For Audits of Architectural and Engineering (A/E) Consulting Firms

2016 Edition

UNIFORM AUDIT & ACCOUNTING GUIDE

AASHTO American Association of State Highway and Transportation Officials

ACKNOWLEDGMENTS

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

Over the years, many people have contributed to the Guide by providing input, conducting research, attending working sessions, facilitating meetings, editing, proofreading, and providing other support. The participants included representatives from State Departments of Transportation, the FHWA, the American Council of Engineering Companies (ACEC), public accounting firms, and AASHTO. Their knowledge, time, travel funding, and supplies were instrumental in the nationwide team effort that led to this 2016 edition of the Guide.

Scot P. Gormley, External Audit Manager with the Ohio Department of Transportation, served as the primary designer and editor of this 2016 Edition of the Guide, with additional support and assistance provided by Dan Purvine of A/E Clarity Consulting and Training, LLC.

Preface

ABOUT THIS GUIDE

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

During 2007, the members of the Audit Subcommittee approved the establishment of a Task Force to update the Guide. The work of the Task Force resulted in a major update of the Guide in 2010 (the 2010 Edition), which was further refined and updated in 2012 (the 2012 Edition). These revisions were necessary to ensure that the Guide was consistent with current auditing standards and procedures, accounting principles, and Federal regulations. The 2010 and 2012 revisions also addressed questions and concerns expressed by various parties, including the FHWA, State DOT audit agencies, Architectural and Engineering design firms (hereinafter referred to as "A/E firms" or "engineering consultants"), and public accounting firms. These questions and concerns arose through current practice and, in part, through the findings and recommendations from an audit performed by the U.S. Department of Transportation's Office of Inspector General (OIG).[1]

This 2016 Edition of the Guide incorporates several updates, refinements, and clarifications necessary to reflect changes in the statutory and regulatory framework applicable to A/E contracts that have occurred since the publication of the 2012 Edition. This 2016 Guide should be used as a tool by State DOT auditors, A/E firms, and public accounting firms that perform audits and attestations of A/E firms. The techniques presented herein primarily focus on examination, auditing, and reporting procedures to be applied to costs that are incurred by A/E firms for engineering and design-related services performed on various Federal, State, and Local transportation projects.

The techniques discussed in this Guide were designed to be applied to audit and attestation engagements performed in connection with engineering consultants' *Statements of Direct Labor, Fringe Benefits, and General Overhead* (hereinafter referred to as "indirect cost rate schedules"), as well as the related accounting systems, job-costing systems, and labor-charging systems that serve as the basis for the indirect cost rate schedules. However, this Guide is not intended to be a comprehensive auditing procedures manual but is instead a guide to assist users in understanding terminology, policies, procedures and audit techniques, and sources for applicable Federal Regulations. This Guide provides only general guidance and is not meant to, and cannot, supersede either the Federal Acquisition Regulation (FAR) or any related laws or regulations.[2]

Users should be aware that the FAR Cost Principles change frequently; accordingly, please review the

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[1] See "Oversight of Design and Engineering Firms' Indirect Costs Claimed on Federal-Aid Grants" (Report Number: ZA-2009-033), issued February 5, 2009.

[2] Although use of this Guide is not required by Federal law or regulation, most State DOTs expect engineering consultants, external CPAs, and other involved parties to comply with the minimum procedures and techniques illustrated and discussed herein. As recommended by the FHWA, most State DOTs have adopted risk assessment procedures to help determine engineering consultants' compliance with FAR Part 31 and related laws and regulations. Consistency with this Guide may be a key factor in assessing risk, and departures from the procedures recommended herein, lacking adequate justification, may lead to additional scrutiny by a reviewing State DOT. Accordingly, engineering consultants are strongly encouraged to adopt the uniform reporting procedures illustrated herein, including, but not limited to, labor charging practices, cost accumulation and reporting processes, and the format and content of indirect cost schedules (including the recommended standard disclosures). Engineering consultants should contact their respective cognizant State DOTs for further details and clarifications regarding risk assessment and application of this Guide.

applicable FAR version in conjunction with this Guide. Likewise, illustrations and sample reports either included or referenced herein were derived from various sources and information current at the time the Guide was published. Due to periodic changes in Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), and Government Auditing Standards (GAGAS or the "Yellow Book"), users should refer to any applicable, more current guidance/standards and modify the sample reports accordingly.

***Note**: Please see the AASHTO website for contact information for all State transportation agencies.*

An electronic version of this Guide is available on the AASHTO home page: www.transportation.org.

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APPENDICES

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Chapter 1 – Organization of this Guide and Defined Terms

1.1 – Organization of This Guide

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

Short Reference	Full Reference
Section 2.4	Chapter 2, section 4
Section 3.2.D	Chapter 3, section 2, subsection D
Section 5.6.A.2	Chapter 5, section 6, subsection A, paragraph 2
Section 5.4..a	Chapter 5, section 4, subsection F, paragraph 2, clause a

1.2 – General Terms

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

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

- The "*DCAA Contract Audit Manual*" (CAM or DCAA Manual 7640.1) is an official publication of the Defense Contract Audit Agency (DCAA). The CAM prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in performing audits in compliance with FAR Part 31 and related laws and regulations. The CAM is published semiannually by the DCAA.
- The "*Federal Acquisition Regulation*, Part 31" (FAR). The FAR is codified at 48 CFR Part 31. The FAR is the primary regulation governing the acquisition of supplies and services with Federal funds. 48 CFR Part 31 sets the criteria for determining costs eligible for reimbursement on Federally-funded agreements and may be used to determine allowable costs for contracts funded solely by State funds.
- "FAR-Compliant Audit" refers to a formal audit of the indirect cost rate schedule and associated notes, to obtain reasonable assurance that the costs presented in the schedule substantially comply with the Cost Principles of FAR Subpart 31.2. When performing FAR-compliant audits, auditors must apply the standards applicable to financial audits as contained in the Government Auditing Standards issued by the Comptroller General of the United States.
- The "*Federal Travel Regulation*" (FTR) is contained in 41 CFR Chapters 300 through 304. The FTR implements policies for travel by Federal civilian employees and others authorized to travel at the Federal Government's expense. The FAR incorporates certain FTR provisions for use in determining the allowability of contract costs incurred by engineering consultants.
- "GAAP" refers to the *Generally Accepted Accounting Principles*, a widely accepted set of rules, conventions, standards, and procedures for reporting financial information, as established by the Financial Accounting Standards Board (FASB).
- "*Generally Accepted Auditing Standards*" (GAAS) are published by the American Institute of Certified Public Accountants (AICPA). GAAS apply to financial statement audits and contain guidance regarding auditors' professional qualifications, the quality of audit effort, and the characteristics of professional and meaningful audit reports.
- The "*Government Auditing Standards*," also known as "Generally Accepted Government Auditing Standards" (GAGAS) or "Yellow Book" standards, are issued by the U.S. Government Accountability Office (GAO).[3] GAGAS prescribe general procedures and professional standards that examiners must apply when performing audits or attestation engagements of firms that conduct business with governmental entities. GAGAS standards also incorporate the Generally Accepted Auditing Standards specific to financial-related audits.
- "Indirect cost rate schedule" refers to the primary document used by engineering consultants to compute indirect cost rates (overhead rates) used for billings on Government projects. An indirect cost rate schedule is based on amounts obtained from the engineering consultant's general ledger (after the adjusting entries have been posted to the accounts), as well as from amounts in the engineering consultant's cost accounting system. This schedule must be in agreement with, or must be reconciled to, amounts from the engineering consultant's general ledger or post-closing trial balance. An indirect cost rate schedule also is commonly referred as an "overhead schedule," "schedule of indirect costs" or "Statement of Direct Labor, Fringe Benefits, and General Overhead."
- "Management" refers to A/E firm owners, officers, and/or others responsible for the formulation and execution of the firm's policies and procedures, including, but not limited to, internal controls, personnel policies, compensation policies, and labor-charging practices.
- "Overhead" or "indirect cost" refers to any cost that is not directly identified with a single final cost objective, but is identified with two or more final cost objectives or with at least one intermediate cost objective. Engineering consultants charge their indirect costs by applying an overhead rate to an allocation base (e.g., direct labor cost).

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[3] *Government Auditing Standards*, GAO-12-331G (Washington, D.C.: December 2011 Revision).

- "Overhead rate" or "indirect cost rate" refer to a factor/ratio computed by adding together all of a firm's costs that cannot be associated with a single cost objective (e.g., general and administrative costs and fringe benefit costs), then dividing by a base value (usually direct labor cost) to determine a rate. This rate is applied to direct labor, as incurred on projects, to allow a firm to recover the appropriate share of indirect costs allowable per the terms of specific agreements. In this Guide, the terms "indirect cost rate" and "overhead rate" are used synonymously.
- "State DOT" or "DOT" refers to a State department of transportation or other State transportation agency.
- "Statements on Auditing Standards" or "SASs" are interpretations of U.S. Generally Accepted Auditing Standards as issued by the Auditing Standards Board (ASB), the senior technical committee of the AICPA designated to issue auditing, attestation, and quality control standards and guidance.

1.3 – OTHER DEFINED TERMS

Actual Costs

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

Actual Cost Agreement

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

Advance Agreement

Contract language that specifies the treatment of special or unusual costs. For example, the use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of FAR 31.109 between the engineering consultant and the cognizant audit agency. The advance agreement should specify the basic characteristics of the sampling process. FAR 31.109 provides that advance agreements must be "in writing, executed by both the contracting parties, and incorporated into applicable current and future contracts. An advance agreement shall contain a statement of its applicability and duration."

Agreement

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

All-Inclusive Hourly Rate Agreement

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

Allocable Cost

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

(a) Is incurred specifically for the contract;

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

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

Allowable Cost

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

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

Audit

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

Audit Cycle

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

Audit Resolution Process

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

Audit Trail

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

Billing Rates (Hourly Labor Rates)

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

Contracting Officer

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

Corporation

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

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

Cost Center

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

Cost Objective

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

Cognizant Audit

This concept was developed to assign primary responsibility for an audit to a single entity (the "cognizant agency") to avoid the duplication of audit work performed in accordance with Government Auditing Standards to obtain reasonable assurance that claimed costs are accordance with the FAR Subpart 31.2 cost principles. Such audit work may be performed by home-State auditors, a Federal audit agency, a CPA firm, or a non-home State auditor designated by the home-State auditor.

Common Control

Exists in related-party transactions when business is conducted at less than arm's length between businesses and/or persons that have a family or business relationship. Examples are transactions between family members, transactions between subsidiaries of the same parent company, or transactions between companies owned by the same person or persons. Common control exists when a related party has *effective control* over the operating and financial policies of the related entity. Effective control may exist even if the related party owns less than 50 percent of the related entity. (For further discussion, see Section 8.23.B and Section 11.2.G.1, Example 11-8.)

Cost-Plus-Fixed-Fee Agreement

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

Cost of Money (Facilities Capital Cost of Money (FCCM))

Although interest costs associated with the financing of capital are unallowable, some costs associated with the engineering consultant's investment in fixed assets are allowable. Specifically, Facilities Capital Cost of Money (FCCM) is an imputed cost determined by applying a charge rate to the engineering consultant's fixed assets used in contract performance. FCCM is not required to be recorded in the engineering consultant's formal accounting records; instead, FCCM is computed as a charge rate based on the following factors:

- The average annual net book value of the engineering consultant's investments in the fixed assets used for allowable business activities (in accordance with the cost principles of FAR Subpart 31.2),
- The prorated average Prompt Payment Act Interest Rate[4] determined by the U.S. Secretary of the Treasury for the accounting period in question, and
- The engineering consultant's direct labor base used to determine overhead rates.

(See Section 8.6 for further discussion regarding FCCM.)

Cost Principles of FAR Subpart 31.2

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

Directly-Associated Cost

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

Direct Cost

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

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

Entrance Conference

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

Exit Conference

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

Federal-Aid Highway Program (FAHP) Contracts

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

[4] Current Treasury rates are available at: http://www.treasurydirect.gov/govt/rates/tcir/tcir_opdprmt2.htm.

Field Office

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

Financial Statements

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

Finding (Audit Finding)

An audit finding may result from an engineering consultant's deficiencies in internal control, fraud, illegal acts, the violation of contract or grant provisions, and/or abuse. When auditors identify deficiencies, they should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. In accordance with GAGAS, when documenting a finding, the auditor should include the condition, criteria, cause, effect, and a recommendation for correction. See GAGAS Chapters 4.10 to 4.14 for more details. Attestation engagements are discussed in GAGAS Chapters 5.11 to 5.15.

General and Administrative (G&A) Expenses

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

Interim Audit

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

Internal Controls

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

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

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

Lump-Sum (Fixed-Price) Agreement

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

Negotiated Hourly Rate Agreement

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

Overtime Compensation

Generally, this is compensation paid to employees who work more than 40 hours per week or 80 hours in a pay period. Overtime pay rates may be based on employees' normal hourly rates or may include "premium overtime" such as time and a half or double time. In accordance with the Fair Labor Standards Act (FLSA), premium overtime pay generally is required for hourly workers but is optional for certain salaried employees (exempt employees).

Partnership

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

Post Audit (Project Close-Out Audit)

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

Pre-Award Review

An examination conducted by, or on behalf of, a State DOT to verify financial information supplied by an engineering consultant. The examination may involve a desk review performed at the audit office and/or fieldwork at the engineering consultant's place of business. Upon completion, the audit results are provided to the State DOT contracting officer for use during contract negotiations.

Provisional Hourly Rate Agreement

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

Reasonable Cost

A cost is reasonable, if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. See Section 4.3 for additional discussion.

Sole Proprietorship

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

Source Documents

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

Task Assignment (Task Order) Agreement

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

Total-Hour Accounting System

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

Unallowable (Cost)

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

Uncompensated Overtime

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

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Chapter 2 – Adequacy of Accounting Records

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

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

2.1 – Indirect Cost Rate Schedule

**[References: FAR 31.201-4, 31.203(f); CAS 401, 402, 403, & 405;
23 U.S.C. 112(D) & 23 CFR 172.7(b)]**

A. Generally

An indirect cost rate schedule is the primary document used to show the calculation of indirect cost rates. The schedule must be prepared based on actual costs recorded in the engineering consultant's general ledger (after adjusting entries have been posted to the accounts), as reconciled to the consultant's cost accounting system. Since an indirect cost rate generally is computed as the ratio of allowable indirect costs to total allocable direct labor costs, the indirect cost rate schedule must identify direct labor cost as a separate line item.

***Note**: The indirect cost rate schedule should clearly display the unallowable costs that have been removed from the various accounts (for sample indirect cost rate schedules, see Tables 5-5, 5-6, & 5-7 in Section 5.6.C.3.). If the schedule is presented "net of unallowable costs," then the details of the unallowable costs <u>must</u> be disclosed in the accompanying notes. Additionally, other relevant disclosures must be included in the indirect cost rate schedule, other financial statements, and any special schedules to provide adequate explanatory information about the financial data, organizational structure of the firm, and operating policies (see further discussion in Chapter 11).*

The engineering consultant is responsible for presenting/proposing indirect cost rate(s), and the consultant may choose to compute separate rates to reflect various segments of business activity. This is permissible, but only if:

- the cost pools and/or segments are identified properly,
- costs are allocated consistently to the pools and/or segments,
- no costs are duplicated in rates computed for other pools or segments, and
- the rates are applied consistently for all projects, regardless of funding source, contract type, or customer (e.g., Government versus commercial).

Additionally, engineering consultants are permitted to establish their own policies and procedures regarding home and field office accounting, provided that the policies and procedures are compliant with applicable cost principles. Per FAR 31.203(f): "Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives." Once the engineering consultant develops a rate structure and cost allocation methodology in compliance with applicable Cost Accounting Standards, costs must be applied consistently and fairly to all contracts.

***Note**: The auditor should issue a single, FAR-compliant audit report that reflects the engineering consultant's rate structure and cost accounting practices. The auditor should <u>not</u> issue multiple audit reports reflecting adjustments based on various special State DOT requirements. Instead, State DOTs that have separate laws governing consultant reimbursements should work directly with the engineering consultant to handle any special adjustments required to the issued FAR-compliant audit.*

B. Facilities Capital Cost of Money and Other Items

Other items, such as the computation of Facilities Capital Cost of Money (FCCM), must be disclosed separately in the notes to the indirect cost rate schedule. Although FCCM generally is computed as a rate based on direct labor cost, FCCM should *not* be included as part of the overhead rate. FCCM is not required, but if it is proposed, the engineering consultant should show the detailed computation of the FCCM rate. (See Section 11.2 for further details regarding FCCM and other recommended minimum audit report disclosures.)

C. Disclosure of Field Office Rates

The indirect cost rate schedule or accompanying notes should show the calculation of the overhead rate. In some cases, multiple overhead rates will be shown, such as functional rates for segments of the business or rates for separate subsidiaries. When a company uses Field Office (onsite) rates in addition to Home Office (offsite) rates, costs and labor amounts for both rates should be displayed on the indirect cost rate schedule. The rate structure and allocation methodology should be clearly explained in the notes.

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

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

Contracting officers may disallow all or part of any costs that lack adequate support. Additionally, when an engineering consultant uses accounting practices that are not consistent with FAR or CAS requirements, costs resulting from such practices must be disallowed to the extent that these costs exceed the amount that would have resulted from the proper application of the FAR and CAS.

D. Accounting Period: Application of Submitted Indirect Cost Rates

In accordance with 23 U.S.C. 112(D) & 23 CFR 172.7(b), indirect cost rates generally are applicable for a one-year period, and engineering consultants are required to update their indirect cost rates annually.

However, once an indirect cost rate has been established for a contract, the rate may be extended beyond a one-year period, provided that all the contracting parties agree to the extension. This is only permissible on a contract-by-contract basis, and agreement to the extension of the one-year applicable period must not be a condition of contract award. (See Section 4.7 for further discussion regarding the base period for allocating indirect costs.)

2.2 – UNALLOWABLE COSTS

A. Generally

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

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

B. Directly-Associated Costs

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

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

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

FAR 31.201-6(e)(2) provides that, when material in amount, salary expenses for the time employees participate in activities that generate unallowable costs should be treated as directly-associated costs. However, time spent by an employee outside the normal working hours should not be considered, unless the employee engaged in those company activities so frequently outside the normal working hours that it would indicate that the activities were a part of the employee's regular duties.

2.3 – FINANCIAL STATEMENTS

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

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

2.4 – MANAGEMENT REPRESENTATIONS

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

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

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

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

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

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

2.5 – MANAGEMENT AND CPA'S ROLES AND RESPONSIBILITIES

A. Management Responsibilities

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

In conjunction with management's responsibility to certify[5] that the indirect cost rate schedule includes only allowable costs in accordance with FAR Part 31, in preparation for an independent audit of the schedule, the engineering consultant should perform its own analysis of the high-risk accounts or line items and make appropriate adjustments to the indirect cost rate schedule. As management bears the ultimate responsibility for identifying, segregating, and removing unallowable costs, management should perform a preliminary review to assess whether internal controls are working effectively and whether all

[5] FHWA Order 4470.1A establishes the FHWA's policy for contractor certification of the costs used to establish indirect cost rates in accordance with the applicable cost principles contained in FAR Part 31 for engineering and design-related service contracts funded with Federal-aid highway program (FAHP) funding and administered by State DOTs, local public agencies, and other grantees and subgrantees. See Appendix F, or http://www.fhwa.dot.gov/legsregs/directives/orders/44701a.htm. Most State DOTs have adopted policies consistent with Order 4470.1A; accordingly, engineering consultants generally are required to submit a compliance statement (certification) annually to each State DOT.

unallowable costs have been removed from the final, submitted indirect cost rate.

