; adjustments should be maintained as part of the audit trail.

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

Uncompensated Overtime

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

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

Acceptable accounting methods for uncompensated overtime:

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

Any other methods would require further review to determine acceptability.

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

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

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

Premium Overtime

Consultants should have the capability of maintaining records that segregate overtime premium amounts as direct or indirect costs. An acceptable method is to charge premium overtime as a direct charge when it is the consultant's regularly established policy and when appropriate tests

demonstrate that this policy results in equitable cost allocations. Premium overtime should be segregated as a direct cost whether reimbursable or not.

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 overtime premium is allocated to overhead.

Other Labor Considerations

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

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

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

Areas of Potential Risk

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

Sole Proprietors' and Partners' Salaries

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

Contract Labor/Purchased Labor

In some cases, firms contract for services provided by engineers, technicians, etc. rather than hire individuals as employees. This is commonly referred to as "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:

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

Other Direct Costs—Outside Vendors/Employee

Expense Reports

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

Field Office Rates

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

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

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

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

Field Office Indirect Costs

As a general rule, SHAs do not require extensive staffing of consultants' field offices. Most administrative and management functions will be performed in the home or branch office. Therefore, an equitable portion of these offices' indirect costs should be allocated to the field office. The costs that are allocated, and the basis for the allocation, depend largely on the consultant's customary accounting practices. Some SHAs require separate cost centers for accumulation of field office costs.

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

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

Indirect Labor—Non-Project Time: Labor costs pertaining to non project time of professional staff is generally recorded specifically within the Field or Home Office accounts. If these costs are not segregated a ratio based on the Field Office Direct Labor percentage may be used to allocate costs to the Field Offices.

Indirect Labor—Support Staff: Indirect salaries (accounting, legal, purchasing, personnel, management, etc.) should also be allocated to the field office overhead pool. A ratio of total Field Office labor to Total Company Labor would be a reasonable method to allocate these costs. Some firms allocate the costs on a direct labor basis.

Indirect Expenses

Certain field office related costs should be allocated 100 percent to the field office pool (e.g., field equipment, on-site trailer rental for multiple projects, field supplies, etc.).

Other general indirect expenses are allocated to the field office overhead pool based on a reasonable estimate of the benefits accruing to the field office pool. One possible method is to compute a percentage based on the field office total labor compared to the total company labor:

$$\frac{\text{Field Labor (Direct plus Indirect)}}{\text{Total Company Labor (Direct plus Indirect)}} = \text{Field Office Labor \%}$$

The resulting percentage is applied to the various general expense line item accounts identified in a firm's overhead schedule.

Note: The firm must disclose the existence of Field Office Rates in the Schedule of Indirect Costs. A separate column showing the Field Office expenses, direct labor and resulting rate along with footnote disclosure describing allocation methods used should be provided. An example of a Schedule of Indirect Costs including a Field Office rate is included in Chapter 9.

Chapter 5—Selected Items of Cost

The purpose of this chapter is to provide guidance for **selected items of cost**. It is organized by FAR Part 31.2 sub-sections in ascending order, numerically. It is not meant to be authoritative or to supersede the FARs. The items in this chapter have been reviewed and updated as of March 2005, although the FAR is continuously revised. The entire text of the FARs should be consulted when determining proper accounting treatment (see Chapter 12 for sources). A listing of Common Unallowable Expenses, to be used as a quick reference, is included at the end of this chapter.

Advertising and Public Relations (FAR 31.205-1)

Advertising Costs

Selected **allowable** advertising costs include:

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

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

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

Trade Show Expenses and Labor

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

Public Relations Costs

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

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

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

Bad Debts and Collection (FAR 31.205-3)

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

Compensation (FAR 31.205-6)

Reasonableness (refer to FAR 31.201-3 and 31.205-6(b))

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

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

Bonuses and Incentive Compensation (FAR 31.205-6(f))

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

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

Auditors may challenge bonus plans that are not based strictly on production, cost reduction, or efficient performance.

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

Compensation Limits (Executive Compensation Benchmarks) (FAR 31.205-6(p))

Compensation limitations involve numerous factors including size of firms, type of industry, geographic area, classes of employees doing similar work, type of ownership, form of compensation payments, and other factors. Auditors must review a wide range of company information and review outside sources in order to determine reasonable compensation.

In addition to reasonableness, executive compensation for government contractors is specifically limited by part 31.205-6(p) of the FARs. This section of the FAR must be referenced in order to apply the limits for senior executives.