***Note**: Management should prepare narratives describing the internal controls reviewed, and any associated schedules showing the results of the preliminary review, and these documents should be shared with the independent auditor and/or State DOT auditor. Likewise, documents related to the testing of labor or direct costs also should be shared.*

B. The CPA Auditor's Responsibilities

1. Generally

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

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

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

The CPA auditor is responsible for—

- Issuing an independent opinion on the engineering consultant's compliance with Government regulations, including FAR Part 31 and related laws.[6]
- Issuing a report describing the extent of the auditor's testing of the engineering consultant's internal controls and the results of such testing.[7]

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

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

2. The CPA's Responsibilities for Fraud Detection

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

[6] See sample opinion letter in Section 11.2.

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

below:

- ***GAGAS 4.17c and 5.18b***. Auditors must report deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.

- ***GAGAS 4.30 and 5.29***. When either of the following circumstances exists, auditors should report directly to parties outside the audited entity with respect to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse:

  (a) When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the information directly to the specified external parties.

  (b) When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriated steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.

- ***GAGAS 4.31 and 5.30***. Auditors should comply with the requirements discussed above even if the auditors have resigned or were dismissed from the audit prior to its completion.

- ***GAGAS 4.32 and 5.31***. Auditors have a professional obligation to obtain sufficient evidence that management of the audited entity appropriately reported findings to outside parties.

C. Selection of CPA Firm as Overhead Auditor

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

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

- Design and execute an audit program that meets the AICPA's professional standards, as well as the specific testing recommendations described in the sample CPA Workpaper Review Program provided in Appendix A of this Guide.

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

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

3

Chapter 3 – Standards for Attestations and Audits

3.1 – Background

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

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

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

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

3.2 – Engagement Types

Contract engagements generally include the following:

A. Review of Indirect Cost Rates for Costs Incurred

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

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

B. Indirect Cost Rate (Forward Pricing) Review

This type of engagement requires an examination of the engineering consultant's forward pricing indirect cost rate(s) used to prepare estimates of costs that will be incurred in future periods. Forward pricing rates are similar to cost-incurred rates described above in Section 3.2.A in that forward pricing rates are based on historical costs. However, these rates are adjusted to reflect estimates of future costs and activity levels to project indirect cost rates for future periods.

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

C. Contract Pre-Award Review

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

D. Contract Cost Review

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

3.3 – AUDITING STANDARDS

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

A. Government Auditing Standards (“Yellow Book” or “GAGAS” Standards)

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

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

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

B. GAGAS Engagement Types

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

1. Financial Audits

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

2. Attestation Engagements

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

3. Performance Audits

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

***Note**: This Guide primarily deals with financial audits and attestations,[8] and auditors should review the full text of GAGAS to determine the applicable standards for these types of engagements. Standards may vary, depending on the type of audit or attestation engagement, and additional audit standards and procedures (e.g., standards issued by the Institute of Internal Auditors and/or Federal agencies) may be appropriate, depending on the circumstances.*

3.4 – OPINION ON INTERNAL CONTROL

[Reference: Sarbanes-Oxley Act of 2002]

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

[8] Performance audits are beyond the scope of this Guide.

4

Chapter 4 – Cost Principles

4.1 – Overview of Federal Acquisition Regulation, Part 31

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

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

The provisions apply to commercial organizations, educational institutions, State, local and Federally-recognized Indian tribal governments, and nonprofit organizations. FAR 31.105, dealing with construction and architect-engineering contracts, states that the allowability of costs shall be determined in accordance with FAR Subpart 31.2. Accordingly, the following discussion focuses on Subpart 31.2–Contracts with Commercial Organizations.

The total cost of a contract includes all costs properly allocable to the contract under the specific contract provisions. The allowable costs to the Government are all costs that are reasonable, allocable, and are not prohibited by FAR Part 31.

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

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

1. Any limitations set forth in Subpart 31.2 of the FAR;
2. Allocability;
3. Cost Accounting Standards (CAS) promulgated by the Cost Accounting Standards Board (CASB); if applicable, otherwise, generally accepted accounting principles and practices appropriate to the particular circumstances;
4. Terms of the contract; and
5. Reasonableness.

4.2 – State and Local Cost Principles

Although FHWA regulations require State DOTs to accept indirect cost rates compliant with FAR Part 31 and to accept cognizant audits of FAR-compliant indirect cost rates, those regulations are not applicable to contracts *that do not involve Federal funding*. Accordingly, for contracts with no Federal funding, some State DOTs and local agencies define allowable costs more restrictively than FAR Part 31. For example, costs restricted by State and local policies sometimes include:

- Travel costs,
- Selling costs,
- Compensation costs in excess of locally-established ceilings, and/or
- Limits on incentive compensation.

Additionally, some State DOTs and local agencies prescribe certain cost accounting methodologies that vary from methodologies normally applied by an engineering consultant and used for Federally-funded contracts.

For example, cost accounting methodologies prescribed by contracting agencies sometimes include:

- Restatement of multi-tiered indirect cost rate structures to a single rate based on direct labor.
- Allocation of overtime premium as a direct project cost, even though the engineering consultant normally allocates all overtime premium to projects as an indirect cost.
- Allocation of overtime premium as an indirect cost even though the engineering consultant normally allocates all overtime premium to projects as a direct cost.
- Restrictions on the use of effective rates for distribution of labor costs.
- Allocation of certain direct costs such as computers, copies, or expendable supplies as indirect costs, even though the engineering consultant normally allocates these items to projects as direct costs based on usage.
- Restatement of separate field and home office indirect cost rates as a combined company-wide rate.

When an engineering consultant presents FAR-compliant indirect cost rates and alternate rates based on State or local requirements, the indirect cost rate schedule should present the indirect cost rate in accordance with FAR Part 31, representing cost accounting practices consistently followed by the engineering consultant on Federally-funded contracts. When a consultant presents rates that are adjusted for State and local cost restrictions and/or alternative cost accounting methods, those adjustments and rates should be disclosed through notes to the FAR-compliant indirect cost rate schedule.

***Note**: When a State DOT performs an audit or workpaper review based on State cost principles or cost accounting requirements that vary from FAR Part 31 and/or the firm's normal cost accounting practices, the State DOT should not identify the audited rates as cognizant, as the rates are not based on FAR Part 31 cost principles or allocation methods prescribed for Federally-funded contracts.*

4.3 – ALLOWABILITY, INCLUDING REASONABLENESS

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

A. Generally

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

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

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

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

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

(1) *Reasonableness*.
(2) Allocability.
(3) Standards promulgated by the CAS Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
(4) Terms of the contract.
(5) Any limitations set forth in [FAR 31.201].

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

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

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

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

C. Methodologies for Applying FAR 31.201-3

While the tests, standards, and other considerations referenced in FAR 31.201-3 entail varying degrees of subjectivity and professional judgment, it is strongly recommended, as a best practice, that primary emphasis be placed on quantitative analysis in addressing the reasonableness of costs. Specifically, ordinary costs are amounts that are common, usual, and otherwise characteristic of the industry segment. When analyzing cost elements for reasonableness, engineering consultants and auditors are strongly recommended to use the concept of *ordinary cost* as a starting point, as discussed below.

1. Using Quantitative Analysis to Determine Ordinary Cost

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

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

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

(c) Analysis of Variances. Once baselines for specific cost elements are established, variances in excess of benchmark thresholds, if determined to be material based on professional judgment, should be identified, analyzed, and addressed by the engineering consultant and/or in the auditor's workpapers within the context of a multi-factor analysis, in accordance with the considerations outlined by FAR 31.201-3 and other related regulations. If costs with material variances are determined to be reasonable, then the basis for acceptance of the variances in the context of FAR 31.201-3 should be explicitly identified in the audit workpapers, so that the cognizant agency or other reviewer is made fully aware of the facts underlying this determination.

2. Determining Reasonableness: Common Cost Categories

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

4.4 – ALLOCABILITY

[Reference: FAR 31.201-4]

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

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

4.5 – UNALLOWABLE COSTS

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

Costs that are expressly or mutually agreed to be unallowable, including directly-associated costs, must be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly-associated cost is any cost which is generated solely as a result of incurring another cost, and which would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly-associated costs are also unallowable. The practices to account for and present unallowable costs are described in CAS 405 (48 CFR 9904.405), Accounting for Unallowable Costs.

4.6 – DIRECT AND INDIRECT COSTS

[References: FAR 31.202, FAR 31.203]

In evaluating an engineering consultant's overhead, auditors should consider direct as well as indirect costs. A direct cost is any cost that can be identified specifically with a particular contract or project. Costs identified specifically with a contract or project are direct costs and must be allocated/charged directly to the contract or project. All costs specifically identified with a project are direct costs of that project and may not be allocated to another project, either directly or indirectly. Finally, a cost may not be charged as direct and also be included in an indirect cost pool.

***Note**: For reasons of practicality, any small dollar direct cost may be treated as an indirect cost if the accounting treatment is consistently applied to all projects and produces substantially the same results as treating the cost as a direct cost. However, any related variances and credits also should be treated as indirect costs.*

Indirect costs should be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. Commonly, manufacturing overhead, selling expenses, and general and administrative (G&A) expenses are separately grouped. The engineering consultant must record indirect costs in accordance with GAAP and must consistently allocate these costs to intermediate or final cost objectives, as appropriate.

4.7 – APPLICABILITY OF COST ACCOUNTING STANDARDS

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

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

4.8 – ALLOCATION BASES FOR INDIRECT COSTS

[Reference: FAR 31.203(c)]

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

EXAMPLE 4-1: COMMON ALLOCATION BASES

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

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

Rate Structures and Cost Allocation Methods. Once an engineering consultant establishes an appropriate base for distributing indirect costs, the base should not be fragmented by removing individual elements. Rate structures and cost allocation methods must be applied consistently to all contracting entities, including State DOTs. As an example, a consultant with a single, company-wide cognizant audited rate should not establish and apply a segment rate for a contracting entity when the costs included in the segment rate also are included in the company-wide rate. *Likewise, direct costs must be consistently allocated and applied to all benefited objectives/projects, regardless of specific contract provisions*.

EXAMPLE 4-2:

> *Sample Company maintains CADD usage logs and allocates computer costs directly to projects, but one of Sample's customers does not allow computer costs to be billed as direct charges. Sample must consistently allocate CADD costs directly to the project, even though the costs are not billable to the customer.*

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

5

Chapter 5 – Cost Accounting

5.1 – Allocation Bases, Generally

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

Some of the common allocation bases are discussed below:

A. Direct Labor Cost

Direct labor cost is the allocation base most commonly used to assign indirect costs to contracts. Direct labor costs generally are computed by multiplying all direct project labor hours by labor rates, as summarized for all employees within the applicable allocation unit. Labor rates are based on actual employee wages incurred, and indirect costs are allocated to projects by multiplying the indirect cost rate by the direct labor cost incurred to complete the projects.

B. Direct Labor Hours

Indirect costs also may be allocated based on direct labor *hours*, instead of *cost*. When using this method, indirect costs are allocated to projects by multiplying the indirect cost rate by the direct labor hours incurred to complete the projects.

C. Total Labor Hours (Total Hours Worked)

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

D. Total Cost Input

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

E. Total Cost Value Added

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

F. Consumption/Usage

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

5.2 – ACCOUNTING FOR UNALLOWABLE COSTS IN ALLOCATION BASES

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

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

CAS 405-40(e) further specifies that:

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

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

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

EXAMPLE 5-1:

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

5.3 – COST CENTERS

Cost centers are established to accumulate and segregate costs associated with a single purpose. The costs are then assigned to cost objectives (projects) based on unit charges/consumption rates. For example, engineering consultants frequently compute unit charges for cost categories such as CADD, in-house printing, computers, and company vehicles. When establishing a cost center, the goal should be to estimate a unit charge that will minimize variances resulting from over- or under-applied costs.

Although some accounting systems will attempt to adjust unit charge rates throughout the year as actual costs become known, is it more common for the cost variances to be handled as an adjustment to the overhead cost pool, which is where the costs would have been allocated if they had not been directed to the cost center. However, if the over- or under-allocation is significant, then it may be necessary to adjust the contract/project charges.

Some firms do not create cost centers; instead, they estimate the cost of providing certain services by computing unit rates based on certain elements from general ledger accounts (e.g., automobile depreciation from a depreciation account). Once established, these unit charges are offset to overhead as "credit backs" or cost recoveries for allocated direct costs as they are incurred on projects. This type of costing is less precise and should not be used if the unit charges being accumulated are significant to the firm's overall operation. If handled on a direct-cost basis, the direct cost rates must be supported and audited. The burden is on the engineering consultant to prove the direct cost rates and that direct costs were properly removed from the indirect cost pool. The overhead audit should include disclosure notes regarding the audited direct cost rates and a listing of cost categories that the engineering consultant charges direct. See Chapter 10 for testing guidance and Chapter 11 for disclosure guidance.

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

A. Functional Cost Centers

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

B. Subsidiaries, Affiliates, Divisions, and Geographic Locations

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

5.4 – ALLOCATED COSTS

A. Generally

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

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

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

B. Fringe Benefits

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

C. Overhead

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

D. General and Administrative (G&A)

G&A expenses generally comprise all costs associated with business operations that cannot be specifically identified with a smaller unit of business activities. For example, certain management or administration costs that are incurred for an entire business unit may be considered G&A, but other accounting or legal costs benefiting a segment of the business may be considered part of the overhead pool of that specific business segment.

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

1. Computer/CADD Costs

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

2. Fleet or Company Vehicles

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

3. Equipment

Costs accumulated to this center are similar to both computer and company vehicle pools. Company equipment can be a wide variety of items from small to large that are used in various activities. Some examples include nuclear density meters, GPS equipment, and traffic counting machines.

4. Printing/Copying/Plan Reproduction

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

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

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

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

Like-cost categories should be allocated consistently in the accounting system. As an example, employee personal vehicle mileage must be allocated to similar cost objectives in the same manner as company vehicle mileage. One category of like costs may not be allocated directly to contracts while the related like cost category are recovered as part of the indirect cost rate.[9]

F. Internal Labor Costs

1. Direct Labor

Labor costs are usually the most significant costs incurred by design and engineering firms in the performance of Government contracts. Incurred labor costs form the basis for estimating labor for future contracts. Therefore, it is imperative that engineering consultants establish and maintain a proper, accurate 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

[9] Note: Other common *like-cost* categories include computers and telephones.

and preprinted, if possible, with the employee's name, number, and fiscal week. An inadequate system would allow employees to erase prior entries without recording the adjustment. Employees should initial all time sheet changes and adjustments should be maintained as part of the audit trail.

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

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

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

2. Uncompensated Overtime for Salaried Employees

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

To ensure the proper allocation/distribution of labor costs, the engineering consultant must establish procedures requiring the consistent recording and accounting for hours worked, whether paid or unpaid. This is necessary because labor rates and labor overhead costs can be affected by total hours worked, not just paid hours worked. These procedures also must ensure consistency of labor-cost allocations as used in the indirect cost calculation, job cost accounting system, cost estimates for proposals, and invoicing on actual-cost contracts.

Per DCAA CAM Section 6-410.3.d:

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

For engineering consultants with *material*(†) amounts of uncompensated overtime labor, it is necessary to account for the uncompensated overtime properly to minimize the risk that Government projects will absorb disproportionate amounts of direct labor costs. Accordingly, the engineering consultant must evaluate and document the effect of uncompensated overtime.

(†) ***Note****: Although the materiality determination is dependent on a variety of factors, there may be instances where uncompensated overtime exists but clearly does not have an effect on the indirect cost rate. For example, in the case of an employee who works overtime and only works on administrative activities, the employee's entire salary is recorded as indirect labor, regardless of the amount of any uncompensated overtime.*

The consultant may use one of the following methods to distribute labor for salaried employees:

***2.1. Effective Rate Method*.**

Using this method, effective hourly pay rates are computed weekly, based on actual time charges. (Effective hourly rates also could be computed per payroll period or on a monthly basis; the concept is the same). This requires the firm to divide each employee's total salary by their respective hours worked for the period, which results in variable wage rates being allocated to cost objectives (direct and indirect). For example, if Employee Smith is paid $1,400 per week and works 40 hours per week, then Smith's effective hourly wage rate is $35. By contrast, if Smith actually works 55 hours in week 1and 50 hours in week 2, then his effective wage rates are $25.45 and $28, respectively.

***2.2. Salary Variance Method*.**

Under this method, labor costs are allocated at standard hourly rates for every hour worked and overhead is reduced for the appropriate portion of labor costs generated by uncompensated overtime hours. Standard rates are computed as the total salary cost to be paid divided by the estimated number of hours that a salaried employee is expected to work. Under the salary variance method, the direct labor base used to calculate the indirect cost rate must equal the direct cost of labor in projects at standard rates. Any variance (difference) between the amount of labor distributed at standard rates and actual labor expenses (paid) must be applied (usually as a credit) to indirect labor.

Typically, the application of the variance to indirect costs is recorded each pay period as part of the engineering consultant's labor accounting process. For illustration purposes, the following example assumes an annual adjustment. In this example, if Employee Smith earns $72,800 and is expected to work 2,080 hours a year, then his standard hourly wage rate is $35. If Smith actually works 2,150 hours during the year, then the total labor distributed at standard rates would be $75,250 ($2,450 more than Smith was actually paid). The $2,450 variance is applied to indirect labor.

Many firms calculate standard rates based on a standard work week of 40 hours. To minimize the amount of the variance and improve the accuracy of cost accounting, firms that expect salaried employees to work more than a 40-hour week may base standard rates on a more realistic estimate of hours worked rather than an arbitrary value such as 40 hours a week or 2,080 hours a year.

A labor distribution using the salary variance method is illustrated below in Table 5-1:

Table 5-1: Salary Variance Method

Employee	Direct Hours	Indirect Hours	Hours Worked	Annual Salary	Standard Hourly Rate	Direct Labor	Indirect Labor	Labor Variance	Total Labor
Smith	1,800	350	2,150	$72,800	$35	$63,000	$12,250	$(2,450)	$72,800
Ending Direct Labor:		$63,000							
Ending Indirect Labor:		$9,800	($12,250 - $2,450)						

a. Issues Arising from Inconsistent Methods of Labor Distribution Under the Effective Rate Method

When the labor distribution method used to calculate the indirect cost rate is based on effective rates, billings and estimates on Government contracts also should be based on effective rates.

Engineering consultants often prepare cost estimates and invoices at standard rates. If an A/E firm distributes labor for its indirect cost rate calculation using effective rates but develops cost proposals and invoices at standard rates, this creates the potential for overbilling, as the standard labor rate billed on a contract normally would exceed the effective labor rate used to calculate the base for the indirect cost rate. In situations where Government contracts are billed and estimated at standard rates when the labor costs are distributed using effective rates for the indirect cost rate calculation, an adjustment is warranted and required.

When effective rates are used to calculate the indirect cost rate and prepare invoices on contracts, the engineering consultant also must prepare its estimates using labor rates that reflect all the hours that salaried employees are expected to work. This may be done for salaried employees by developing "standard hours" for estimating that are based on historical hours worked by salaried employees. Use of effective rates for estimating is especially critical for lump-sum and specific-rate-of-compensation contracts.

It is important to analyze the effect of the potential overbilling on the engineering consultant's government contracts. In some cases, for example where employees working on government contracts are paid for all hours worked or where such employees do not incur uncompensated overtime, the use of the Effective Rate Method may not result in overbilling. However, it should be noted that, in cases where a consultant asserts that an inconsistent labor distribution or incomplete accounting for uncompensated overtime has no effect on government contracts the burden of proof is upon the engineering consultant.

When an inconsistent labor distribution exists, there are approaches that can be taken prevent overbilling on contracts:

1. An adjustment to the direct and indirect labor amounts in the indirect cost rate calculation can be made so that the direct labor amount reflects labor priced at the standard rate method used to bill and estimate direct labor costs. Both the direct and indirect labor costs must be adjusted so that total labor in the distribution equals actual labor expense. Adjusting direct labor without making a balancing adjustment to indirect labor cost would be inconsistent with FAR 31.201-1 (Composition of total cost). Making this adjustment essentially converts the labor distribution to the Salary Variance Method described above.
2. An adjustment could be made by re-pricing invoiced direct labor on a job-by-job basis using effective labor rates. For actual cost contracts, the engineering consultant would issue revised invoices to the government. For lump-sum or specific-rate-of-compensation contracts estimated based on standard rates, the engineering consultant may be required to notify the government that contract estimates were developed based on inaccurate pricing data and may have to re-price those contracts using estimates based on effective rates.

***Note**: If the engineering consultant chooses to continue using an effective rate distribution method to calculate its indirect cost rate that is not consistent with the company's invoicing and estimating practices, in future periods, the company must modify its procedures for estimating and invoicing costs to eliminate the potential for overstatement of costs in total. In some cases, the circumstances would result in the firm's auditor reporting the issue as an internal control deficiency that may or may not be a material weakness.*

b. When Clients Require Different Cost Accounting Methods for Labor

Some State and local contracting officers require engineering consultants to price labor on contracts using a method that is not consistent with the method the firm uses to calculate its indirect cost rate. For example, some contracting agencies require all firms to price labor for salaried employees using a standard rate based on 40 hours a week even if a firm normally uses effective rates.

In cases where a firm normally calculates its indirect cost rate using effective rates but is required by a contracting agency/State DOT to invoice and estimate costs at standard rates on certain contracts due to State-specific requirements the contracting agency also could require disclosure of an alternative indirect cost rate as noted previously in Section 4.2.

When this condition occurs, the consultant firm must establish procedures to ensure indirect cost rates are calculated and applied to contracts consistent with the method of calculating labor rates for salaried employees based on the requirements of the contracting agency. Unless the contracting agency has specified a required method, the consultant should prepare estimates and invoices using the method used for its FAR-compliant indirect cost rate.

The following methods of accounting for uncompensated overtime are ***unacceptable***:

- Distribute labor costs only to those cost objectives worked on during the first 8 hours of the day or the first 40 hours of the week.
- Allow employees to select the cost objectives to be charged when more than 8 hours per day or 40 hours per week are worked, or the A/E firm has an informal policy as to how employees are to select the objectives to be charged.

3. Overtime Premium

Engineering consultants must maintain records that properly classify overtime premium[10] amounts as

[10] "Overtime premium" is the difference between an employee's standard hourly wage rate and the special hourly wage rate paid for hours worked in excess of 40 per week. For example, an employee whose standard hourly rate is $10 for the first 40 hours worked per week and $15 per hour for hours worked in excess of 40 has overtime premium of $5 for each hour worked in excess of 40. In cases where overtime is project related, the straight-time rate paid for

direct or indirect costs. Additionally, engineering consultants must establish overtime policies that are applied consistently and result in equitable cost allocations.

There are several alternative methods that may be used to allocate the cost of overtime premium to final cost objectives. These include the following:

- Overtime premium may be allocated exclusively as an indirect cost and distributed to all projects as part of the indirect cost rate(s).
- Overtime premium may be allocated as a direct project cost or an indirect cost, based on the activity that caused the overtime hours to be incurred. The engineering consultant must have established criteria to determine where to assign overtime premium when employees earning overtime premium work on multiple final cost objectives during a week (see Example 5-2).
- As an alternative, some firms build the anticipated cost of overtime premium into established standard charge rates for non-exempt employees. In this situation, the standard charge rate is based on an estimate of each employee's total regular and overtime wages earned divided by the estimated total hours in pay status. Variances between the standard rates and actual rates are allocated through the indirect cost pool in a manner similar to variances for salaried employees who are charged at standard rates.

Note*: When overtime premium is allocated as a direct project cost, there are various acceptable practices for allocating indirect costs to overtime premium. For example, some engineering consultants include overtime premium costs in the direct labor base and allocate indirect costs to overtime premium costs. Other consultants exclude overtime premium costs from the direct labor base and do not apply the firm's indirect cost rate to overtime premium costs.*

Overarching Concept: *Consultants must treat overtime premium costs consistently for all contracts, regardless of the customer (Government versus commercial) or type of contract (e.g., lump sum versus actual cost) involved. Accordingly, overtime premium costs must be allocated consistently, regardless of whether the costs are billable.*

EXAMPLE 5-2: OVERTIME PREMIUM

Sample Design Firm has eight total active projects, including three lump-sum contracts and five cost-plus fixed fee contracts. Only two of the cost-plus fixed fee contracts allow overtime premium to be billed as a direct cost. Sample Firm's policy is to allocate project-related overtime premium directly to projects; accordingly, the overtime premium must be allocated to all eight projects consistently, regardless of whether the premium costs are billable.

Note*: Some State DOTs and/or local agencies may have specific policies regarding allocation of overtime premium, including whether to include overtime premium in the bases used to allocate indirect costs. When a consultant is required by a state or local agency to deviate from a consistently-applied, FAR-compliant methodology, and must calculate and present different indirect cost rates to meet the state or local requirements, alternate rates should be disclosed in notes to the indirect cost rate schedule.*

4. Other Considerations Regarding Internal Labor Costs

- ***Approvals and Authorizations***. The engineering consultant should have procedures to ensure that labor hours are recorded accurately and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals.
- ***Reconciliation of Labor System to Payroll and General Ledger***. The engineering consultant should have procedures requiring that the total direct and total indirect labor costs reflected in labor distribution summaries (job cost) agree with the total labor charges as entered in the timekeeping, payroll systems and general ledger. This reconciliation ensures the labor charges to

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overtime hours worked must be included in the direct labor base, while the premium amount is subject to additional considerations (see discussion above).

contracts represent actual paid or accrued costs and that such costs are appropriately recorded in the accounting records.

- ***Reconciliation of General Ledger and Indirect Cost Rate Schedule to Payroll Tax Returns (IRS Form 941s)***. The engineering consultant should have procedures requiring that the total labor costs recorded in the general ledger, and included on the indirect cost rate schedule, reconcile to the payroll data submitted to the Internal Revenue Service.
- ***Labor Costs Directly Associated with Unallowable Activities***. The engineering consultant should have procedures requiring that direct and indirect labor costs directly associated with unallowable costs are identified and segregated.

5. Potential Areas of Risk Regarding Internal Labor

- ***Overrun Contracts***. When contract costs have exceeded or are projected to exceed the maximum contract value, the excess costs must *not* be diverted to other cost objectives such as indirect labor, overhead accounts, or other contracts.
- ***Significant Changes in Direct/Indirect Labor Accounts***. Trend analyses may reveal instances where charges to direct or indirect labor accounts have increased significantly. Two common ratios often used for trend analysis are the *Productivity Ratio or Utilization Ratio* (direct labor/total salaries) and the *Multiplier Ratio* (net fee revenue/direct labor). A review should be performed to determine the nature of any significant changes from prior years.
- ***Reorganization/Reclassification of Employees***. The organizational structure of the engineering consultant should be analyzed to determine if the potential exists for the inconsistent treatment of similar labor. For example, a program manager should not charge direct on cost-type contracts and indirect on fixed-price/commercial contracts.
- ***Adjusting Journal Entries/Exception Reports (Labor Transfers)***. Adequate rationale and supporting documentation should be available for all significant labor transfers.
- ***Budgetary Control***. Engineering consultants may operate management systems that require strict adherence to budgetary controls. If the system is inflexible, then labor charges may tend to follow the identical route of the budgeted amounts. Rigid budgetary control systems can result in predetermined labor charges.
- ***Mix of Contracts***. Engineering consultants must identify and allocate costs consistently in the accounting system, regardless of contract type. For firms that use combinations of lump-sum contracts and cost-reimbursement contracts, there is a significant risk that direct labor and other direct costs may not be allocated to the correct cost objective, resulting in the understatement of direct labor and overstatement of indirect labor or incorrect direct project charging.

Note: *For further discussion, see Chapter 9–General Audit Considerations.*

6. Sole Proprietors' and Partners' Salaries

The compensation of owners or partners must be allocated as direct labor when they are personally engaged in performing tasks on contracts. If sole proprietors or partners do not receive a salary, then their compensation must be determined by advance agreements or negotiation.

G. Contract Labor/ Purchased Labor

[Reference: CAS 418]

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

Two acceptable methods of accounting for this labor are:

1. Allocated as a direct cost to projects, or

2. Treated as other labor (direct or indirect as appropriate)

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

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

Other Direct Costs (ODCs) typically include items such as subcontractors, travel, and outside printing. ODCs also may include internally-allocated costs based on charge-out rates developed by the firm, such as company vehicle mileage and copying (see earlier discussion in Section 5.4.E).

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

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

5.6 – FIELD OFFICE RATES

[Reference: FAR 31.203(f)]

A. Generally

Certain contracts require work in field locations; accordingly, engineering consultants are not always able to perform contracted services from their established home- or branch offices. Field offices include, for example, project trailers located at project sites, and/or offices or other facilities provided by State DOTs for an extended period of time. In these cases, the life of a field office generally is determined by the duration of the project.

Per FAR 31.203(f): "Separate cost groupings for costs allocable to offsite locations may be necessary to permit equitable distribution of costs on the basis of the benefits accruing to the several cost objectives." Accordingly, for projects where the engineering consultant's employees do not work out of their own offices and do not receive office support in their daily activities, it may be appropriate to establish a field rate to reflect more accurately the overhead costs allocable to field labor. The purpose of the field rate is to pay the engineering consultant for the fringe benefits and home office management and administrative support provided to field employees. Field rates also reflect efficiencies gained through the high utilization rates[11] of employees assigned to client locations on a full-time basis.

Engineering consultants may choose to compute separate home office and field rates in their indirect cost rate schedules. Generally, this requires labor to be tracked and categorized by location, and labor allocations must be supported with appropriate documentation such as detailed timesheets and associated job-cost records. Some engineering consultants may even establish a separate company for field projects, with an indirect cost rate prepared specifically for field operations.

In cases where an engineering consultant does not have an established field rate, the consultant may propose or negotiate a field rate for a specific project, if required by a State DOT or other customer. In accordance with FHWA guidance, State DOTs may require a field rate to be used for a specific project,

[11] *Utilization rate* is the percentage of time an employee spends doing project work.

but State DOTs may *not* require the establishment of separate home and field rate accounting.[12]

***Note**: All costs identified with a specific project must be consistently treated as direct costs of such project in the engineering consultant's accounting records. Accordingly, these costs are eligible for reimbursement as direct costs, subject to any contract-specific limitations.*

Additionally, although field offices may exist in several forms, regardless of the engineering consultant's organization, **consistency** *in allocating costs to cost objectives is critical. This Guide presents several possible methods for computing field office rates. The use of alternative methods may be acceptable. The use of all methodologies must be supported by notes to the indirect cost rate schedule or in a separate disclosure statement when engineering consultants present separate home and field rates in their indirect cost rate schedules. See Section 5.6.C for further discussion of cost accounting considerations applicable to field offices.*

B. Types of Field Offices

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

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

C. Cost Accounting Considerations

As noted previously in Section 5.6.A, engineering consultants must be consistent in the development and application of field rates. Accordingly, if an engineering consultant has computed a field rate, this rate must be consistently applied across all applicable business segments and disciplines.

Field rate accounting has an impact on the home office rate. If an engineering consultant has established separate home and field rate accounting for purposes of developing their indirect cost rate schedule, then the engineering consultant's home office rate will be higher than if the consultant had only a single company-wide rate.

1. Field Office Direct Labor

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

2. Field Office Indirect Costs

There are many factors to consider when developing methodologies for field and project office rates, and these factors may vary among engineering consultants. However, direct labor is the common base used in the development of field rates.

The following method described for allocating costs is a possible approach, but field- and project-office

[12] Accordingly, the use of a project-specific rate does not create a de facto home- and field-office rate structure that must be accepted by other State DOTs. For example, a consultant with a project-specific field rate that applies to only one project will use its corporate-level indirect cost rate for other projects.

rate calculations based on different methodologies than what is provided in this Guide may be acceptable. The underlying requirement is the consistent allocation of costs using a method, or combination of methods, to allocate costs on the basis of the benefits received by home office and field pools. Many engineering consultants disclose their allocation methodology in the notes to the indirect cost rate schedule (or associated audit report) or have an approved Cost Allocation Disclosure Statement that documents the field-office allocation methodology.

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

Generally, engineering consultants do not assign administrative staff to field offices; instead, most administrative and management functions are performed at the consultant's home or branch office. Therefore, an equitable portion of the home or branch office indirect costs should be allocated to the field office. The costs that are allocated, and the basis for the allocation, depend largely on the engineering consultant's customary accounting practices.

Some State DOTs require separate cost pools for accumulation of field office costs. Certain home office indirect cost should be fully allocated to the home office overhead pool, and certain field office indirect cost should be fully allocated to the field office pool. (See further discussion in Section 5.6.C.3).

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

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

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

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

TABLE 5-4: COMPUTATION OF FIELD OFFICE LABOR RATE

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

Indirect Labor—Support Staff. In connection with general support provided to field offices, indirect labor costs for accounting, legal, purchasing, personnel, management(†), and similar costs also should be included in the field office overhead pool. In cases where it is feasible for such support staff to track and account for the time they devote to supporting field activities, this time should be specifically identified and assigned to the field office overhead pool based on actual time/cost. By contrast, when it is impractical for staff to track specific time spent in support of field activities, these indirect labor costs may be *allocated* between the home office overhead pool and the field office overhead pool by using a ratio such as the Field Office Labor Rate shown above.

(†) Note*: Project managers who spend time working directly on field projects must account for this time as* direct *labor cost of the affected projects.*

3. Other Considerations Regarding Indirect Cost Allocations

Indirect Costs Fully Allocated to Home Office. Certain home office indirect costs should be fully allocated to the home office overhead cost pool. These costs include, for example, the costs of equipment benefitting home office projects only. Costs of support functions that support both home and field offices should be allocated accordingly.

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

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

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

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

TABLE 5-5: SAMPLE INDIRECT COST RATE SCHEDULE

Sample Consulting Company
Statement of Direct Labor, Fringe Benefits, and General Overhead
For the Year Ended December 31, 200x

Description	General Ledger Account Balance	Disallowed Costs	Notes	Proposed Company Wide	% of Direct Labor
DIRECT LABOR	$ 1,950,501	$ -		$ 1,950,501	100.00%
FRINGE BENEFITS					
6300 Benefits: Bonuses	$ 234,060	$ (28,560)	(a)	$ 205,500	10.54%
6310 Benefits: 401(k) - Employer's Contribution	97,525	-		97,525	5.00%
6320 Benefits: PTO (vacation, sick, and holiday)	253,565	-		253,565	13.00%
6820 Insurance: Disability	58,515	-		58,515	3.00%
6830 Insurance: Life	21,846	(800)	(b)	21,046	1.08%
6840 Insurance: Medical	136,535	-		136,535	7.00%
6850 Insurance: Workers' Comp	15,799	-		15,799	0.81%
7500 Payroll Taxes: FICA and Med	180,421	-		180,421	9.25%
7510 Payroll Taxes: FUTA and SUTA	78,020	-		78,020	4.00%
TOTAL FRINGE BENEFITS	$ 1,076,286	$ (29,360)		$ 1,046,926	53.67%
GENERAL OVERHEAD					
6700 Indirect Labor	$ 741,190	$ (3,300)	(c)	$ 737,890	37.83%
6000 Advertising and Marketing	23,991	(6,750)	(d)	17,241	0.88%
6100 Automobile Expense	68,268	(13,580)	(e)	54,688	2.80%
6200 Bank Service Charges	9,753	-		9,753	0.50%
6400 Contributions and Gifts	14,629	(14,629)	(f)	-	0.00%
6500 Depreciation Expense	117,030	-		117,030	6.00%
6600 Dues and Subscriptions	16,189	(350)	(g)	15,839	0.81%
6800 Insurance: Automotive	15,409	-		15,409	0.79%
6810 Insurance: Business Liability	23,406	-		23,406	1.20%
6900 Interest Expense	36,084	(36,084)	(h)	-	0.00%
7000 Licenses and Permits	21,456	-		21,456	1.10%
7100 Maintenance and Repairs	97,135	-		97,135	4.98%
7200 Meals and Entertainment	19,310	(1,050)	(i)	18,260	0.94%
7300 Miscellaneous Fees, Fines, and Penalties	6,827	(6,827)	(j)	-	0.00%
7400 Office Expense: Cleaning	8,192	-		8,192	0.42%
7410 Office Expense: Postage and Delivery	4,486	-		4,486	0.23%
7420 Office Expense: Office Supplies	32,183	-		32,183	1.65%
7430 Office Expense: Other Office Expense	35,889	-		35,889	1.84%
7600 Personal Property Tax	42,911	-		42,911	2.20%
7700 Professional Fees: Accounting and Legal	30,428	-		30,428	1.56%
7800 Rent	180,049	(2,400)	(k)	177,649	9.11%
7900 Telephone	60,466	-		60,466	3.10%
8000 Utilities	29,472	-		29,472	1.51%
Direct Cost Recovery	-	(107,278)	(l)	(107,278)	-5.50%
TOTAL GENERAL OVERHEAD	$ 1,634,753	$ (192,248)		$ 1,442,505	73.96%
TOTAL FRINGE BENEFITS AND GENERAL OVERHEAD	$ 2,711,039	$ (221,608)		$ 2,489,431	127.63%

FAR References and Notes:

(a) 31.205-6(b)(2): Executive compensation in excess of reasonable amount is disallowed.
(b) 31.205-19: Key-officers' life insurance is disallowed (beneficiary is company and/or officers).
(c) 31.201-6(e)(2): Labor costs associated with advertising, entertainment, and other unallowable activities are disallowed.
(d) 31.205-1: Advertising materials and costs are disallowed.
(e) 31.205(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
(f) 31.205-8 & 31.205-13: Contributions and gifts are disallowed.
(g) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
(h) 31.205-20: Interest is disallowed.
(i) 31.205-13 & 31.205-50: Entertainment is disallowed.
(j) 31.205-15: Late fees, fines, and penalties are disallowed.
(k) 31.205-11(f) & 31.205-36: Related party rent is limited to allowable cost of ownership.
(l) 31.202: Internal allocation direct cost credit.