Benchmarks are established annually by the Office of Federal Procurement Policy (OFPP), which is under the Office of Management and Budget (OMB). The Office of Management and Budget Administrator, pursuant to Section 808 of Public Law 105-85, determines the limits, which are based on salaries of executives of publicly owned corporations that have annual sales of over \$50 million. The term compensation includes wages, salary, bonuses, deferred compensation, and employer contributions to defined pension plans. The cost rule is applied to the senior executives at corporate offices and business segments.

Maximum limits for contract costs incurred after the following effective dates are as follows: (The amounts can be obtained annually from the OMB web site)

Maximum Compensation Limits

July 1, 1996	\$200,000
January 1, 1997	\$250,000
January 1, 1998	\$340,650
January 1, 1999	\$342,986
January 1, 2000	\$353,010
January 1, 2001	\$374,228
January 1, 2002	\$387,783
January 1, 2003	\$405,273
January 1, 2004	\$432,851
January 1, 2005	\$473,318

Pension Plans (FAR 31.205-6(j))

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

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

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

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

Employee Stock Ownership Plans (FAR 31.205-6(q))

Employee stock ownership plans (ESOPs) are an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. These complex plans have become more prevalent in recent years. The contractor's contributions to an employee stock ownership trust (ESOT) can be in the form of cash, stock, or property.

The purpose of an ESOP may be for deferred compensation or for a supplementary pension plan; each would be covered by different regulations. In order to determine whether certain ESOP costs are allowable, FAR 31.205-6(q) should be referenced along with Cost Accounting Regulations 48 CFR 9904.412 and .415.

Valuations for ESOPs must be done on a case-by-case basis and certain contributions in excess of fair market value are **unallowable**.

Severance Pay (FAR 31.205-6(g))

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

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

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

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

the employee remaining with the organization after a change in management control is also **unallowable** (“golden handcuff”).

Personal Use of Company Vehicles (FAR 31.205-6(m)(2))

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

Contributions or Donations (FAR 31.205-8)

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

Cost of Money (FAR 31.205-10)

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

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

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

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

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

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

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

Depreciation (FAR 31.205-11)

In general, depreciation of plant, equipment and other capital 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.

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

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

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

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

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

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

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

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

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

Entertainment (FAR 31.205-14)

Costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are **unallowable**. Costs of membership in social, dining, country clubs, or other organizations having the same purposes are also **unallowable**, regardless of whether the cost is reported as taxable income to the employees.

Fines and Penalties (FAR 31.205-15)

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

Bid and Proposal (FAR 31.205-18)

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

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

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

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

“Key-man life insurance” is individual insurance, (not group insurance for all employees), on the lives of officers, partners, proprietors, or employees who are considered critical to the operations of the company. The company is named as the beneficiary and each person insured is evaluated based on his/her age, health history, and value to the company. The premiums are considered an **unallowable** expense unless the insurance is included as additional compensation to the employee, and the employee’s family is listed as beneficiary.

“Re-work insurance” is not a term used in the FAR. Insurance industry terminology is generally “Professional Liability” or “Errors and Omissions,” which is a type of casualty insurance. FAR 31.205-10(e)(3) contains the following provision:

“The cost of insurance to protect the contractor against the costs of correcting its own defects in materials and workmanship is **unallowable**. However, insurance costs to cover fortuitous or casualty losses resulting from defects in materials or workmanship are **allowable** as a normal business expense.”

Interest Costs (FAR 31.205-20)

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

Lobbying Costs (FAR 31.205-22)

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

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

Losses on Other Contracts (FAR 31.205-23)

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

Organization and Reorganization (FAR 31.205-27)

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

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

Patent Costs (FAR 31.205-30)

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

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

Retainer Agreements (FAR 31.205-33)

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

Relocation Costs (FAR 31.205-35)

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

- mortgage-related costs if employees were not homeowners prior to the move
- if the move was for a period of time less than 12 months
- the move does not benefit the employer
- employer does not have a consistent relocation policy for all employees
- costs represent loss on sale of a home
- continuing mortgage principal payments on sold residence

Rent/Lease (FAR 31.205-36)

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

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

1. The lease transfers ownership of the property to the lessee by the end of the lease term.
2. The lease contains a bargain purchase option.
3. The lease is equal to 75 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.

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

Selling Costs (FAR 31.205-38)

Selling costs are **allowable** if reasonable.

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

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

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

Travel Expenses (FAR 31.205.46)

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

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

- Date and place
- Purpose of trip
- Name of personnel or relationship to the company
- For transportation costs a log must be maintained

Legal Costs (FAR 31-205-47)

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

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.