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

SAMPLE CONSULTING COMPANY, INC.
Statement of Direct Labor, Fringe Benefits, and General Overhead—with Field Rate
For the Year Ended December 31, 200x

Description	General Ledger Account Balance	Disallowed Costs	Notes	Proposed Company Wide	ALLOCATIONS Proposed Home Office	Proposed Field Office	Notes	Percent to Field Office
DIRECT LABOR..	$ 1,950,501	$ -		$ 1,950,501	$ 1,826,853	$ 123,648	(m)	6.34%
FRINGE BENEFITS								
6300 Benefits: Bonuses..	$ 234,060	$ (28,560)	(a)	$ 205,500	$ 193,000	$ 12,500	(m)	
6310 Benefits: 401(k) - Employer's Contribution......	97,525	-		97,525	91,254	6,271	(m)	
6320 Benefits: PTO (vacation, sick, and holiday).....	253,565	-		253,565	241,421	12,144	(m)	
6820 Insurance: Disability....................................	58,515	-		58,515	54,805	3,710		6.34%
6830 Insurance: Life..	21,846	(800)	(b)	21,046	19,712	1,334		6.34%
6840 Insurance: Medical.......................................	136,535	-		136,535	127,879	8,656		6.34%
6850 Insurance: Workers' Comp............................	15,799	-		15,799	14,797	1,002		6.34%
7500 Payroll Taxes: FICA and Med........................	180,421	-		180,421	168,982	11,439		6.34%
7510 Payroll Taxes: FUTA and SUTA....................	78,020	-		78,020	73,074	4,946		6.34%
TOTAL FRINGE BENEFITS..	$ 1,076,286	$ (29,360)		$ 1,046,926	$ 984,924	$ 62,002		
GENERAL OVERHEAD								
6700 Indirect Labor (G&A and support allocation)....	$ 741,190	$ (3,300)	(c)	$ 737,890	$ 681,482	$ 37,760	(n)	5.25%
6700 Indirect Labor (field labor allocation)				-		18,648	(m)	
6000 Advertising and Marketing............................	23,991	(6,750)	(d)	17,241	16,336	905		5.25%
6100 Automobile Expense...................................	68,268	(13,580)	(e)	54,688	51,817	2,871		5.25%
6200 Bank Service Charges.................................	9,753	-		9,753	9,241	512		5.25%
6400 Contributions and Gifts................................	14,629	(14,629)	(f)	-	-	-		5.25%
6500 Depreciation Expense..................................	117,030	-		117,030	115,801	1,229	(o)	1.05%
6600 Dues and Subscriptions...............................	16,189	(350)	(g)	15,839	15,007	832		5.25%
6800 Insurance: Automotive.................................	15,409	-		15,409	14,600	809		5.25%
6810 Insurance: Business Liability.........................	23,406	-		23,406	22,177	1,229		5.25%
6900 Interest Expense...	36,084	(36,084)	(h)	-	-	-		5.25%
7000 Licenses and Permits..................................	21,456	-		21,456	20,330	1,126		5.25%
7100 Maintenance and Repairs.............................	97,135	-		97,135	92,035	5,100		5.25%
7200 Meals and Entertainment.............................	19,310	(1,050)	(i)	18,260	17,301	959		5.25%
7300 Miscellaneous Fees, Fines, and Penalties......	6,827	(6,827)	(j)	-	-	-		5.25%
7400 Office Expense: Cleaning.............................	8,192	-		8,192	8,106	86	(o)	1.05%
7410 Office Expense: Postage and Delivery............	4,486	-		4,486	4,439	47	(o)	1.05%
7420 Office Expense: Office Supplies....................	32,183	-		32,183	31,845	338	(o)	1.05%
7430 Office Expense: Other Office Expense...........	35,889	-		35,889	35,512	377	(o)	1.05%
7600 Personal Property Tax.................................	42,911	-		42,911	42,460	451	(o)	1.05%
7700 Professional Fees: Accounting and Legal.......	30,428	-		30,428	28,831	1,597		5.25%
7800 Rent...	180,049	(2,400)	(k)	177,649	175,784	1,865	(o)	1.05%
7900 Telephone..	60,466	-		60,466	57,292	3,174		5.25%
8000 Utilities...	29,472	-		29,472	29,163	309	(o)	1.05%
Direct Cost Recovery..	-	(107,278)	(l)	(107,278)	(106,152)	(1,126)	(o)	1.05%
TOTAL GENERAL OVERHEAD..................................	$ 1,634,753	$ (192,248)		$ 1,442,505	$ 1,363,407	$ 79,098		
TOTAL FRINGE BENEFITS AND GENERAL OVERHEAD.......	$ 2,711,039	$ (221,608)		$ 2,489,431	$ 2,348,331	$ 141,100		

Note allocation of indirect labor to Home Office and Field Office.

INDIRECT COST RATE AS PERCENTAGE OF DIRECT LABOR..	128.55% Home Office	114.11% Field Office

FAR References & Notes:

(a) 31.205-6(b)(2): Executive compensation in excess of reasonable amount is disallowed.
(b) 31.205-19: Key-officers' life insurance is disallowed (beneficiary is company and/or officers).
(c) 31.201-6(e)(2): Labor costs associated with advertising, entertainment, and other unallowable activities are disallowed.
(d) 31.205-1: Advertising materials and costs are disallowed.
(e) 31.205(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
(f) 31.205-8 & 31.205-13: Contributions and gifts are disallowed.
(g) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
(h) 31.205-20: Interest is disallowed.
(i) 31.205-13 & 31.205-50: Entertainment is disallowed.
(j) 31.205-15: Late fees, fines, and penalties are disallowed.
(k) 31.205-11(f) & 31.205-36: Related party rent is limited to allowable cost of ownership.
(l) 31.202: Internal allocation direct cost credit.
(m) Field employee labor and fringe specifically identified.
(n) Indirect general administrative and support labor less identified field portion is allocated.
(o) Accounts allocated at a lower percentage to field offices--see facilities cost calculation in Table 5-7.

TABLE 5-7: FIELD OFFICE COMPUTATIONS

Field Employee Worksheet

Employee Name & Classification	Direct Labor	Bonuses (fringe benefit)	401(k) (fringe benefit)	PTO (fringe benefit)	Field-Specific Totals
Name 1 - Project Manager	-	-	-	-	-
Name 2 - Senior Engineer	$ 50,176	$ 7,500	$ 2,620	$ 4,928	$ 65,224
Name 2 - Project Engineer	41,216	3,500	1,966	4,048	50,730
Name 4 - Technician 1	32,256	1,500	1,685	3,168	38,609
	$ 123,648	$ 12,500	$ 6,271	$ 12,144	$ 154,563

Field Office Direct Labor Calculation

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

Field Office Labor Calculation

	Company Wide	Field Office
Direct Labor	$ 1,950,501	$ 123,648
PTO (vacation/sick/holiday)	253,565	12,144
Indirect Labor	737,890	18,648
Totals	$ 2,941,956	$ 154,440
		÷
Total Company Labor		2,941,956
Field Office Labor %		5.25%

Facilities Cost Calculation

Number of support staff in home office (†)	8
	÷
Total number of staff in home office	40
Percentage of facilities cost to allocate to home and field	20%
	x
Field Office Labor %	5.25%
Facilities Cost Allocation %	1.05%

(†) Support staff are employees in positions such as HR, Accounting, Payroll, Management supporting all employees (home and field).

6

Chapter 6 – Labor-Charging Systems and Other Considerations

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

6.1 – Background

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

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

6.2 – Labor Costs, Generally

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

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

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

6.3 – LABOR COSTS ASSOCIATED WITH BID AND PROPOSAL AND SELLING ACTIVITIES

Bid and Proposal costs and Selling costs are two types of labor costs of particular, consistent concern to State DOTs and audit agencies. The allowability of these costs is discussed below in Sections 6.3.A and 6.3.B, respectively.

A. Bid and Proposal Costs (B&P)

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

1. B&P Definition

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

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

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

2. B&P Identification and Accumulation

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

3. B&P Efforts Sponsored by Grant or Required by Contract

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

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

B. Selling Effort and Activities

This Section, 6.3.B, contains general guidance in determining the allocability, allowability, and reasonableness of selling costs under Government contracts, as discussed in FAR 31.205-38.

1. Direct Selling

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

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

Generally, the costs of direct selling efforts are allowable.

2. Brokerage Fees, Commissions, and Similar Costs

[Reference: FAR 31.205-38(c)]

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

3. Other Cost Principles Related to Selling Efforts

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

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

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

4. Recordkeeping Requirements

[References: FAR 31.201-2(d)]

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

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

6.4 – DCAA ACCOUNTING GUIDE

[References: FAR 31.002, DCAAP No. 7641.90]

The Defense Contract Audit Agency (DCAA) issued Pamphlet No. 7641.90 (DCAAP 7641.90), *Information for Contractors*.[13] The DCAAP provides useful guidance but does not have the effect of law. The DCAAP is referenced at FAR 31.002 and provides extensive guidance regarding labor-charging systems. Specifically, sections 2-301 through 2-302.2 provide guidance regarding the—

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

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

A. Accounting System Internal Control

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

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

B. Labor Charging System Internal Control

1. Generally

The key link in any sound labor time charging system is the individual employee. It is critical to labor charging internal control systems that management indoctrinates employees on their independent responsibilities for accurately recording time charges. This is the single most important feature management can emphasize in recognizing its responsibility to owners, creditors, and customers to guard against fraud and waste in the labor charging function.

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

- The engineering consultant should have adequate segregation of duties for labor-related activities; for example, the responsibility for timekeeping and payroll accounting should be separated.
- Supervisors who are accountable for meeting contract budgets should not have the opportunity to initiate employee time charges. (It is recognized that, for a very small company, this type of

[13] Dated January 2005. The DCAAP is available at http://www.dcaa.mil/dcaap7641.90.pdf.

segregation may not be possible, whereas for a larger company, this type of segregation would be required in order to have good internal controls over labor costs.)

- The engineering consultant's procedures and controls must be evident, well defined, and reasonable so there is no confusion concerning the reason for the controls and no misunderstanding as to what is and what is not permissible.
- The engineering consultant must continuously maintain the controls and verify their effectiveness. Controls must be updated to correct any deficiencies, and violations must be remedied through prompt and effective action to serve as a deterrent to prospective violations.
- Individual employees must be constantly, although unobtrusively, made aware of controls that act as an effective deterrent against violations. Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through the posting of signs throughout the workplace to remind employees of the importance of accurate and current timecards.
- The engineering consultant should have a system of feedback to provide employees with opportunities to report to management any suspected mischarging or violations of the consultant's system of internal controls, with anonymity guaranteed.

2. Timecard Preparation

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

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

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

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

- Supervisory observation of employee arrival and departure to prevent improper clock-in/clock-out.
- Employee possession of timecard/timesheet.
- The employee prepares his or her timecard/timesheet in ink, as work is performed.
- Only one timecard/timesheet is prepared per employee per period; timecards/timesheets are preprinted with employee name and identification number; and timecards/timesheets are submitted to the designated timekeeping office or are collected by an authorized person.
- Pre-coded data is printed on job cards for identification purposes (e.g., codes for various leave types or indirect labor).
- Direct labor employees record their time no less often than daily. Sufficient formal subsidiary records must be maintained, if necessary, to ensure accuracy in labor recording and the proper allocation of labor costs to intermediate and final cost objectives when multiple jobs are worked in a day.

- Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.
- The correct distribution of time by project numbers, contract number or name, or other identifiers for a particular assignment. To ensure accuracy, a listing of project numbers and their descriptions should be provided in writing to the employee.
- Recording all hours worked whether they are paid or not. This is necessary because labor costs and associated overheads are affected by *total* hours worked, not just paid hours worked. Therefore, labor rate computations and labor overhead costs should reflect all hours worked. Unpaid hours worked are termed "uncompensated overtime."
- Employees and supervisors sign the timecards/timesheets in accordance with procedures, verifying the accuracy of the recorded effort.
- The job cost system is reconciled to the general ledger on a regular and consistent basis. This reconciliation should occur no less frequently than once every 30 days.

***Note**: A labor-charging checklist is attached at the end of this chapter to assist engineering consultants and accounting professionals in the assessment of the engineering consultant's labor-charging system.*
(See Table 6-1.)

3. Timekeeping Policy

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

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

6.5 – COMPLIANCE AND REVIEW

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

TABLE 6-1: LABOR-CHARGING CHECKLIST

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

Important Note: In this 2016 edition of the Guide, Chapter 7 has been updated only to reflect the issuance of the National Compensation Matrix (NCM). Other changes to this chapter may be required based on the latest rulings by the Armed Services Board of Contract Appeals (ASBCA). However, at this point, the impact of those rulings is unclear. Additional updates to Chapter 7 will appear in future editions of the Guide.

7

Chapter 7 – Compensation

7.1 – General Principles

[Reference: FAR 31.205-6]

Pursuant to FAR 31.205-6—

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

7.2 – Allowability of Compensation

[Reference: FAR 31.205-6]

Total compensation generally includes allocable and allowable wages, salaries, bonuses, deferred compensation, and employer contributions to defined contribution pension plans. Individual elements of compensation must be reviewed for allowability in compliance with the FAR, not for individual element reasonableness.

As required by FAR 31.205-6(b)(2), compensation must be evaluated for reasonableness in *total*, not for reasonableness of individual elements of compensation such as salary, bonus, or other fringe benefits. The total of all allowable compensation elements must be reasonable for the work performed.

Note*: Reasonableness of compensation is discussed more specifically in Section 7.3.*

7.3 – REASONABLENESS OF COMPENSATION

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

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

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

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

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

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

Accordingly, in compliance with FAR 31.205-6 engineering consultants must ensure and properly document that the compensation for each employee or job class of employees is reasonable for the work performed. The auditor is responsible for reviewing/testing the engineering consultant’s compensation analysis to the extent considered necessary based on the auditor’s risk assessment. The compensation analysis should be evaluated to determine whether the engineering consultant has properly evaluated the allowability of the individual elements and the reasonableness of total compensation. As required by FAR 31.205-6(b)(2), compensation must be evaluated for reasonableness in total, not for reasonableness of individual elements of compensation such as salary, bonus, or other fringe benefits. Additional audit guidance appears in DCAA Contract Audit Manual (DCAA CAM) Sections 6-413 and 6-414. Much of the guidance included therein has been incorporated into this Guide in the following sections.

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

[References: FAR 31.205-6(p), Public Law 105-85 Section 808(b), DCAA CAM Section 6-413.7, 10 U.S.C. 2324(e)(1)(P) and 41 U.S.C. 4304(a)(16); 41 U.S.C. 1127]

Pursuant to FAR 31.205-6, an engineering consultant is permitted to charge reasonable compensation to Government contracts as either a direct cost, indirect cost, or a combination of both. For all contracts awarded on or after June 24, 2014, FAR 31.205-6(p)(3) limits allowable compensation for all consultant employees to the benchmark compensation amount (BCA)[14] for the applicable consultant fiscal year determined by the Administrator of the Office of Federal Procurement Policy (OFPP).[15]

For contracts awarded prior to June 24, 2014, FAR 31.205-6(p)(1) limits compensation for Senior Executives to the benchmark compensation amount as determined by the Office of Federal Procurement Policy under 41 USC 1127 as in effect prior to June 24, 2014.[16]

***Note**: Engineering consultants and CPA firms should consult the requirements of FAR 31.205-6(p) which refer to the Benchmark Compensation Amount as well as the requirements of the Bipartisan Budget Act of 2013 which establish a lower limit on compensation for all contractor employees effective for contracts executed on or after June 24, 2014.*

Audits of indirect cost rates for consultant fiscal years ending on or after June 24, 2014 should be based on the limitations specified in FAR 31.205-6(p)(3) applied to all consultant employees. These compensation limits shall be used for estimating costs of new contracts as well as determining final costs for contracts awarded on or after June 24, 2014. Because the limits referenced in the FAR 31.205-6(p)(3) are more restrictive than the limits in FAR 31.205-6(p)(1), the consultant firm may elect to use an indirect cost rate subject to the limitations in FAR 31.205-6(p)(3) as the final cost rate for contracts awarded prior to June 24, 2014.

If an engineering consultant chooses to calculate final cost rates for contracts awarded prior to June 24, 2014 using the limitations in FAR 31.205-6(p)(1), the audited indirect cost rates should be based on FAR 31.205-6(p)(3) with the amount of adjustments to the indirect cost rate(s) representing additional costs allowable under FAR 31.205-6(p)(1) disclosed through a note or a separate schedule. When a State DOT performs a cognizant audit or work paper review of a firm that applies the higher BCA for contracts signed prior to June 24, 2014, the cognizant audit or approval should clearly indicate the basis and appropriate use of each rate.

Although the BCA is the statutory maximum for compensation costs that may be charged to Government contracts, the BCA must not be construed as an entitlement or a guaranteed amount of cost recovery. Instead, compensation is subject to the FAR allowability criteria discussed in FAR 31.201-2, including the allocability and reasonableness provisions of FAR 31.201-4 and FAR 31.205-6, respectively.[17] Owners of closely-held firms are subject to an additional restriction—no payment that represents a distribution of profits may be submitted as a cost against a Government contract.

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[14] Determination of the BCA is required by Section 39 of the OFPP Act, as amended (which is codified at 41 U.S.C. 1127). Accordingly, the BCA also is known as the "Section 1127 Statutory Formula Cap Amount." In this Guide, "BCA" is used consistently to refer to the Section 1127 Statutory Formula Cap Amount.

[15] See https://www.whitehouse.gov/omb/procurement/cecp.

[16] See http://www.whitehouse.gov/omb/procurement_index_exec_comp.

[17] This was reinforced by the Federal Office of Management and Budget: "While the benchmark executive compensation amount is the maximum allowable amount of compensation costs for certain executives of Government contractors, the benchmark amount as applied to a particular executive is not necessarily a safe harbor. Without regard to the benchmark compensation amount, the allowable compensation costs for each affected executive are still subject to the Federal Acquisition Regulation and the Cost Accounting Standards as applicable and appropriate to the circumstances, e.g., reasonableness and allocability. The Executive Compensation Cap is implemented at FAR 31.205-6(p)." (See http://www.whitehouse.gov/omb/procurement_index_exec_comp.)

7.5 – DETERMINING THE REASONABLENESS OF EXECUTIVE COMPENSATION

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

A. Generally

Pursuant to DCAA CAM Section 6-414.4c:

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

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

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

B. Procedures for Determining Reasonableness

The engineering consultant must determine the reasonableness of executive compensation in a manner compliant with the criteria established in FAR 31.205-6 and the two major Armed Services Board of Contract Appeals (ASBCA) decisions dealing with compensation: *Techplan Corporation*,[18] and *Information Systems and Networks Corporation*.[19]

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

***Note**: In cases where a consultant does not perform an acceptable compensation analysis, State DOTs may use the National Compensation Matrix (NCM) as a benchmark for determining the reasonableness of executive compensation. See Section 7.7 for specifics regarding the NCM.*

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

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

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

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

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

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

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

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

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

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

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

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

Position: President / CEO

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

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

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

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

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

TABLE 7-2: ESTIMATED REASONABLE COMPENSATION

(M = million)

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

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

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

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

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

TABLE 7-3: COMPARISON TO ACTUAL EXECUTIVE COMPENSATION:

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

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

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

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

7.6 – CRITERIA FOR DEMONSTRATING SUPERIOR PERFORMANCE

[References: DCAA CAM Section 6-414.4h]

A. Generally

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

> Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. Above average levels of compensation are usually identified by percentiles, such as the 75th percentile. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry's average. The ASBCA, in its decision on Information Systems & Networks Corporation ASBCA No. 47849, "capped" executive compensation at the 75th percentile when justified by performance.
>
> (1) Examples of financial performance measures may include the following:
>
> - Revenue Growth
> - Net Income
> - Return on Shareholder's [sic] Equity
> - Return on Assets
> - Return on Sales
> - Earnings per Share
> - Return on Capital
> - Cost Savings
> - Market Share
>
> (2) The contractor must show that the measure chosen is representative of the executive's performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive's performance, and certainly there should be no extra compensation due to performance which results primarily from the contractor's status as a Government contractor. Performance is typically measured using more than one criterion of performance. For example, a contractor may have significant sales growth through acquisitions and mergers while operating at a loss. In this situation, the contractor would not be considered to have superior performance based on the lone measure of sales growth.
>
> (3) Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable.

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

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

The analysis methodology steps include the following—

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

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

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

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

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

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

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

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

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

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

***Note**: Regardless of firm performance, executive compensation costs in excess of the Benchmark Compensation Amount[20] are unallowable.*

[20] See prior discussion in Section 7.4.

7.7 – STATE DOT OVERSIGHT: REVIEW OF EXECUTIVE COMPENSATION

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

A. Reviewing the Engineering Consultant's Compensation Analysis

As discussed previously in Section 7.5.B, engineering consultants are responsible for preparing a compensation analysis to demonstrate that claimed compensation costs are reasonable, and otherwise allowable,[21] in compliance with FAR 31.205-6, as interpreted and clarified by the ASBCA in *Techplan* and *Information Systems*. State DOTs and/or independent CPA auditors should review the consultant's analysis to validate compliance with the procedures described in Section 7.5.B.

***Note**: If the engineering consultant's compensation analysis is fully compliant with the Techplan and Information Systems criteria discussed previously in Section 7.5.B, then State DOTs will be required to accept the consultant's analysis.*

B. Using the National Compensation Matrix (NCM) to Evaluate Executive Compensation

In cases where engineering consultants do not prepare an acceptable compensation analysis, State DOTs must use other tools and techniques to obtain reasonable assurance that executive compensation costs are reasonable and otherwise allowable. To promote consistency in this process, a group[22] was formed to prepare a "National Compensation Matrix" (NCM or Matrix) for use in determining reasonable levels of executive compensation for engineering consultants in compliance with the criteria established in Section 7.5.B. The NCM Team began its deliberations on October 24, 2011, and the NCM was issued on May 8, 2012. The NCM is available at http://audit.transportation.org/Pages/default.aspx.

In future periods, the NCM will be updated as deemed appropriate by the NCM Team. In the event that the NCM is not updated in any given year, the amounts stated in the most recent NCM should be adjusted (escalated or de-escalated, as appropriate) based on instructions issued with the NCM.

Note Regarding State DOT Contracting Terms:

Engineering consultants should be aware that, if a State DOT imposes a direct hourly rate limitation pursuant to contractual agreement (and consistent with the FAR cost principles), then the difference between compensation paid versus compensation billed is still direct labor and must be allocated to projects accordingly. The amount not reimbursed by the State DOT must not be moved to another project or transferred to an indirect labor account. Accordingly, the unrecovered/unbilled amount represents a reduction to the profitability of a specific contract.

[21] Only the net amount of total compensation attributable to allowable business activities is subject to the reasonableness test. Accordingly, before performing a review for reasonableness, the engineering consultant must first disallow all unallowable forms of compensation and compensation associated with unallowable activities.

[22] The group (NCM Team or Team) included representatives from AASHTO, various State DOTs, the FHWA, ACEC, independent CPAs, and an independent Certified Compensation Professional (CCP).

7.8 – EXECUTIVE COMPENSATION—REQUIRED SUPPORTING DOCUMENTATION

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

- A complete compensation analysis prepared in accordance with all the criteria discussed in Section 7.5, or
- The NCM.[(†)]

(†) ***Note**: Regardless of whether the engineering consultant prepares its own compensation study using published compensation surveys or instead uses the NCM, the consultant must perform the procedures described in Section 7.5.C, Steps 1, 2, 8, and 9. (Consultants that use the NCM are not required to complete Steps 3 through 7 from Section 7.5.C.)*

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

For each executive, the engineering consultant must voluntarily disallow all compensation that exceeds the maximum amounts established by the consultant's analysis, or alternatively, the amount in excess of the applicable NCM threshold. The following information must be provided on the schedule and must be disclosed separately for each applicable position:

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

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

7.9 – ADDITIONAL PROCEDURES – RELATED PARTIES

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

Potential related-party indicators[23] that may impact audit risk include, but are not limited to, the following:

- Agreements under which one party pays expenses on behalf of another party.
- Circular business arrangements and transactions between related parties.

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

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

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

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

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

7.10 – SPECIAL CONSIDERATION FOR CLOSELY-HELD FIRMS

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

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

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

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

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

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

7.11 – BONUS AND INCENTIVE PAY PLANS

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

Payments made under bonus and incentive-pay plans frequently represent a large portion of the total compensation costs claimed by consultants. To be allowable charges against Government contracts, bonus payments must be allocable to Government contracts, reasonable in amount, and must not represent a distribution of profits to owners.[24] FAR 31.205-6(f)(1) further specifies that bonus payments are allowable, provided the:

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

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

A. Bonus and Incentive Plans

Typically, bonus plans are applicable to a broad class of employees. Some plans include eligibility for all employees, while others limit eligibility to professional and management staff. Individual participation may be based on the productivity of an individual, team, overall company, or some combination of these factors. Bonuses may be based on a percentage of an employee's base salary, or alternatively may be issued as lump-sum distributions, based on the available pool of money to be distributed. Other incentive payment plans, such as hiring bonuses and employee recruiting/referral payments, are allowable if they are part of the engineering consultant's recruitment process, are in conformity with the consultant's standard practices, and are applied consistently.

B. Profit-Distribution Plans

By contrast, profit-distribution plans involve a distribution of net earnings to owners. Individual distributions are based on partners' capital account balances, level of partnership (e.g., junior versus senior partner), number of owned shares, or some other factor linked to ownership. Consistent with FAR 31.205-6(a)(6), bonuses paid to owners of closely-held corporations should be subject to special scrutiny for potential distribution of profits when the firm does not have other mechanisms to provide a return on investment to owners such as payment of dividends, distributions, or a separate bonus plan for profit distributions.

C. Documentation of Bonus and Profit-Distribution Plans

Some companies have both bonus plans *and* profit-distribution plans. However, only the portion that is a valid bonus is allowable as a recoverable overhead expense. Best practices would provide that engineering consultants should prepare and maintain written bonus plans that identify eligibility requirements and provide details regarding how bonus payments are determined, to help ensure bonus costs are allowable.

In lieu of a written plan, auditors should perform a review to ensure: (a) awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and (b) basis for the award is supported.

Best practices also would provide for written profit-distribution agreements. Although not required under FAR 31-205-6(f), a written plan will serve to reduce confusion as to what is a bonus and what is a profit distribution. A bonus policy is recommended to include an adequate description of the performance measures used to determine bonus amounts, such as employee performance evaluation ratings,

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

contributions toward the firm's revenue growth, and responsibilities for cost containment.

Best practices suggest that written bonus plans should include the following components–

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

7.12 – FRINGE BENEFITS

[Reference: FAR 31.205-6(m)]

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

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

A. Deferred Compensation, Generally

[References: FAR 31.001, CAS 415]

FAR 31.001 defines *deferred compensation* as:

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

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

B. Pension Plans

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

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

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

Allowable Contributions. The amount contributed to qualified pension- or profit-sharing plans on behalf of principals and other employees is allowable. However, the payments must be reasonable in amount and be paid pursuant to an agreement entered into in good faith between the consultant and employees, before the work or services are performed and pursuant to the terms and conditions of the established plan. Contributions for pension costs must comply with FAR 31.205-6(j), which incorporates CAS 412 and 413.

Changes in Pensions Plans. As noted in FAR 31.205-6(j)(1), the cost of changes in pension plans are not allowable if the changes are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future. Additionally, one-time-only pension supplements not available to all plan participants are generally unallowable, unless the supplemental benefits represent a separate pension plan, and the benefits are payable for life at the option of the employee. Finally, increased payments to retired participants for cost-of-living adjustments are allowable if paid in accordance with a consistent policy or practice.

C. Employee Stock Ownership Plans (ESOPs)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. Severance Pay

[Reference: FAR 31.205-6(g)]

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

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

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

7.13 – SUPPLEMENTAL BENEFITS

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

A. Supplemental Executive Retirement Plans (SERPs)

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

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

B. Long-Term Incentive (LTI) Plans

[Reference: FAR 31.205-6(i)]

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

C. Executive Severance

[Reference: FAR 31.205-6(g)]

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

D. Golden Parachutes

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

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

E. Golden Handcuffs

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

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

8

Chapter 8 – Selected Areas of Cost

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

8.1 – Background

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

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

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

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

A. Directly-Associated Costs

One of the concepts that must be addressed, per FAR 31.201-6 Accounting for Unallowable Costs, is that costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly-associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly-associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred.

When an unallowable cost is incurred, its directly-associated costs are also unallowable. Directly-associated costs include, but are not limited to, labor, fringe, travel, meals, supplies used, and similar costs.

B. Burden of Proof

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

C. Determining Reasonableness

In accordance with FAR 31.201-3, a cost is *reasonable* if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. The reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by an engineering consultant. The burden of proof shall be upon the consultant to establish a cost is reasonable.

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

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

D. Direct Costs

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

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

8.2 – ADVERTISING AND PUBLIC RELATIONS

[Reference: FAR 31.205-1]

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

A. Advertising Costs

Selected allowable advertising costs include:

- Employee recruitment, including help-wanted advertising costs in accordance with FAR 31.205-34; and
- Costs of activities to promote sales of products normally sold to the U.S. Government, including trade shows, which contain a significant effort to promote exports from the United States.

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

B. Trade Show Expenses and Labor

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

The unallowable costs specified in FAR 31.205-1(f)(2) pertain to *exhibiting* products and services at trade shows. Accordingly, labor costs for booth attendants, and other associated costs such as booth rental and promotional items, must be disallowed—unless incurred for the export sales purposes described above. By contrast, labor costs generally are allowable for employees who merely attend trade shows for training.

C. Public Relations Costs

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

Specifically, costs of promotional material, motion pictures, videotapes, brochures, handouts, and magazines that are designed to elicit favorable attention to the engineering consultant are unallowable unless used primarily for employee training and orientation. Costs of memberships in civic and community organizations and costs of souvenirs, models, imprinted clothing, buttons and other mementos provided to customers or the public are also unallowable. Costs of sponsoring meetings, symposia, seminars and other special events when the principal purpose of the event is other than the dissemination of technical information are unallowable.

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

D. Bad Debts and Collection Costs

[Reference: FAR 31.205-3]

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

8.3 – COMPENSATION

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

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

For more specifics and details regarding Compensation, see Chapters 5, 6, and 7. (*)

(*) Chapter 7 provides detailed procedures for determining the allowability and reasonableness of executive compensation costs.

8.4 – PERSONAL USE OF COMPANY VEHICLES

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

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

8.5 – CONTRIBUTIONS OR DONATIONS

[Reference: FAR 31.205-8]

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

8.6 – FACILITIES CAPITAL COST OF MONEY (FCCM)

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

Facilities capital cost of money (FCCM) is an imputed cost related to an engineering consultant's investment in fixed assets/facilities used in contract performance, regardless of whether the source of the investment is equity or borrowed capital. FCCM is billed as a rate; however, FCCM is *not* a form of interest on borrowing. The costs of the capital investment must be determined, measured, and allocated to contracts in accordance with CAS 414.

Engineering consultants are not *required* to propose FCCM in pricing and performing a contract. However, when an engineering consultant chooses to claim cost of money, the estimated FCCM must be specifically identified in the cost proposals relating to the contract under which the cost is to be claimed.

Accounting for FCCM generally occurs through a memorandum entry of the cost. The engineering consultant must maintain, in a manner that permits audit and verification, all relevant schedules, cost data, and other data necessary to support the entry.

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

The interest rate used to compute FCCM is the arithmetic mean of the Federal Prompt Payment Act Interest Rate, as determined semiannually by the U.S. Secretary of the Treasury. These rates are published semiannually in the *Federal Register*[25] on or about January 1 and July 1. For a fiscal year ending December 31, the arithmetic mean would be the simple average of the rates for the January 1 through June 30 period and the July 1 through December 31 period.

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

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

8.7 – DEPRECIATION

[Reference: FAR 31.205-11]

Depreciation of plant, equipment and other capital/fixed assets is allowable if it does not exceed the amount used for financial reporting purposes, is reasonable, and is allocable to assets used in the engineering consultant's primary business activities. Depreciation for financial reporting should be determined using a systematic and rational method of cost recovery based on the useful business life of an asset. Accordingly, depreciation claimed on the indirect cost rate schedule should *not* be based on accelerated cost recovery methods that may be used for IRS tax purposes (e.g., IRC Section 179 write-offs or "bonus depreciation").

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[25] The rates also are available here: https://www.fiscal.treasury.gov/fsservices/gov/pmt/promptPayment/rates.htm.

When reviewing depreciation expense, special considerations apply to organizations under common control, fully depreciated assets, asset disposals, capital leases, rentals and other special CAS provisions contained in the FAR. Consistency is a key element.

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

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

Costs are reasonable if the engineering consultant follows policies and procedures that are: (a) consistent with those followed in the same cost center for business other than Government, and (b) reflected in the engineering consultant's books of accounts and financial statements.

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

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

***Note**: As discussed previously, expenses computed based on special tax deduction methodologies (e.g., I.R.C. Section 179 or "bonus depreciation") are not allowable.*

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

8.8 – EMPLOYEE MORALE, HEALTH, AND WELFARE

[Reference: FAR 31.205-13]

Entertainment expenses, which are unallowable, often are incorrectly categorized as Employee Morale expenses. Employee-morale type expenses often are covered by the entertainment cost principle, FAR 31.205-14.

***Note**: FAC 90-31, effective October 1, 1995, clarified that entertainment costs are unallowable under any cost principle, without exception. Consequently, the entertainment cost principle at FAR 31.205-14 overrides all other cost principles.*

To be allowable, expenses and income generated by employee welfare and morale activities must comply with FAR 31.205-13. This includes employee welfare and morale expenses incurred on activities to improve working conditions, employer employee relations, employee morale, and employee performance.

Types of activities that fall under this subsection are limited. Examples of *allowable* activities include in-house publications, health clinics, wellness/fitness, and employee counseling services. Also allowable are food services and dormitory services (i.e., cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations, and other similar types of services) at or near the consultant's facilities, subject to the requirements of FAR 31.205-13.

Generally, gifts are expressly unallowable; however, the cost principle specifically excludes two categories of awards from the unallowable gift definition:

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

Additionally, recreation expenses are expressly unallowable unless they meet all of the following criteria:

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

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

- Entertainment provided as part of public relations, employee relations, or company celebrations;
- Gifts to the public;
- Gifts to employees which are not for performance or achievement or are not made according to an established plan or policy;
- Travel tickets or tickets to shows or sporting events; and
- Recreational trips, shows, picnics, or parties.

8.9 – ENTERTAINMENT

[Reference: FAR 31.205-14]

Costs of amusement, diversions, social activities, and any directly-associated costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable. Costs of membership in social, dining, country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees. Examples of unallowable company sponsored employee social events, include, but are not limited to, outings to professional and college sporting events, company picnics, theme and holiday parties, and expo fairs.

8.10 – FINES AND PENALTIES

[Reference: FAR 31.205-15]

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

8.11 – GAINS AND LOSSES ON DEPRECIABLE PROPERTY

[Reference: FAR 31.205-16]

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

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

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

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

8.12 – IDLE FACILITIES AND IDLE CAPACITY COSTS

[Reference: FAR 31.205-17]

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

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

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

8.13 – BID AND PROPOSAL COSTS

[Reference: FAR 31.205-18]

Frequently, the composition of bid and proposal (B&P) costs is a key issue. Although marketing[26] and B&P activities can be similar in nature and frequently are performed by the same employees, there is an important distinction between the activities. That is, basic B&P costs are costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-government contracts. By contrast, marketing costs are more general in nature. Therefore, engineering consultants must establish procedures for segregating B&P costs from selling and marketing costs.

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

8.14 – PRECONTRACT COSTS

[References: FAR 31.205-32 & FAR 31.109(h)]

FAR 31.205-32 provides that (emphasis added):

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

Precontract costs are associated with specific contracts and therefore must not be included in the indirect cost pool. Precontract costs that meet the requirements of FAR 31.205-32 may be billable as direct project

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

charges; however, an advance agreement may be required (see FAR 31.109(h)). Precontract labor must remain allocated as a direct cost regardless of whether it is billable to a client.

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

8.15 – INSURANCE

[Reference: FAR 31.205-19]

A. Insurance on Lives of Key Personnel

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

B. Professional Liability Insurance

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

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

C. Losses and Insurance Deductibles

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

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

D. Self Insurance

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

Many engineering consultants rely on self-insurance to cover ordinary risks and losses but maintain various forms of purchased insurance to cover major risks and catastrophic losses. The self-insurance charge plus insurance administration expenses may be equal to, but must not exceed, the sum of comparable purchased insurance plus the associated insurance administration expenses. The engineering consultant's actual loss experience shall be evaluated regularly, and self-insurance charges for subsequent periods shall reflect such experience in a similar manner to purchased insurance.

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

8.16 – INTEREST COSTS

[Reference: FAR 31.205-20]

Interest on borrowings (however represented), bond discounts, costs of financing and refinancing capital (net worth plus long-term liabilities), legal and professional fees paid in connection with preparing prospectuses, and costs of preparing and issuing stock rights are unallowable (but see FAR 31.205-28). However, interest assessed by State or local taxing authorities under the conditions specified in FAR 31.205-41(a)(3) is allowable.

8.17 – LOBBYING COSTS

[Reference: FAR 31.205-22]

Lobbying and political activity costs are generally unallowable. Some examples of these types of costs are:

- Activities that attempt to influence Federal, State, or local legislation or the outcomes of Federal, State, or local elections;
- Contributions to political parties or organizations;
- Legislative liaison activities; and
- Activities that attempt influence employees of the executive branch of government.

Certain activities may be allowable if detailed records are maintained. They may include activities such as providing technical and factual presentation of information through testimony, statements, or letters in response to a document request on topics directly related to contracts, or lobbying activities that may directly reduce contract cost.

8.18 – LOSSES ON OTHER CONTRACTS

[Reference: FAR 31.205-23]

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

8.19 – ORGANIZATION AND REORGANIZATION COSTS

[References: FAR 31.205-6, FAR 31.205-27]

All costs incurred in connection with planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions or raising capital, are unallowable. However, an exception to this appears in FAR 31.205-27(b); the cost of activities primarily intended to provide compensation (acquiring stock for executive bonuses, employee savings plans, and employee stock ownership plans), are not considered organizational costs, but instead are governed by FAR 31.205-6.

8.20 – PATENT COSTS

[Reference: FAR 31.205-30]

Patent costs not required by the Government contract are unallowable. Certain costs may be allowable if they are incurred as a requirement of a Government contract. They include costs such as preparing disclosures, filing documentation, searching records, and counseling related to general patent matters.

8.21 – RETAINER AGREEMENTS

[Reference: FAR 31.205-33]

Costs for specialized work performed by outside consultants and other professionals are allowable if the work is for an allowable purpose and is supported by detailed evidence of the nature and scope of the work performed. When engineering consultants engage such professionals on a retainer-fee basis, FAR 31.205-33(e) requires that allowable retainer fees be supported by evidence that:

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

The following supporting evidential matter requirements also apply to retainer agreements, except retainer agreements are not required to (and generally do not) have specific statements of work. FAR 31.205-33(f) contains three specific documentation requirements that must be met for any professional and consultant service costs, including those on retainer-fee basis, to be allowable. These requirements are:

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

8.22 – RELOCATION COSTS

[Reference: FAR 31.205-35]

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

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

(C) Costs of temporary lodging, as discussed in paragraph (a)(2) of this subsection.

(ii) When reimbursement on a lump-sum basis is used, any adjustments to reflect actual costs are unallowable.

The following types of relocation costs are *unallowable*:

(1) Loss on the sale of a home.

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

(i) Real estate brokers' fees and commissions.

(ii) Costs of litigation.

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

(iv) Mortgage life insurance.

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

(vi) Property taxes and operating or maintenance costs.