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

A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. These combinations are classified as mergers or consolidations and are accounted for as purchases or pooling of interests. The purchase method accounts for a business combination as the acquisition of one company by another (merger). Any difference between the cost of an acquired company and the sum of the fair values of tangible and identifiable intangible assets less liabilities is recorded as goodwill.

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

When the purchase method is used, **allowable** costs for amortization, cost of money, and depreciation are limited to the amounts that would have been allowed had the combination not taken place.

Consultants must maintain detailed records which identify and track elements of costs for future reporting periods.

Alcoholic Beverages (FAR 31-205-51)

Costs of alcoholic beverages are **unallowable** and consultant's records should clearly segregate these costs and exclude them from the indirect cost schedule. These costs should also not be included in direct contract cost invoices.

Listing of Common Unallowable Expenses

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

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

Chapter 6—Management’s Responsibility for Accounting Records

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

It is the responsibility of management to require CPAs to provide access to working papers to Federal or state agency auditors.

Schedule of Indirect Cost

The Schedule of Indirect Cost is the primary document for presenting the overhead rate. It will be developed from financial statement and/or general ledger amounts as well as from amounts in the company’s cost accounting system. This schedule must be in agreement with or reconciled to financial statement and/or general ledger amounts.

The schedule should clearly display the **unallowable** amounts that have been removed from the indirect expense accounts. If the schedule is presented “net of **unallowable** costs,” a description of the **unallowable** costs must be disclosed in the accompanying notes.

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

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

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

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 Schedule of Indirect Costs. The rate structure and allocation methodology should be clearly explained in the footnotes.

It should be emphasized the consultant is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed

have been incurred, are allocable to the contract, and comply with applicable cost principles. Examples of supporting documentation include time sheets and usage logs. Costs which are not adequately supported may be disallowed all or in part by the auditor. When accounting practices are inconsistent with the FARs, costs resulting from such practices shall not be allowed in excess of the amount that would have resulted from those consistent with the FARs.

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

Unallowable Costs

FARs 31.201-6 requires that **unallowable** costs and any directly associated cost be identified and excluded from billings, claims or proposals for government contracts. In addition, **unallowable** costs must participate in indirect cost allocations just as they would if they were **allowable**. See **Chapter 5** for a list of **common unallowable costs**.

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

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

Financial Statements

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

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

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

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

Disclosures

Disclosures are required to be included with financial statements and special schedules. This would include explanatory information about the financial data. Disclosures may describe the types of accounting systems and methods. They may describe the types of operations or contracts. A schedule of

principal owners is often included. **Note: For examples of minimum disclosure requirements see Chapter 9.**

Examples are:

- Whether the statements/schedules are, or, are not, in compliance with authoritative pronouncements such as GAAP, FARs, etc.
- Extraordinary events that may have a material impact on the financial statement/schedule amounts must be disclosed.
- Direct cost items that the firm regularly charges to projects should be clearly identified in a footnote.

Management Representations

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

- the financial information is **accurate**
- the financial information is **complete**
- the information is in **compliance** with government regulations (i.e., FARs)
- estimates are based on **sound** financial data and **consistent** assumptions
- all actual indirect cost rates represented to any government body have been disclosed

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

Some states require annual submissions of financial, procedural, and other company information as well as Schedules of Indirect Costs. Some states require annual CPA audits/examinations of the Schedule of Indirect Costs.

Under the provisions of the Sarbanes–Oxley Act of 2002, publicly traded companies must now submit annual reports that are management representations of the company's internal control structure. Also required is the CPA firm's attestation of the internal control reports.

Chapter 7—Audit Considerations

Consultant indirect cost rates present unique and significant issues that auditors must consider when planning and performing engagements. For detailed information and guidance, the following are some publications that may be helpful (additional sources are listed in Chapter 12):

- Government Auditing Standards (“Yellow Book”) by U.S. General Accounting 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 by 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 U.S. Office of Management and Budget
- 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 OFPP

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

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

Internal Controls

Management is responsible for maintaining an **effective internal control structure**. Much has been written in both the public sector and the government sector in recent years regarding appropriate internal control procedures. The unique requirements of cost-based government contracting require cycles and

elements of internal control that must be evaluated as part of the engagement. The following important elements must be considered during the auditor's evaluation of internal control of a consulting firm:

- Systems for monitoring compliance with government procurement regulations
- Estimating systems and proposal preparation practices
- Contract cost accounting practices
 - Systems for tracking and allocating labor cost
 - Systems for allocating non-labor direct costs
 - Systems for allocating costs through cost centers
- Billing procedures and controls
- Miscellaneous Revenues/Credits
- Change order identification, pricing, and reporting
- Cost aspects of related-party and inter-organizational transactions

Compliance with government procurement regulations is an important aspect for government contractors. Examples include compliance with **Cost Accounting Standards (CAS)** and **Federal Acquisition Regulations (FARs) Part 31**. Controls must be in place that are designed to provide reasonable assurance of compliance with applicable regulations. Management must ensure that employees are made aware of compliance policies and that procedures are carried out and updated as regulations change.

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

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

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

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

Other areas where management must devote significant attention include: **Disbursements/Expenditures, Allocations of Other Direct Costs, Billing Procedures, Related Party Transactions,** and **Interorganizational Transfers.** Systems must be in place to ensure accurate recording of transactions. Controls must exist to insure that entries are reviewed and approved and that errors are promptly corrected. Management must maintain records to support the transactions and provide for an audit trail. Where integrated accounting systems are in place, management must have procedures to ensure that transactions are accurately recorded, summarized, and transferred through the systems.

Understanding the Consultant's Business

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

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

Consideration of Other Financial and Contract Audits

Information may be obtained from the contractor pertaining to other audits. These may include Audited Financial Statements (by CPA firm), audits by other SHAs, audits by local government agencies, audits by Federal government agencies (i.e., Defense Contract Audit Agency), or financial statement compilations/reviews by CPA firms.

Computerized Information Systems

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

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

Audit Risk and Materiality

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

When making risk assessments, auditors must consider materiality. Under GAGAS, the terms "material" and "significant" are synonymous. This is a highly judgmental area where auditors must perform risk assessments in order to determine appropriate levels of risk for the specific engagement. One of the additional (beyond the three AICPA standards) GAGAS standards relate to: **"detecting material misstatements resulting from violations of contract provisions or grant agreements or from abuse."**

GAGAS 4.04 states: **"Auditors should use professional judgment and consider the needs of users in applying the AICPA standards and related guidance to audits of a government entity or an entity that receives government awards. For example, auditors may need to set lower materiality levels than in audits in the private sector because of the public accountability of the audited entity, the various legal and regulatory requirements, and the visibility and sensitivity of government programs."**

GAGAS 4.17a states: **"Auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from violations of provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts or other financial data significant to the audit objectives."**

GAGAS 4.18 states: **"AICPA standards and GAGAS require auditors to assess the risk of material misstatements of financial statement amounts or other financial data significant to the audit**

objectives due to fraud and to consider that assessment in designing the audit procedures to be performed.”

Type and Volume of Contracts

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

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

Chapter 8—Audit Engagement Procedures

General

The following guidelines should be considered when developing specific audit procedures for consultant indirect cost rate engagements.

Labor Costs

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

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

1. The labor sample should be tracked from employee time records to:
 - The payroll records to assure hours recorded are paid.
 - The cost system to assure hours are posted properly to jobs.
 - The general ledger to assure that the total posted is recorded in the financial accounting system.
2. The overall labor in general ledger accounts should be reconciled to:
 - The job cost system
 - The payroll reports submitted to the Internal Revenue Service (i.e., 941s).
3. Audit procedures should also determine if the labor accounts and individual time card entries sufficiently screen labor to:
 - Determine the allowability of payroll cost. (i.e., Do the records separate excess compensation and time spent on **unallowable** activities?)
 - Determine the proper allocation of labor. (i.e., Do the records charge all labor performed on similar tasks the same way?)
 - Determine if labor is posted in a manner from which the labor base can be computed. (i.e., If the base is direct labor without premium overtime do the records accumulate direct labor and direct premium overtime?)

Allocated Costs

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

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

Audit issues of particular concern are:

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

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

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

Other Direct Costs

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

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

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

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

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

Other Audit Procedures

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

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

1. A detailed overhead rate schedule is needed to assure the auditee has separated **unallowable costs** as required by FARs.
2. An accounting and control survey is needed which will answer questions about possible areas of concern. Examples are:
 - Gains or losses on assets
 - Personal use of autos
 - Transactions with common control entities
 - Bonus plans
 - Direct costing policies
 - Acquisitions and re-structuring
 - Depreciation schedules
3. A tax return prepared for the fiscal year(s) being audited. Many areas addressed in the return are of concern to the Internal Revenue Service as well as for government contracting.
4. A disclosure statement (required by Cost Accounting Standards) when Federal contracts exceed a given amount as follows:
 - (1) Any business unit that is selected to receive a CAS-covered contract or subcontract of **\$50 million or more** shall submit a Disclosure Statement before award.
 - (2) Any company which, together with its segments, received net awards of negotiated prime contracts and subcontracts subject to CAS totaling **\$50 million or more in its most recent cost accounting period**, must submit a Disclosure Statement before award of its first CAS-covered contract in the immediately following cost accounting period. However, if the first CAS-covered contract is received within 90 days of the start of the cost accounting period, the contractor is not required to file until the end of 90 days.
 - (3) Other specific rules may apply and exceptions can be made in certain circumstances.