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

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

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

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

8.23 – RENT/LEASE

[Reference: FAR 31.205-36]

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

A. Capital Leases

In some cases, leased property is considered a purchased asset and must be accounted for as a capital lease. Accounting for capital leases requires the property acquired through the lease to be capitalized and amortized/depreciated over the property's useful life. The criteria for classifying leases are discussed in paragraph 7 of FASB Statement No. 13. If a lease meets one or more of the following four criteria, the lease shall be classified as a capital lease; otherwise, it shall be classified as an operating lease:

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

B. Common Control & Cost of Ownership

Common control is another important issue when considering the allowability of rental costs. In accordance with FAR 31.205-36(b)(3), charges in the nature of rent for property between any divisions, subsidiaries, or organizations under common control are allowable to the extent that the charges do not exceed the normal costs of ownership (e.g., depreciation, taxes, insurance, facilities capital cost of money, and maintenance), provided that no part of such costs shall duplicate any other allowed cost. Rental cost of *personal property* (property other than real estate) leased from any division, subsidiary, or affiliate of the contractor under common control, that has an established practice of leasing the same or similar property to unaffiliated lessees, shall be allowed in accordance with FAR 31.205-36(b)(1).

FAR Part 31 does not specifically define *common control*; however, per ASC 850-10-20, *control* is defined as: "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise." ASC 850-10-20 also identifies and lists related parties. The question of whether two entities are under common control, or related parties, is a question of fact. The key question is whether one party has the ability to exercise control over the operating and financial policies of the related party.

An individual does not need to have over 50 percent ownership to have control. Regardless of the ownership percentage, costs exceeding the constructive cost of ownership are unallowable in total and should not be prorated based thereon.

The auditor must evaluate the control relationship and review the transactions that actually occurred to determine whether common control exists. A party may have actual control even if such control is not evidenced by the agreement. Therefore, it is important to review the events and transactions that actually occurred in making a determination of whether control exists. Two of the most important areas to review are: (1) the actual decision-making process, and (2) the reasonableness of the lease terms.

***Note**: If any portion of business assets, including square footage of a building, is used for a purpose other than the engineering consultant's business operations, then the associated costs must be excluded from the cost-of-ownership computation. This includes personal use of assets and/or the sublet of office space to another business entity. Costs that can be specifically identified with the sublet space should be disallowed entirely, and a commensurate amount of shared costs (e.g., depreciation and property taxes) should be disallowed based on the relative square footage of the sublet space.*

***(For further details, see Section 11.2.G.1, Example 11-8**.)*

C. Sale and Leaseback Transactions

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

- ***Gain Transactions***. FAR 31.205-16 limits the recognition of any gain associated with the disposition of capital assets to the amount of depreciation costs previously recognized. The Government participates in the cost and credit for the use of the capital asset by the contractor; however, per FAR 31.205-16(d), the Government participation in the gain (i.e., credit) does not extend to any appreciation in asset value in excess of the asset's acquisition cost.
- ***Loss Transactions***. Sale and leaseback transactions usually are consummated as a means of raising capital; therefore, recognizing losses based on the net amount realized, instead of the fair market value of the asset, may place the Government at risk for reimbursing the costs of raising capital, as well as losses that may be artificially inflated. FAR 31.205-16(b)(2) provides protection

to the Government by limiting the allowable amount of a loss to the amount by which the net book value exceeds the fair market value of the asset. The allowable loss is zero if the fair market value exceeds the net book value of the asset.

8.24 – SELLING COSTS

[Reference: FAR 31.205-38]

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

- Advertising (FAR 31.205-1).
- Corporate image enhancement and public relations costs (FAR 31.205-1).
- Bid and Proposal costs (FAR 31.205-18).
- Entertainment costs (FAR 31.205-14).
- Direct selling costs (FAR 31.205-38; see further discussion below*).
- Long-range market planning costs (FAR 31.205-12).

Determining Allowability. Selling costs are allowable if they:

- Are reasonable and allocable in accordance with FAR 31.201-3 and FAR 31.201-4, respectively;
- Meet the criteria established in FAR 31.205-1(d) through (f), FAR 31.205-12, FAR 31.205-18, and FAR 31.205-38 (as applicable); and
- Are not specifically disallowed by other FAR cost principles (e.g., the FAR 31.205-14 Entertainment cost principle).

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

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

Allocability. Selling and marketing costs may be subject to challenge by State DOTs if the costs can be considered unnecessary or unallocable to Government contracts. In determining the reasonableness of selling costs, State DOTs may consider the nature and amount of the expenses in light of expenses a prudent individual would incur in a competitive business, the proportionate amounts expended/allocated between Government and commercial business, the trend and comparability of current costs with historical costs, comparisons to industry benchmarks for selling costs, and the nature and extent of the selling and marketing efforts in relation to the contract value.

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

8.25 – TAXES

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

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

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

***Note**: Auditors should ensure that engineering consultants that have elected Subchapter S tax status[27] claim only the State or local taxes that are required to be paid by, or are otherwise accrued by, the engineering consultant at the corporate level. The State and local income taxes resulting from the individual shareholders' pass-through income are not allocable to Government contracts and must not be included in the engineering consultant's indirect cost rate.*

8.26 – TRAVEL EXPENSES

[References: FAR 31.205-46, DCAA CAM Section 7-1003]

A. Generally

Depending on their nature and purpose, travel expenses may be allowable as either indirect or direct charges. Travel costs incurred in the normal course of overall administration of the business are allowable and should be treated as indirect costs. By contrast, travel costs incurred in connection with a specific contract/project must be allocated/charged to the contract regardless of whether the costs are reimbursable in accordance with contract terms. Engineering consultants must prepare billing invoices in accordance with the FAR Part 31 cost principles, subject to any additional contractual limitations that may exist.

***Note**: Engineering consultants may have cost accounting practices that are developed in accordance with the Cost Accounting Standards, which may override the general contract costing practices outlined above.*

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 that the method used results in a reasonable charge. In accordance with FAR 31.205-46(a)(2), lodging, travel meals,(*) and incidental costs must be disallowed to the extent that, on a daily basis, they exceed the FTR per diem rates (or JTR rates for Alaska or Hawaii and outlying areas of the United States).

*(*) **Non-travel Business Meals**. FAR Part 31 specifically references Federal per diem rates only in connection with travel. Meals not associated with travel are allowable if they are properly supported, have a valid business purpose, and are reasonable in amount. Non-travel business meals are governed by FAR 31.205-43(c), which provides that incidental meal costs incurred during business meetings are allowable if the principal purpose of the meeting is the dissemination of trade, business, technical, or professional information.*

B. Substantiation of Travel Costs

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

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

C. Aircraft Costs

Costs of travel in aircraft owned, leased, or chartered by the engineering consultant are required to be fully documented and justified. The engineering consultant must maintain and make available flight manifest/logs for all flights and at a minimum, the flight manifest/log must specify:

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

- Date, time, and points of departure;
- Destination, date, and time of arrival;
- Name of each passenger and relationship to the contractor;
- Authorization for the trip; and
- Purpose of trip.

Aircraft costs may include the costs of lease, charter, operation (including personnel, such as the pilot and co-pilot), maintenance, depreciation, insurance, and other related costs. Allowable aircraft costs generally must not exceed the lowest priced airfare available for the point of departure and destination. Refer to FAR 31.205-46(c)(2) for additional information.

Travel costs via private aircraft in excess of the standard commercial airfare are not allowable except:

1. When one or more of the conditions described in FAR 31.205-46(b) are present that would justify costs in excess of the lowest standard commercial airfare, such as requiring circuitous routing, travel during unreasonable hours, or excessively prolonged travel;
2. When an advance agreement has been executed per FAR 31.205-46(c)(2), in accordance FAR 31.109(b), which states that advance agreements may be negotiated either before or during a contract but should be negotiated before incurrence of the costs involved; or
3. When travel by such aircraft is specifically required by contract specification, term, or condition.

Refer to DCAA CAM Section 7-1003 for further guidance.

D. Vehicle Costs

In accordance with FAR 31.205-46(d), the costs of personal usage of vehicles related to direct and indirect vehicles generally are unallowable costs. In cases where transportation costs and consultant-owned or -leased vehicles are involved, only the portion of vehicle costs incurred in connection with company business is allowable. Accordingly, engineering consultants are required to maintain adequate documentation, such as vehicle mileage logs completed in accordance with IRS requirements, to establish that the vehicle costs in the indirect cost pool exclude personal use, direct project costs, and travel associated with any unallowable business-related activities (e.g., lobbying, general advertising, etc.).

Additionally, as referenced previously in Section 8.4, extra scrutiny must be applied to costs associated with luxury vehicles. Engineering consultants must provide justification for, and support the reasonableness of, costs associated with the purchase or lease of such vehicles. Costs in excess of reasonable amounts must be identified and disallowed.

***Note**: For further discussion regarding the consistent accounting treatment of the vehicle costs, refer to Section 5.4.E and FAR 31.202(a).*

8.27 – LEGAL COSTS

[Reference: FAR 31.205-47]

Legal costs, as defined in FAR 31.205-47(a), can range from very simple to very complex issues. As a result, FAR provisions do not cover or explain every possible set of events to determine if legal costs are allowable or unallowable. The allowability depends on who brought the legal action and specific FAR sections governing activities as allowable or unallowable.

The following guideline provides an understanding in the rules that may determine the allowability of costs relating to legal proceedings. The absence of FAR language regarding any specific elements of legal proceeding costs does not imply that such costs are either allowable or unallowable.

A. Allowability

The first step of legal costs to be considered allowable is the test of FAR 31.201-2, Determining Allowability. See Section 4.3 for criteria regarding allowability.

B. Fines, Penalties and Mischarges

Fines, penalties and mischarging costs are unallowable, except when incurred as the result of compliance with terms of a contract. Penalties do not include restitution, reimbursement, or compensatory damages. (FAR 31.205-15).

C. Documentation of Costs

All legal fees and services must be supported by evidence of the nature and scope of the services provided. All costs, including any retainer fees, must provide evidence and scope of the actual work performed and the rate of compensation. The support must be sufficiently detailed to allow an auditor to make an independent determination regarding the allowability of the claimed cost.

D. Specific Unallowable Legal and Other Proceeding Costs

In most cases, costs are unallowable if incurred in connection with:

- Defense of a Government claim, appeal or prosecution of claims against the Government. (FAR 31.205.47(f)(1)).
- Organization, reorganization or resisting mergers and acquisitions. (FAR 31.205-47(f)(2)).
- Defense of antitrust suits. (FAR 31.205-47(f)(3)).
- Defense suits by past or current employees under Section 2 of the Major Fraud Act of 1988 where contractor settles or is found liable. (FAR 31.205-47(f)(4)).
- Professional service costs associated to certain disputes between contractors. (FAR 31.205-47(f)(5)).
- Costs related to patent infringement litigation, unless allowed by the contract. (FAR 31.205-47(f)(6)).
- Cost for assisting others where there is no legal obligation to provide or assisting others, arising from action where the participant was convicted of a violation of a law or regulation or found liable in a proceeding. (FAR 31.205-47(f)(7)).
- Costs associated with protests of Federal government solicitations or contract awards or the defense against such protest of such solicitations or contract awards, except when incurred as the result of compliance with terms of a contract.

E. Allowable vs. Unallowable Costs

If legal costs pass the tests outlined in Sections 8.27.A through D above, then the allowability of legal costs depends on who brought the legal action, as categorized in the following three groups. Each of the groups has its own tests, as described below:

1. **Legal Proceedings by or Against a Government**. Costs incurred relating to any proceedings brought by a Federal, State, local, or foreign government for the engineering consultant's violation or failure to comply with laws or regulations, or costs incurred relating to proceedings brought on by a third party in the name of the United States under the False Claims Act, generally are unallowable (assuming the engineering consultant did not prevail in defending the lawsuit*****) if the result is:

   - A conviction in a criminal proceeding. (FAR 31.205-47(b)(1)).
   - In civil or administrative proceedings, a finding of civil liability involving fraud or similar misconduct or imposition of a monetary penalty where the proceeding does not involve an allegation of fraud or similar misconduct. (FAR 31.205-47(b)(2)).
   - Final decision by an appropriate official of an executive agency to: (FAR 31.205-47(b)(3)).
     - Suspend or disbar.
     - Rescind or void.

- Terminate a contract for default by reason of a violation of failure to comply with a law or regulation. (FAR 31.205-47(b)(3)(ii)).
- Disposition of the matter by consent or compromise if the proceeding could have resulted in any of the results listed in the preceding items above. (FAR 31.205-47(b)(4)).

(*) However, if an engineering consultant is successful in litigation, then the consultant may treat up to 80 percent of the costs as allowable, per FAR 31.205-47(e)(3). Chart 8-1 displays the steps to determine the correct treatment.

***Note**: In the following charts, the term "contractor" is used to refer to engineering consultants.*

CHART 8-1: LEGAL PROCEEDINGS BY OR AGAINST A GOVERNMENT

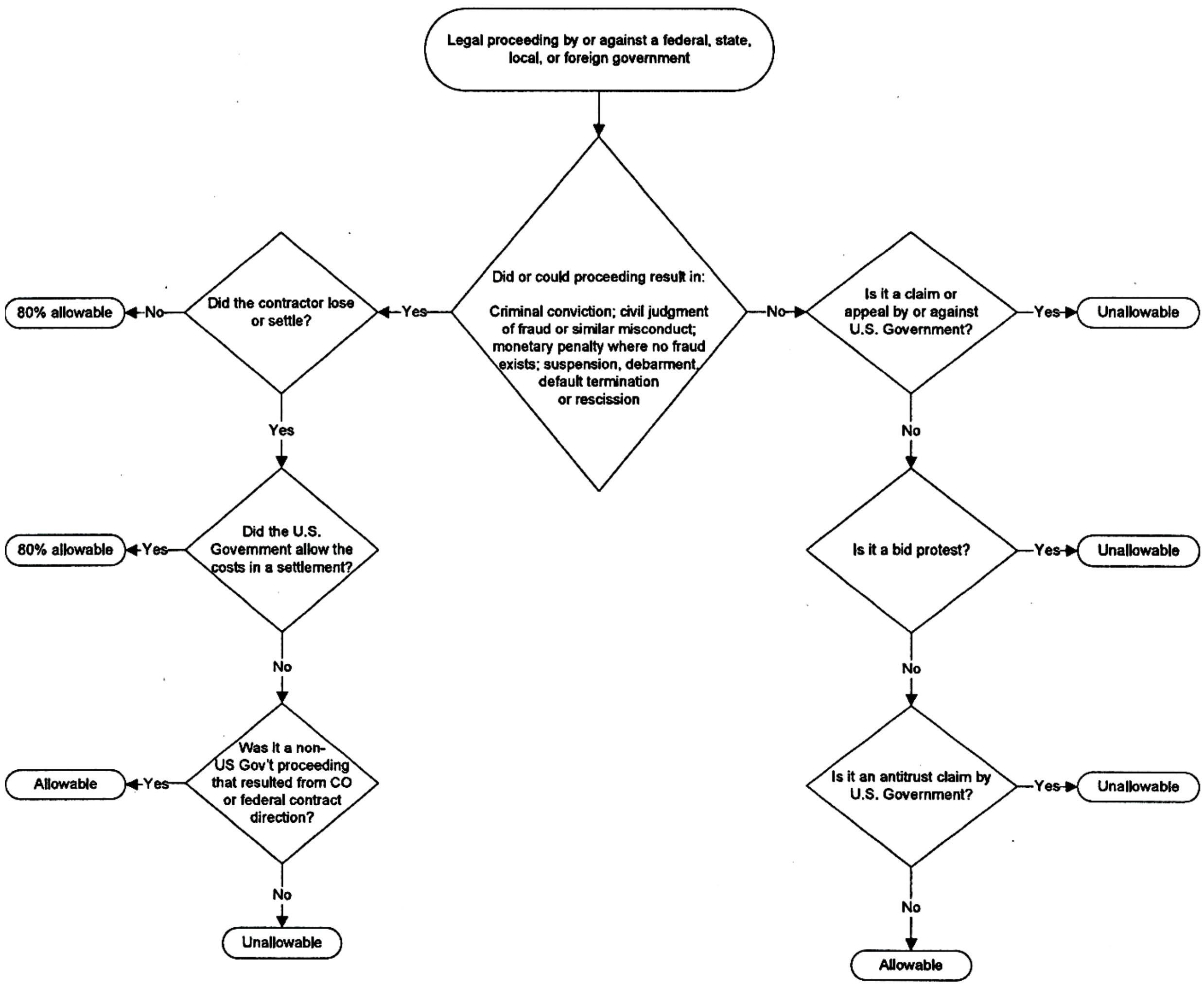

Chart reprinted with permission of Thomson Reuters from "Allowability of Legal Costs" by Martin Willard, Briefing Papers - April, 2010. These flowcharts are intended to summarize existing law, not to replace legal analysis of applicable law in specific cases.

2. **<u>Legal Proceedings by a *Qui Tam* Relator (whistle blower), and the U.S. Government Does Not Intervene</u>.** For a *Qui Tam* action, the person bringing suit will be entitled to a portion of the recovery as a reward for exposing a violation of law and recovering funds for the U.S. Government. In this

category, depending on if there is a settlement, if the engineering consultant wins, or if the contracting officer determines that a claim has very little likelihood of success, legal costs are either unallowable in full, or allowed up to 80 percent, as illustrated in Chart 8-2:

CHART 8-2: *QUI TAM* LAWSUITS

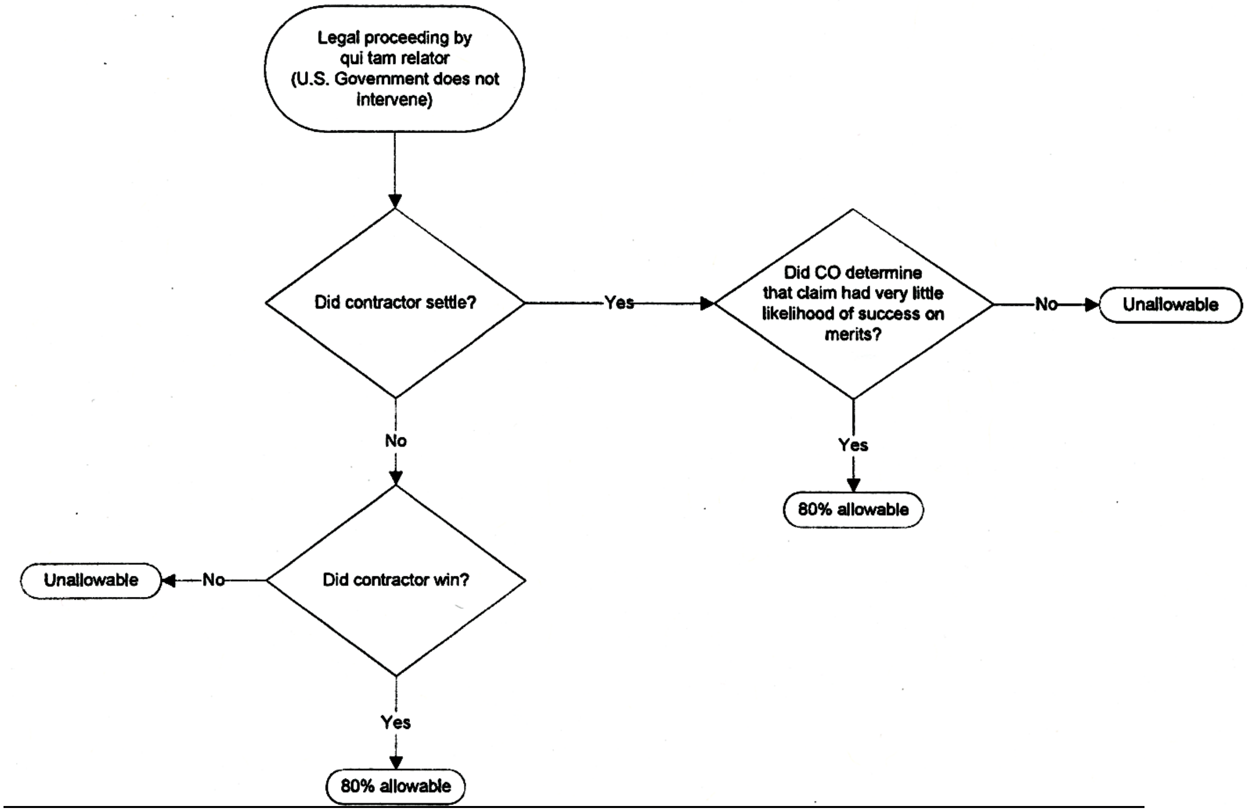

Chart reprinted with permission of Thomson Reuters from "Allowability of Legal Costs" by Martin Willard, Briefing Papers - April 2010. These flowcharts are intended to summarize existing law, not to replace legal analysis of applicable law in specific cases.