Chapter 9—Reporting and Report Disclosures

General Reporting Considerations

The auditors' reports may take a variety of formats and styles, but they must meet the GAGAS Reporting Standards for:

- Reporting Standards for Financial Audits, **or**
- Reporting Standards for Attestation Engagements

GAGAS reporting standards first incorporate the AICPA reporting standards for each type and then require additional GAGAS standards. There are a total of 10 standards for Financial Audits and 9 standards for Attestation Engagements. The complete text of the standards is available in the Yellow Book. See Chapter 2 for a summary matrix of the standards.

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

- Independent Auditor's Report on Schedule of Indirect Costs
- Schedule of Indirect Costs
- Listing of Unallowable Account Adjustments with FAR References
- Notes to the Schedule of Indirect Costs—Minimum Disclosures
- Independent Auditor's Report on Internal Controls

The American Association of State Highway and Transportation Officials (AASHTO), Audit Subcommittee, and the American Council of Engineering Companies (ACEC) Transportation Committee have approved the report formats.

Auditor's Report on Schedule of Indirect Costs

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 Schedule of Indirect Costs for a consulting engineering firm. If the auditor performed an "attestation engagement examination" the report wording would be modified, but in both cases an auditor's opinion is required. The complete report would include the Schedule of Indirect Costs and Footnote Disclosures (see following pages).

INDEPENDENT AUDITOR'S REPORT ON THE SCHEDULE OF INDIRECT COSTS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs for the fiscal year ended December 31, 2004. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this 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 Schedule of Indirect Costs. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provides a reasonable basis for our opinion.

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

In our opinion, the 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, 2004 on the basis of accounting described in Note 2.

In accordance with the *Government Auditing Standards* we have issued a report dated April 4, 2005 on our consideration of the Company's internal controls and its compliance with laws and regulations.

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

Bob Brooks, CPA, Director
External Audit Branch

April 4, 2005

Note: The following page displays a typical Schedule of Indirect Costs for a firm that has both Home Office and Field Office rates. **Unallowable** expense adjustments are clearly identified and referenced to appropriate FAR sections or to specific state regulations, where applicable.

HotShot Engineering Associates, Inc.
Schedule of Indirect Costs
YE December 31, 2005

Description	Financial Stmt Expense	Unallowable Expense	FAR Ref	Total Proposed	Home Office Costs	Field Office Costs
Direct Labor	\$ 12,500,000	<u>\$ 12,000</u>	<u>(1)</u>	<u>\$12,512,000</u>	<u>\$12,011,520</u>	<u>\$ 500,480</u>
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
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	<u>\$ 7,326,000</u>	<u>\$ (504,000)</u>		<u>\$ 6,822,000</u>	<u>\$ 6,549,120</u>	<u>\$ 272,880</u>
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 & Equipment	100,000			\$ 100,000	-	100,000
Postage & 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 & Reg.	173,000			\$ 173,000	172,205	795
Subscriptions & Publications	41,000			\$ 41,000	40,811	189
Depreciation/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	<u>\$ 9,456,000</u>	<u>\$ (117,000)</u>		<u>\$ 9,339,000</u>	<u>\$ 9,149,221</u>	<u>\$ 189,779</u>
Total Indirect Costs				<u>\$16,161,000</u>	<u>\$15,698,341</u>	<u>\$ 462,659</u>
Percent of Direct Labor				<u>129.16%</u>	<u>130.69%</u>	<u>92.44%</u>
Facilities Capital Cost of Money (FCCM)				<u>\$ 62,505</u>	<u>\$ 62,505</u>	<u>-</u>
Percent of Direct Labor				<u>0.50%</u>	<u>0.52%</u>	<u>0.00%</u>

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)(i)(A) & (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 is unallowable and considered entertainment.
- (4) 31.205-36 - Adjust 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).

Report on Internal Control

Note: 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 CONTROLS

Board of Directors
The Company

We have audited the Schedule of Indirect Costs of the Company for the fiscal year ended December 31, 2004, and have issued our report thereon dated April 4, 2005. We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States of America.

Compliance

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

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing an opinion on the schedule and not to provide assurance on internal control over financial reporting. The management of the Company is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control over financial reporting. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with the Federal Acquisition Regulations Part 31. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal controls over financial reporting in the following categories: cash disbursements and payroll.

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

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

Bob Brooks, CPA, Director
External Audit Branch

April 4, 2005

Minimum Report Disclosures

The following represent disclosures that should be included, with reports, whether they are financial audits or attestation engagements or reports submitted by management of the company. In cases where examples are included, they are for illustrative and explanatory purposes only and are not intended to be all-inclusive regarding rules and regulations. Some may not be applicable for certain firms. Additional disclosures may be required for unusual or complex issues. Disclosures should be included with the schedule of Indirect Costs for each fiscal year. They may be included in the Notes to the Schedule of Indirect Costs or as a separate submission provided by management.

1. DESCRIPTION OF THE COMPANY

Provide an overview of the company including when the company was formed, type of organization (e.g., corporation, LLC, LLP, etc.), 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.

2. BASIS OF ACCOUNTING

The basis of accounting practices should be clearly stated.

Example:

<p>The Company's Schedule of Indirect Costs was prepared on the basis of accounting practices prescribed in Part 31 of the Federal Acquisition Regulations (FARs). Accordingly, the schedule of indirect costs is not intended to present the results of operations of the Company in conformity with accounting principles generally accepted in the United States of America.</p>

3. DESCRIPTION OF ACCOUNTING POLICIES

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

4. DESCRIPTION OF OVERHEAD RATE STRUCTURE

Disclosures should include:

- Identifying the Reporting Unit [e.g., company wide, business segment, technical specialty (design, construction administration, geotechnical, environmental, etc.) or geographical location] pertaining to the overhead rate(s).
- Identifying 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., Federal or state project).

Examples:

Single Base

All costs are allocated to Direct Labor

Multiple Bases

Fringe Benefits—allocated to Direct + Indirect Labor
Office Overhead—allocated to Direct Labor + Fringes
General & Administrative—allocated to Value Added Costs (All company costs excluding sub consultants)

- Identifying whether a dual rate structure exists for Field Office projects and Home Office projects. Specify the allocation methods used.
- Identifying that Direct Project Costs, sometimes referred to as Other Direct Costs (ODC) are consistently charged to all projects, and not just projects that reimburse for ODCs (i.e., computer costs, reproduction, equipment charges and vehicle usage). Include a listing of cost items generally charged directly to projects.
- Identify cost allocation practices between related business entities (e.g., parent company allocating costs to subsidiaries or divisions, allocations between subsidiaries or divisions, allocations to specific product lines, etc.).

5. DESCRIPTION OF LABOR RELATED COSTS

- **Project Labor**
Describe how the company charges labor to all projects (i.e., actual, average, or standard hourly rates).
- **Variiances**
Describe how and when variances are recorded if using other than actual labor costs.
- **Paid Time Off**
Explain the company's policy and accounting practice as to paid vacation, sick leave, and comp time. Include the consultant's policy as to accounting for accrued sick leave upon termination.
- **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.

Examples:

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.

- **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:

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

- **Pension Plans/Deferred Compensation/ESOP**

If pension and/or deferred compensation costs (as defined by FARs §31.205-6(j) and §31.205-6(k) respectively) are included in indirect costs, identify whether the plan(s) meet the above regulations and explain how the costs were determined (e.g., cash contribution, stock or options to purchase stock of the consultant, assets other than cash).

In regard to Employee Stock Option Purchase (ESOP) plans, identify the dollar amounts of principal, interest, and administrative costs of the contribution to the Employee Stock Option Trust (ESOT). Identify any other significant impacts from market valuations, etc.

Example:

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

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

- **Contract Labor**

Provide the methodology used by the 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.

Example:

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

6. DESCRIPTION OF DEPRECIATION/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:

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 in the Schedule of Indirect Cost Pools are allowable under FAR §31.205-11(e).

7. 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 FARs adjustments [per §31.205-26(e) and §31.205-36(b)(3)].

Note: When determining actual costs for related party charges Facilities Capital cost of money may be included as a cost of ownership of the related party tangible assets.

Example:

The Company rents one of its two offices from a Limited Liability Partnership 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 would be:

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

Consequently, rental expense has been adjusted downward by \$190,500 to reflect the provisions of FARs §31.205-36(b)(3). The officers of the Company have personal usage of Company vehicles. Amounts attributable to this personal use (\$X,XXX for 20xx) were disallowed.