***Note**: In accordance with Charts 8-1 and 8-2, for the types of costs described therein, if a proceeding is lost, the costs are unallowable. If any other type of legal proceeding is lost, refer to Chart 8-3 to determine allowability of costs.*

3. **Legal Proceedings Brought By, or Asserted Against, a Private Party.** In this category, the allowability of legal costs depends on who the defendant is, what type of action is disputed, and whether the action is settled or won. For any proceedings by a private party other than a *Qui Tam* relator, FAR Part 31 does not impose the 80-percent-limitation-of-cost rule. Instead, allowability or unallowability is determined as shown in Chart 8-3:

CHART 8-3: LEGAL PROCEEDINGS BROUGHT BY, OR ASSERTED AGAINST, A PRIVATE PARTY

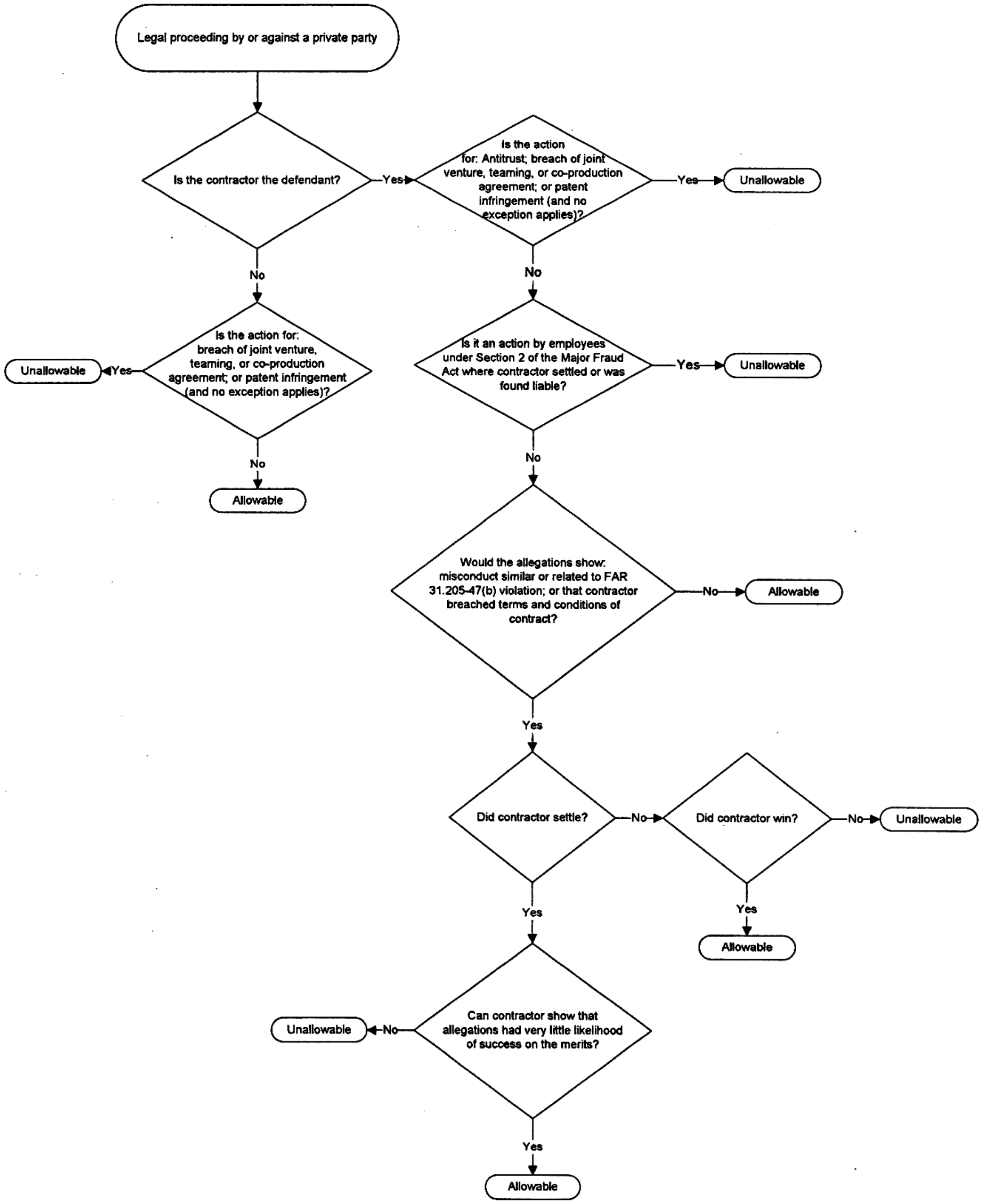

Chart reprinted with permission of Thomson Reuters from "Allowability of Legal Costs" by Martin Willard, Briefing Papers - April 2010. These flowcharts are intended to summarize existing law, not to replace legal analysis of applicable law in specific cases.

F. Costs Depended on Proceeding Outcome

When the allowability of costs depends on the outcome of the litigation, these costs shall be segregated and accounted for by the engineering consultant separately. During a lengthy proceeding, the contracting officer shall generally withhold payment of the proceeding costs. An exception would be a conditional payment upon provision of security or assurance, and agreement by the engineering consultant to repay all unallowable costs, plus interest, if the costs are subsequently determined to be unallowable.

G. Multi-Year Proceedings

For multi-year contracts, and where legal proceedings span multiple years, State DOTs and engineering consultants should work together to arrive at a satisfactory method for treating the costs. It is advised to seek legal counsel if necessary, and follow generally accepted accounting principles to account properly for contingencies.

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

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

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

8.28 – GOODWILL AND BUSINESS COMBINATION COSTS

[Reference: FAR 31.205-49 & -52]

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

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

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

Allowability of Business Combination Costs. When the purchase method is used, allowable costs for depreciation and cost of money are limited to the amounts that would have been allowable if the combination had not occurred. Costs for amortization, expensing, or write-down of goodwill (including costs that arise from the impairment[28] of goodwill) are unallowable. Engineering consultants must maintain detailed records to identify and track elements of costs for future reporting periods.

8.29 – ALCOHOLIC BEVERAGES

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

[Reference: FAR 31.205-51]

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

8.30 – LISTING OF COMMON UNALLOWABLE COSTS

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

TABLE 8-1: LISTING OF COMMON UNALLOWABLE COSTS

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

9

Chapter 9 – General Audit Considerations

9.1 – Background

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

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

9.2 – Compliance Requirements

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

- Developing a system of internal controls to ensure compliance with applicable laws and regulations;

- Ensuring that employees are made aware of compliance policies; and
- Ensuring that procedures are enforced and are updated in accordance with changes in applicable laws, regulations, and interpretive guidance.

9.3 – INTERNAL CONTROL

A. Generally

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

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

B. COSO Internal Control Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued an integrated internal control framework[29] designed to provide businesses with guidance in meeting the three primary objectives of internal control: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations. The COSO framework consists of five interrelated components derived from common business operations. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization. The five components include the following:

1. Control Environment

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

2. Risk Assessment

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

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

3. Control Activities

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

4. Information and Communication

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

5. Monitoring

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

9.4 – ESTIMATING AND PROPOSAL SYSTEMS

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

9.5 – COST ACCOUNTING SYSTEMS

A. Generally

Contract cost accounting practices and systems are critical for Government contracting. Well-controlled systems ensure that costs are distributed to cost objectives accurately and form a basis for comparing actual costs with estimated costs. Auditors should perform testing of the engineering consultant's control systems to obtain reasonable assurance that:

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

B. Labor Tracking

Accurately accounting for labor is paramount to accurate cost-based accounting. Detailed records must be maintained, accumulated, and controlled to ensure that both the direct labor and indirect labor amounts are accurate. Procedures must be in place to ensure that direct labor charges are distributed to respective contracts. Indirect labor must be captured and assigned to appropriate indirect labor categories. Auditors should ensure that the combined total cost of direct and indirect labor displayed in the general ledger reconcile to the overall labor recorded in the payroll system for the accounting period under audit.[30]

C. Other Considerations

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

Auditors should perform testing to assess the adequacy of the engineering consultant's controls over disbursements and expenditures, allocations of other direct costs, billing procedures, related-party transactions, and inter-organizational transfers. Auditors frequently use internal control questionnaires (ICQs) to document the existing controls.[31] The ICQs should be used in conjunction with additional procedures (see Chapter 10) to determine whether the engineering consultant's controls are adequately designed and function properly.

9.6 – UNDERSTANDING THE ENGINEERING CONSULTANT'S BUSINESS

A. Risk Assessment

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

B. Types of Audit Risk

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

- The engineering consultant's products and services, including the relationship of those products and services to cost-based Government contracts;
- The nature, size, and location of the engineering consultant's operations;
- Mix of Government and commercial business;
- Competition in the industry;
- Types of contracts (e.g., lump sum, cost plus fixed fee, and time and materials);
- The engineering consultant's accounting policies and procedures;
- Key data for significant contracts including the following:
  - Government agency or department
  - Type of contract
  - Contract price
  - Revenues, costs, and profit or loss recognized to date
  - Incentive, escalation, or other relevant contract provisions;
- Government regulations affecting contract accounting, such as FAR cost principles and State laws;
- Key changes in operations, systems, or segments of the business;
- CAS Disclosure Statement and revisions, if applicable;

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

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

- Key information-processing systems;
- Related party and inter-organizational transactions;
- Litigation, claims and disputes;
- Prior audited indirect cost rates;
- Prior filings with the SEC such as Form 10-K; and
- Minutes from board of directors' meetings.

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

9.7 –OTHER AUDITS AS A RESOURCE

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

9.8 – COMPUTERIZED ACCOUNTING INFORMATION SYSTEMS

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

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

9.9 – AUDIT RISK AND MATERIALITY

A. Audit Risk

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

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

- Size, business volume, and types of accounting systems;
- Familiarity with the Federal Acquisition Regulation and applicable Cost Accounting Standards;
- Employee labor classifications;

- Structure of cost/profit centers and departments;
- Performance metrics tied to meeting budgets or other project-related financial measures;
- Changes in procedures and practices for direct/indirect time charging; and
- Contract/cost objectives where the potential for labor mischarging is high (see further discussion below in Section 9.10).

B. Materiality

[References: GAGAS 4.47 & 5.46]

When performing risk assessments in connection with FAR-compliant audits, auditors must consider materiality, which generally must be set at a low level in accordance with the "public accountability" principle:

> **4.47** The AICPA standards require the auditor to apply the concept of materiality appropriately in planning and performing the audit. . . . Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.
>
> **5.46** The AICPA standards require that one of the factors to be considered when planning an attest engagement includes preliminary judgments about attestation risk and materiality for attest purposes. . . . Additional considerations may apply to GAGAS examination engagements of government entities or entities that receive government awards. For example, in engagements performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS engagements because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.

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

9.10 – TYPE AND VOLUME OF CONTRACTS

The level of risk related to an engineering consultant audit varies depending on the types of contracts employed by the consultant as well as the mix of contract types (i.e., fixed-price or cost-plus contracts[32]). If the engineering consultant uses primarily fixed-price (lump-sum or unit-rate) contracts, then the auditor should place more emphasis on the consultant's estimating procedures and controls designed to ensure that all direct costs are excluded from indirect cost pools. Conversely, if the engineering consultant primarily enters into cost-plus contracts, then the audit emphasis should be on allowability and should focus on determining whether the costs recorded in the cost accounting system reflect actual costs, regardless of whether such costs are billable. Engineering consultants with a mix of fixed-price and cost-plus type contracts require special emphasis on consistent allocation of costs regardless of whether contract revenues are based on costs incurred.

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

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

10

Chapter 10 – Guidance for Developing Audit Procedures

Before accepting a FAR-compliant audit report, the home State DOT or other reviewing State DOT must determine whether the auditor has adequately complied with the procedures described in Chapter 9 (General Audit Considerations) and performed adequate testing in compliance with the recommended minimum audit testing procedures discussed in the following sections.[33]

When employing a CPA firm (or other service provider/auditor) to perform a FAR-compliant audit, the engineering consultant must inform the CPA that:

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

10.1 – Planning and General Procedures

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

Audit work must meet professional standards (Government Auditing Standards and either Generally Accepted Auditing Standards or Attestation Standards), and the audit must be planned and performed to provide reasonable assurance that the indirect cost rate presented on the indirect cost rate schedule complies with the Cost Principles of FAR Subpart 31.2.[34]

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

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

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

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

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

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

As discussed in DCAA CAM Appendix B-102.c, auditors should note that:

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

Additionally, auditors should be aware of the following:

- The indirect cost rate schedule should be prepared based on cost data from the engineering consultant's general ledger, after the adjusting entries have been posted to the accounts and reconciled with any published financial statements.
- The indirect cost rate schedule must be reconciled to the post-closing trial balance or general ledger.
- All unallowable costs uncovered through audit testing must be removed from the indirect cost rate schedule, regardless of amount. Accordingly, any type of materiality level or testing threshold established by the auditor for use in determining large-dollar items[35] may *not* be used as a minimum tolerance level, or "floor," to allow expressly unallowable costs to remain in the indirect cost pool. Examples of expressly unallowable costs include, but are not limited to, interest expense, bad debts, donations, and advertising.[36]

10.2 – AUDIT SAMPLING

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

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

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

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

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

A. Audit Objectives and Sampling Methods

Appendix B of the DCAA CAM provides the following guidance:

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

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

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

B. Sampling for Attributes and Sampling for Variables

Based on the sampling objective and purpose of the test, it is critical for the auditor to consider when it is most appropriate to use attribute sampling, variable sampling, or some combination of the two methods. DCAA CAM Appendix B provides the following guidance—

B-303.a: The sampling of characteristics may be divided into two broad categories of *sampling for attributes* and *sampling for variables* [emphasis added]. When sampling to determine the rate or proportion of errors in the records or to obtain assurance that an error rate is not excessive, the auditor is sampling for attributes. Sampling for variables is performed when a sample is selected in order to estimate an amount such as the dollar value of unallowable costs contained in the total dollar value of material invoices charged to a Government contract. The distinction is important because the methods used to evaluate sample results differ.

B-402: Use of Sampling for Attributes.

a. Attribute sampling can be classified into two approaches of acceptance and estimation sampling. Their use depends on audit objectives. With acceptance sampling, the goal is to either accept or reject the universe. With estimation sampling, the goal is to estimate the actual error rate in the universe.

b. Attribute sampling is performed when there are only two possible outcomes from the evaluation of a sample item: the sampled item either is or is not in compliance with the control being tested. An audit can be built around questions answerable by either "yes" or "no", a feature that distinguishes sampling for attributes from sampling for variables.

B-502: **Use of Sampling for Variables**.

Variable sampling is generally used to verify account balances or cost elements and note any differences. This type of sampling is substantive testing (as opposed to compliance testing) whereby sample items are evaluated for error amounts or variables (as opposed to attributes). The audit sampling universe (e.g., accounts, vouchers, or bill of material) is the entire grouping of items from which a sample will be drawn. Variable sampling can be applied to proposals, incurred costs, progress payments, forward pricing rates, and defective pricing.

An important objective of variable sampling is to estimate a particular universe characteristic such as total unallowable costs (or questioned cost). The estimated questioned cost is commonly known as the "point estimate." A point estimate strikes a balance between potential understatement (considering both likelihood and amount) and potential overstatement of the true universe amount. In statistical sampling, "confidence level" and "precision" are used to measure the reliability of the point estimate. The confidence level deals with "sureness" (or assurance) while precision deals with "closeness" (or accuracy). Auditors must establish desired levels of reliability (discussed in B-504)[37] [footnote added] in order to properly evaluate the sample results.

***Note**: Consistent with DCAA CAM Appendix B-304, before selecting a statistical audit sample using <u>variable sampling</u> techniques to test for unallowable cost items, auditors are expected to scan the engineering consultant's general ledger so that large dollar or sensitive (LDS) transactions can be removed/stratified*[38] *for complete*

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

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

examination, including verification to source documents. Accordingly, the sampling universe should be limited to the group of items that remain after the LDS items have been removed.

C. Determining Sample Size

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

Auditors are encouraged to consult the AICPA's *Audit Sampling* guide,[39] an interpretive publication designed to assist practitioners in the application of the guidance found in SAS No. 111. The *Audit Sampling* guide includes detailed information and tables for determining sample sizes based on the facts and circumstances of an engagement, assessed risks, expected deviation, reliability of controls, and the type of sampling being used. Additionally, the DCAA's EZ-Quant statistical analysis software program is useful for determining and analyzing audit samples using either attribute sampling or variable sampling techniques. EZ-Quant is a free program available for download at http://www.dcaa.mil/ezquant.htm.[40]

***Note**: Although there is no single optimal sample size for use on all engagements, auditors are encouraged to apply sampling methods using a 95-percent confidence level with a precision level in the range of 2 to 5 percent.*[41] *Additionally, as stated previously, all unallowable costs uncovered through audit testing must be removed from the indirect cost rate schedule, regardless of amount, as FAR Part 31 does not establish a tolerance level to permit any amount of unallowable costs to remain in the indirect cost pool.*

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

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

10.3 – TESTING LABOR COSTS

A. Generally

For the majority of engineering consultant contracts, labor is the largest single component of cost. Labor costs are composed of direct labor assigned to contracts (regardless of whether the labor is billable) and indirect labor charges allocated to contracts through an overhead rate. Engineering consultants should consistently monitor the recording of direct and indirect labor costs to ensure accuracy. When consultants use an overhead rate to recover indirect costs, Government contracts will participate in these costs.

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

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

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

Verification of labor costs should begin with the review of the engineering consultant's internal control structure and testing of those controls, as discussed in Section 9.2. Additionally, analytical procedures should be performed to determine if changes in the mix of direct and indirect labor costs indicate a potential risk related to labor cost allocation in accordance with FAR 31.201-3 and as discussed in Section 5.4 F(5). If such a risk is indicated, then the auditor may make further inquiries of the engineering consultant and may perform additional analytical procedures. However, this type of ratio/measurement should not be used as the sole measure of reasonableness; adjustments to labor costs should only be proposed based on identified errors.

Based on the assessed level of control risk, the auditor should determine an appropriate labor sample with a *minimum of 26 timesheets* chosen for testing across an appropriate mix of direct-charge employees,[42] including supervisors and/or project managers. The following examples are presented for illustrative purposes only and are not meant to encompass the full range of acceptable labor testing. The sample size should increase appropriately based on the size of the labor population and conclusions drawn from the risk assessment for labor testing.

EXAMPLE 10-1:

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

EXAMPLE 10-2:

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

B. Recommended Testing Procedures

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

1. The sample should be traced from employee time records to:
    - The payroll records, to ensure hours are recorded and properly allocated.
    - The cost system, to ensure hours are posted properly to jobs.
    - The general ledger, to ensure that the total posted is recorded in the financial accounting system.
2. The timesheets also should be reviewed for compliance with the model time-charging practices established by DCAAP 7641.90 Chapter 2-302, as referenced in FAR 31.002. For example, auditors should determine whether individual employees prepared and signed their own timecards, whether supervisors approved the timecards, and how labor movement was documented and approved. (See Section 6.4 for further discussion of the DCAAP 7641.90 factors.)
3. The total direct and total indirect labor costs recorded in the general ledger accounts must be reconciled to:
    - The job cost system (direct labor costs).