8. FACILITIES CAPITAL COST OF MONEY (FCCM)

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

Example:

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

12/31/xx

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

Chapter 10—Reliance on Other Audits

In order to avoid duplication of audit work it is common practice for auditors to rely on the work of others. GAGAS 4.25 states:

“Underlying GAGAS audits is the premise that Federal, state, and local governments and other organizations cooperate in auditing programs of common interest so that auditors may use others’ work and avoid duplication of audit efforts. Auditors should make arrangements to make audit documentation available, upon request, in a timely manner to other auditors or reviewers. Contractual arrangements for GAGAS audits should provide for full and timely access to audit documentation to facilitate reliance by others on the auditors’ work.”

Additional guidance is provided in GAGAS 7.33.

NHS Act—Section 307

In 1995, Congress passed the latest version of the National Highway System Designation Act (see www.fhwa.dot.gov/infrastructure/progadmin/consultant.) The focus of Section 307 of this act was to remove the ceilings on overhead rates and indirect salaries that had been established by some states, avoid duplicate indirect cost audits of the same firm by multiple audit entities, and reinforce the need for all audit entities to use the Federal Acquisition Regulations for the purpose of determining cost eligibility.

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

The NHS Act, however, did provide a one-year window for states to adopt statutes that would establish “an alternative process intended to promote engineering and design quality and ensure maximum competition.” If a statute were adopted by a state within this period, Section 307 would not bind the state. The deadline was ultimately extended to 6/9/98 and thirteen states adopted such statutes within the allowed time period. **Such states are referred to as “opt out states.” They are: CT, DE, FL, KY, LA, ME, MD, MN, NY, NC, UT, TN, WV.**

Note: The current Federal budget legislation (for years 2005–2006) contains language, which, if passed, proposes to eliminate the concept of “opt out states, and therefore promote greater uniformity.”

Cognizant Agency/Cognizant Audits

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

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

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

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

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

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

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

- (b) A Non-Home State reviews the CPA's working papers and issues a letter of concurrence with the CPA report, which is then accepted by the Home State. If the Home State does not accept the Non-Home State's review, the Home State will have 180 days from receipt to complete a review of the CPA audit report and either concur with it, modify it, or reject it due to a material error requiring re-submittal; otherwise, the CPA audit report with which the Non-Home State has concurred will be cognizant for the one year applicable accounting period.

Guidelines for the review are in the next section of this chapter.

FHWA Final Rule: Administration of Engineering and Design Related Service Contracts

FHWA issued the final rule in July 2002 (see 23 CFR 172 Subpart A). The FHWA considered the above definition of Cognizant Audit but believed that more testing of the procedures would be required. Therefore the definition was not included in the final rule.

The definition of **Cognizant Agency** was adopted in the final rule as follows:

“Any Federal or state agency that has conducted and issued an audit report of the consultant’s indirect cost rate that has been developed in accordance with the requirements of the cost principles contained in 48 CFR part 31.”

In October 2002, FHWA issued a “Supplemental Guidance Document for 23 CFR 172, which provided information in a Question & Answer format that specified how to achieve cognizant audits. For the most part, the recommendation of AASHTO subcommittee was adopted in the FHWA guidance.

Guidelines for Reviewing CPA Indirect Cost Audits

In addition to the above definitions, the AASHTO Audit Subcommittee adopted guidelines to be used in reviewing indirect costs audits performed by public accounting firms and issuing letters of concurrence. The following minimum guidelines should be followed when a state transportation/highway department audit organization reviews a CPA indirect cost audit report and issues a letter of concurrence.

The reviewing state should obtain documentation that evidences the CPA's accomplishment of the continuing education requirements identified in paragraphs 3.45 thru 3.48 and the external quality control review requirements found in paragraph 3.49 of Yellow Book.

- The reviewing state should determine that the CPA's audit report format is in material compliance with the Uniform *Indirect Cost Rate Audit Report Format for Engineering Consulting Firms* prepared and adopted by the AASHTO Audit Subcommittee and the ACEC Transportation Committee.
- The reviewing state should determine that the CPA audit was conducted in accordance with the General Standards, Field Work Standards and Reporting Standards for audits as described in Chapters 3, 4, and 5 of the Yellow Book. The review should also determine compliance with Part 31 of the Federal Acquisition Regulations.

The following steps should be performed to make these determinations:

1. Review of the audit report.
2. Discussions with CPA auditor, if available.
3. Review the CPA's working papers. CPA's must provide access to working papers.
4. Request any additional supplemental tests the reviewing state deems necessary.

The reviewing state upon satisfactory completion of this review shall issue a letter of concurrence with the CPA's indirect cost audit report of the firm. Documentation to support this review shall be retained by the reviewing state for a minimum of three years from the date of the letter of concurrence. The letter of concurrence shall be addressed to the audited firm and signed by the head of the audit organization, or a designee.

Chapter 11—Glossary of Terms

The following terms are used throughout this guide:

Actual Cost Agreement

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

Actual Costs

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

Advance Agreement

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

Agreement

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

All-Inclusive Hourly Rate Agreement

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

Allocable

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

Allowable (Cost)

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

Audit Cycle

The series of steps auditors go through in completing their assigned work. The process includes a review of a firm's permanent file maintained by the Audit Office, preliminary audit work including scheduling of billed costs, arranging an appointment to conduct the audit, entrance conference, field work, review of a firm's documentation, exit conference, report write up, submittal of draft report to auditee for comment, and issuance of the final report.

Audit Resolution Process

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

Audit Trail

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

Billing Rate

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

Cognizant Audit

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

Common Control

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

Contracting Officer

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

Corporation (C-Corp)

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

Other forms of business organizations include: Limited Liability Corporations (LLC), Limited Liability Partnerships (LLP) and Sub-Chapter S Corporations. Each has varying levels of liability for owners and each has different Federal Income Tax provisions.

Cost Accounting Standards

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

Cost Center

Cost centers are used to accumulate and segregate costs.

Cost Objective

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

Cost of Money

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

Cost Plus Fixed Fee Agreement

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

Cost Principles

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

Courtesy Audit

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

Direct Cost

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

Entrance Conference

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

Exit Conference

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

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

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

Finding

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

General and Administrative Expenses

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

Generally Accepted Auditing Standards (GAAS)

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

Generally Accepted Governmental Auditing Standards (GAGAS)

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

Indirect Cost

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

Interim Audit

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

Internal Control

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

Lump Sum (Fixed Price) Agreement

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

Negotiated Hourly Rate Agreement

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

Overhead Expenses

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

Overhead Rate

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

Overtime Compensation

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

Partnership

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

Post Audit

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

Pre-Award Review

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

Provisional Hourly Rate Agreement

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

Reasonable Cost

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

Record of Negotiation

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

Single Audit

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

Sole Proprietorship

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

Source Documentation

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

Task Assignment Agreements

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

Unallowable (Cost)

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

Chapter 12—Listing of Resource Materials

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

Government Auditing Standards—2003 Revision (“Yellow Book”)

Published by:

United States General Accounting Office (GAO), by the Comptroller General

Current version available at: <http://www.gao.gov/govaud/ybk01.htm>

Purpose: (quote from introduction)

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

Federal Acquisition Regulations (FARs)

Published jointly by:

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

Format:

Available in paper, CD-ROM and on the Internet at www.arnet.gov/far. Another way to access the web site is at the Federal Government main home page www.firstgov.gov, then search for “Federal Acquisition Regulations.”

Contained in:

Code of Federal Regulations at 48 CFR Chapter 1

Relevant Part:

Part 31—Contract Cost Principles and Procedures

Purpose:

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

DCAA Contract Audit Manual

Published by:

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

Formats:

Two-volume set of paper manuals published twice per year

Available on CD-ROM called “Defense Acquisition Deskbook”

Available on the internet 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.”

American Institute of Certified Public Accountants (AICPA)

Published by:

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

Formats:

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

Partial Listing of Helpful Materials:

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

Accounting Standards—Current Text

Published by:

Financial Accounting Standards Board

Format:

Hard-copy, three-volume set

Website address: <http://www.fasb.org/>

Purpose:

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

Federal Travel Regulation

Provides information on travel guidelines for Federal government rates, etc.

Website: <http://www.fedtraveler.com/>

Chapter 13—Other General Information

Acknowledgements

The concept of developing an audit guide to assist engineering consultants, CPAs and state auditors with the preparation of Schedules of Indirect Costs originally started at the State and regional levels.

Discussions at the regional level and at annual AASHTO meetings lead to the first edition of the national audit guide released in December 2001. Over the years many people have contributed to the *Uniform Audit & Accounting Guide* by providing input, conducting research, attending working sessions, facilitating meetings, editing, desktop publishing, proofreading, and other support activities. Representatives from State Highway Agencies, FHWA, ACEC, and AASHTO staff participated. Their knowledge, time, travel money and supplies are greatly appreciated in the nationwide team efforts that lead to the 2005 update.

State Contacts

For questions, comments and input for future updates the audit representative from the local State Highway Agency should be contacted. An updated listing of contacts can be found at:

<http://audit.transportation.org/community/audit/directory.nsf/Map?openform>