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

- The payroll reports submitted to the Internal Revenue Service (i.e., Form 941s—Employer's Quarterly Federal Tax Return).

4. Audit procedures also must be performed to determine if the labor accounts and individual time card entries sufficiently screen labor to:
   - Determine the allowability of payroll cost. Do the timecards identify time spent on unallowable activities?
   - Determine the proper allocation of labor. Do the records charge all labor performed on similar tasks the same way?
   - Determine if labor is posted in a manner from which the labor base can be computed. If the base is direct labor costs excluding premium overtime, do the records accumulate direct labor and direct premium overtime?

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

10.4 – TESTING INDIRECT COSTS

A. Generally

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

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

- Large-dollar[43] or sensitive (LDS) transactions should be removed/stratified for complete examination, including verification (vouching) to source documents. The auditor should prioritize the LDS items in terms of risk and materiality to determine whether the LDS items constitute adequate audit coverage of the aggregate account balance. If this coverage is deemed adequate, then no further examination of the account may be required.

  Based on the complexity of the engineering consultant's financial records, the specific risk associated with each account, and the magnitude of specific account balances in relation to the company's total costs, it may be necessary to compute multiple LDS thresholds, on an account-specific basis. For example, individual expenses of $500 or greater might be significant for a *Travel* account, but the LDS threshold likely would be considerably higher for a *Rent* account. Accordingly, sufficient indirect cost testing generally will not occur when an auditor applies a single testing threshold computed based on a percentage of direct labor cost, total costs, total revenue, etc.
- In situations where the auditor determines that additional testing beyond the LDS items is required, the auditor should test the remaining indirect costs in the high-risk accounts (the sampling universe) on a sample basis, using the sampling parameters discussed in Section 10.2.[44] A minimum random sample in the range of **2 to 20 transactions** is recommended for each high-risk account. This requires transactions to be verified from the indirect cost rate schedule back to the general ledger and requires that the transactions be vouched from the general ledger to source documents.

[43] Auditors should select large-dollar items based on appropriate testing thresholds, which will vary based on the unique facts and circumstances of each audit client. Auditors are advised to fully document how the thresholds were determined and applied.

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

***Note**: The auditor should increase the sample size appropriately based on the results of the risk analysis and assessment, when the population size would so justify, or when an account includes costs associated with unallowable activities. A series of recurring transactions, such as monthly rent, should count as only one transaction toward obtaining the minimum sample.*

B. Baseline for Determining Risk

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

1. ***Printing/Reproduction***. Were direct costs consistently allocated to cost objectives/projects and properly removed from the indirect cost pool?
2. ***Dues and Subscriptions***. Review for civil/country club dues, Political Action Committee (PAC) contributions and other lobbying costs, scholarship donations, and non-business purchases.
3. ***Travel***.
   - Were entertainment costs, alcoholic beverages, and personal charges removed from the indirect cost pool? (FAR 31.205-14 and FAR 31.205-51.)
   - Were costs for personal use of company vehicles removed from the indirect cost pool?
   - Were travel costs in compliance with the Federal Travel Regulation? (FAR 31.205-46.)
   - Were direct travel costs treated consistently, and were all direct costs removed from the indirect cost pool?
4. ***Seminars and Conventions***. Review registration forms for allowability/business purpose, sponsorships, golf fees, door prize donations, entertainment, and booth rental costs.
5. ***Insurance***. Did the premiums cover only the audit period? (Review for prepayments related to future periods and late payments for coverage provided in prior periods.) If the company is self insured, were the associated costs in compliance with FAR 31.205-19?
6. ***Professional and Consultant Service Costs***. Review for organization and reorganization costs (FAR 31.205-27), bad debt collections (FAR 31.205-3), direct project costs, and other unallowable activities. Examine retainer fees for reasonableness and adequate support (FAR 31.205-33(d)).
7. ***Rent***. Review costs for facilities and other property, including personal property, to determine if common control exists (FAR 31.205-36). Review lease contracts to ensure that only costs for business-use assets were claimed on the indirect cost rate schedule. Costs associated with sublet, idle, or otherwise unallocable space were identified and disallowed (FAR 31.205-17).
8. ***Depreciation***. Compare claimed depreciation to tax return, and review for a systematic and rational allocation method that was applied consistently over a period of years. Ensure that the amount on the indirect cost rate schedule was properly limited to the amount used for financial reporting purposes (no section 179 write-offs or special tax depreciation are permitted). Ensure the assets are ordinary and necessary business assets with reasonable costs that are allocable to the engineering consultant's primary business activities (FAR 31.205-11(a) & (c)).
9. ***Employee Morale***. Review for unallowable entertainment costs such as parties, picnics, outings, and sporting events (FAR 31.205-14); unallowable gifts; and other allowable costs per FAR 31.205-13. See also DCAA CAM Sections 7-2103(e)(3) & (4).
10. ***Accounts Titled "Miscellaneous Expense," "Other Indirect Costs," "General Office," or Similar Titles***. Review for allocability, reasonableness, business purpose, direct costs, etc. (See Section 8.30 for a list of common unallowable costs.)
11. ***Subconsultants/Outside Consultants***. Ensure proper segregation of direct and indirect cost, business purpose and allowability of activities performed, and reasonableness.
12. ***Other/Miscellaneous Income Accounts***. Review for any amounts that should be credited to an indirect cost account.

13. ***Gains on Sale of Assets***. Ensure proper credit on gains on sales of assets originally included as part of the depreciation expense cost.
14. ***Loss on Sale of Assets***. Ensure proper reporting within the year the transaction occurred, appropriate calculation, appropriate application of credits or charges to the cost groupings in which the depreciation or amortization was originally recorded, and appropriate recording of cash received in connection with the retirement or disposal of assets.

Note*: The auditor should fully document the identification of high-risk accounts, based on a risk assessment and the application of professional judgment. If the auditor's procedures vary significantly from those listed above, the auditor must provide an adequate explanation to justify the deviation. If the State DOT conducting the review determines that the deviation is not properly justified, the State DOT may reject the overhead rate determined through the audit. Additionally, when designing a testing approach, auditors should be aware that a representative/official from the engineering consultant's management generally will be required to certify the accuracy of the indirect cost rate being proposed.[45] That is, most State DOTs require an affirmative statement that the indirect cost rate was computed net of all known unallowable costs.*

10.5 – ALLOCATED COSTS

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

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

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

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

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

[45] See http://www.fhwa.dot.gov/legsregs/directives/orders/44701a.htm - *FHWA Policy for Contractor Certification of Costs in Accordance with Federal Acquisition Regulations (FAR) to Establish Indirect Cost Rates on Engineering and Design-related Services Contracts*. In this Order, the FHWA encouraged State DOTs to adopt policies requiring engineering consultants to certify the allowability of costs submitted on indirect cost schedules. This Order is reproduced in Appendix F.

10.6 – OTHER DIRECT COSTS (ODCS)

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

Note: *Auditors should be aware that, instead of establishing dedicated ODC accounts as recommended above, some engineering consultants capture both ODCs* <u>*and*</u> *indirect costs in summary accounts that appear on the indirect cost rate schedule.*[46] *Accordingly, auditors should examine indirect expense accounts to determine whether—*

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

10.7 – FAILURE TO MEET MINIMUM AUDIT PROCEDURES

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

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

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

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

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

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

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

11

Chapter 11 – Audit Reports and Minimum Disclosures

11.1 – Generally

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

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

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

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

- Independent Auditor's Report on indirect cost rate schedule. (*)
- Indirect cost rate schedule.
- Listing of unallowable account adjustments, with associated FAR References.
- Notes to the indirect cost rate schedule, including minimum disclosures. (See further discussion in Section 11.2.)
- Independent Auditor's Report on Internal Control.[47] (*)

***(*)Note**: For samples of an indirect-cost-rate audit report and report on internal control, see: http://audit.transportation.org/Pages/default.aspx. The AASHTO Audit Subcommittee and the ACEC Transportation Committee have approved the report formats, which are updated from time to time to reflect changes in AICPA reporting standards.*

11.2 – Minimum Audit Report Disclosures

The following subsections describe disclosures that should be included with audit reports, regardless of whether the audits reports are generated from financial audits or attestation engagements. In cases where

[47] 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.)

examples are included, they are for illustrative and explanatory purposes only and are not intended to be comprehensive regarding rules and regulations. Some of the recommended disclosures may not be appropriate or necessary for certain firms. Conversely, additional disclosures may be required for firms with unusual or complex issues. Disclosures should be included with the overhead audit report for each fiscal year and may either be included in the notes to the indirect cost rate schedule or as a separate section within the report. The standard recommended disclosure notes are listed and discussed below in Sections 11.2.A through 11.2.I.

A. Description of the Company

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

B. Basis of Accounting

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

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

C. Description of Accounting Policies

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

D. Description of Overhead Rate Structure

Disclosures should include language to—

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

  EXAMPLE 11-2:

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

  Multiple Bases
  - Fringe benefits costs allocated based on Direct + Indirect Labor.
  - Office overhead costs allocated based on Direct Labor + Fringe Benefits.
  - General and administrative costs allocated based on Value Added Costs (all company costs, excluding subconsultants).
- Identify whether a dual rate structure exists for field office projects and home office projects. Specify the allocation methods used.
- Identify cost allocation practices between related business entities (e.g., parent company allocating costs to subsidiaries or divisions, allocations between subsidiaries or divisions, and/or allocations to specific product lines).
- **Identify any State- and/or Local-Specific Policies**. Describe any policies required by a State DOT or local agency that differ from the engineering consultant's FAR Part 31 compliant policies. Explain any inconsistencies, and include any corresponding indirect cost rates that differ from the audited rate in this report.

E. Description of Labor-Related Costs

The disclosures associated with labor costs must include details regarding—

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

    EXAMPLE 11-3:

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

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

5. ***Highly Compensated Employees/Officers/Owners***. As discussed in Section 7.5, the engineering consultant must perform appropriate procedures to evaluate the allowability and reasonableness of executive compensation. These procedures should include an examination of the allowability of the forms of compensation paid to the Company's executives and an evaluation as to whether any of the compensation was related to unallowable activities such as entertainment, lobbying, etc. After eliminating unallowable forms of compensation and compensation amounts related to unallowable activities, the engineering consultant should then evaluate the reasonableness of total allowable elements of compensation, for each executive, by either: (1) performing an analysis using independent survey data as prescribed in Section 7.5, or (2) by examining executive compensation using the National Compensation Matrix (NCM). If the engineering consultant performs its own analysis, care should be taken to properly consider the Benchmark Compensation Amount (BCA), as discussed in Section 7.4.

    The audit report footnote should include the following:

    - A description of the procedures used by the engineering consultant to evaluate allowability of the elements of executive compensation and the activities performed by executives.
    - A statement as to whether the engineering consultant performed its own analysis of executive compensation reasonableness or used the NCM instead. If the consultant performed its own analysis, a description of the procedures performed should be included. This should include a list of any independent compensation surveys used in the consultant's analysis.
    - A statement regarding how the BCA was considered in evaluating executive compensation, noting the applicable amount of the BCA.
    - The total amount of executive compensation disallowed as a result of the evaluation of allowability and reasonableness, preferably as separate amounts for each executive.

    EXAMPLE 11-4: The Company performed an analysis of executive compensation in accordance with Chapter 7 of the AASHTO Audit Guide. The analysis included an examination of the activities performed by Company executives, and the forms of compensation paid to executives. A total of $25,796 was eliminated from overhead related to unallowable entertainment activities and compensation related to changes in the Company's stock price. The analysis also included an evaluation of compensation reasonableness as described in AASHTO Audit Guide section 7.5, using information from the following independent compensation surveys: X, Y, and Z. The reasonable compensation amounts developed using survey data did not exceed the applicable Benchmark Compensation Amount of $XXX,XXX. As a result of the analysis of executive compensation reasonableness, a total of $42,512 of executive compensation was disallowed.

6. ***Pension Plans, Deferred Compensation Plans, and ESOPs***. If pension and/or deferred compensation costs (as defined by FAR 31.205-6(j) and 31.205-6(k), respectively) are included in indirect costs, identify whether the plan(s) meet the above regulations and explain how the costs were determined (e.g., cash contribution, stock or options to purchase stock of the engineering consultant, or assets other than cash). For Employee Stock Option Purchase (ESOP) plans, identify the dollar amounts of principal, interest, and administrative costs of the contribution to the Employee Stock Option Trust (ESOT). Identify any other significant impacts from market valuations.

   EXAMPLE 11-5: The Company operates a 401(k) retirement plan that meets the requirements of FAR 31.205-6(j). During the year, the Company made a cash contribution of 2 percent of participating employees' salaries.

   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 of 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 was $xxx,xxx.

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

   EXAMPLE 11-6: The Company uses contract labor for engineering related services, and bills this labor as if it were for regular employees. The Company provides office space, administrative support, and controls the contract laborers. Therefore, contract laborers are considered employees, and their labor costs ($52,000 for the period audited) have been included in the direct labor base.

F. Description of Depreciation and Leasing Policies

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

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

G. Description of Related-Party Transactions

1. ***Building Rent***. Identify any related parties considered to have common control, to the extent that audit adjustments are required per FAR 31.205-36.

   EXAMPLE 11-8: The Company rents part of an office building owned by the ABC Real-Estate Partnership (ABC). ABC's owners include a Company shareholder, his spouse, and an unrelated third party. (The spouse is not a Company employee or owner.) This shareholder owns only one third of the ABC partnership, but he has effective control over ABC's operating and financial policies.

   ABC incurred $350,000 of expenses to maintain the building, including $45,000 of interest expense. The building has 15,000 total square feet, and the Company occupied 12,750 square feet (85 percent of the total building). ABC rents the remaining building space to an unrelated business. Additionally, ABC's Facilities Capital Cost of Money (FCCM) for the building was $22,500 for the year.

   The rent expense recorded in the Company's financial records includes $400,000 in payments to ABC. The Company excluded $121,625 of the rent expense from the indirect cost schedule, as follows:

   ABC's allowable cost of ownership for the property:

Total expenses	$350,000
Less: Unallowable interest expense	(45,000)
Plus: Facilities Capital Cost of Money	22,500
Equals: Cost of ownership	$327,500
Multiplied by: Allocation factor	85%
Equals: Cost of ownership	$278,375

   Company's adjustment for costs in excess of allowable cost of ownership:

Total rent expense recorded by Company	$400,000
Less: Cost of ownership	(278,375)
Adjustment required by FAR 31.205-36(b)(3)	$121,625

2. ***Personal Use of Company Vehicles***. The officers of the Company have personal usage of Company vehicles, which is tracked through vehicle logs. Amounts attributable to this personal use ($ xxxx for 20xx) were disallowed in compliance with FAR 31.205-6(m)(2).

H. Facilities Capital Cost of Money (FCCM)

Provide the FCCM rate, as calculated in accordance with FAR 31.205-10.

EXAMPLE 11-9: The FCCM rate was calculated in accordance with FAR 31.205-10, using average net book values of equipment and facilities multiplied by the average Federal Prompt Payment Act Interest Rate (Treasury Rate) for the applicable period. Equipment and facilities include furniture and fixtures, computer equipment, vehicles, and leasehold improvements. The calculation follows:

Net Book Value of Assets - Prior Year	$ 600,000
Net Book Value of Assets - Current Year	700,000
Average Net Book Value	$ 650,000
Multiplied by: Average Treasury Rate	3.19%[48]
Equals: Facilities Capital Cost of Money	$ 20,735
Divided by: Direct Labor Cost	3,250,250
Equals: Facilities Capital Cost of Money Rate	0.63%

Note: *Additionally, if the engineering consultant computes home office and field office indirect cost rates, to allocate project costs appropriately, it may be necessary to compute separate FCCM rates based on the assets and direct labor used in the home office and field, respectively.*

[48] The year-2010 average Treasury Rate was used this example, and the engineering consultant was assumed to have a December 31 fiscal year end (FYE). Companies with FYEs other than December 31 must appropriately prorate the Treasury Rate. For current Treasury Rates, see http://www.treasurydirect.gov/govt/rates/tcir/tcir_opdprmt2.htm.

I. List of Other Direct Cost Accounts and Charge Rates

Identify whether Nonsalary Direct Project Costs, sometimes referred to as Other Direct Costs (ODCs) are consistently allocated/costed to all projects, and not just projects that reimburse for ODCs (e.g., computer costs, reproduction, equipment charges, and vehicle usage). Include a listing of cost items generally charged directly to projects.

Additionally, if charge rates were established for any of these costs (e.g., CADD), the rates should be fully disclosed in this note, along with a general description of the audit procedures used to verify the accuracy of the rates.

J. Cost Estimation Process

Include a statement regarding the company's method of estimating costs for pricing purposes. For example, when the CPA determines that the company's estimation process is well designed, consistently applied, and articulates with the financial system, the follow statement is appropriate:

> **EXAMPLE 11-10:** The Company's method of estimating costs for pricing purposes during the proposal process was consistent with the accumulation and reporting of costs under the company's job-order cost accounting system.

K. Management's Evaluation of Subsequent Events

Include a statement regarding the company's consideration of subsequent events up to the date the indirect cost rate schedule was issued. For example, when no adjustments or additional disclosures are necessary, the following statement is appropriate:

> **EXAMPLE 11-11:** The Company has evaluated subsequent events through _________, 20xx, the date upon which the Statement of Direct Labor, Fringe Benefits, and General Overhead was available for issuance, and found no adjustments or additional disclosures were needed.

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Chapter 12 – Cognizance and Oversight

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

> **4.16** When performing GAGAS financial audits and subject to applicable provisions of laws and regulations, auditors should make appropriate individuals, as well as audit documentation, available upon request and in a timely manner to other auditors or reviewers. Underlying GAGAS audits is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform a financial audit in accordance with GAGAS cooperate in auditing programs of common interest so that auditors may use others' work and avoid duplication of efforts. The use of auditors' work by other auditors may be facilitated by contractual arrangements for GAGAS audits that provide for full and timely access to appropriate individuals, as well as audit documentation.
>
> **5.17** When performing GAGAS examination engagements and subject to applicable laws and regulations, auditors should make appropriate individuals, as well as attest documentation, available upon request and in a timely manner to other auditors or reviewers. Underlying GAGAS engagements is the premise that audit organizations in federal, state, and local governments and public accounting firms engaged to perform an engagement in accordance with GAGAS cooperate in performing examination engagements of programs of common interest so that auditors may use others' work and avoid duplication of efforts. The use of auditors' work by other auditors may be facilitated by contractual arrangements for GAGAS engagements that provide for full and timely access to appropriate individuals, as well as attest documentation.

12.1 – National Highway System Designation Act Section 307

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

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

The NHSD Act, however, provided a one-year window for states to adopt statutes that would establish "an alternative process intended to promote engineering and design quality and ensure maximum competition." If a statute were adopted by a State within this period, Section 307 would not bind the state. Thirteen states adopted such statutes within the allowed time period. Such states were referred to as "opt-out States," and included the following: Connecticut, Delaware, Florida, Kentucky, Louisiana, Maine, Maryland, Minnesota, New York, North Carolina, Utah, Tennessee, and West Virginia.

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

12.2 – SECTION 174 OF THE 2006 TRANSPORTATION APPROPRIATIONS ACT

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

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

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

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

12.3 – WHAT IS A COGNIZANT AGENCY?

23 CFR 172 establishes the definition of a cognizant agency for audits in 23 CFR 172.3 Definitions:

Cognizant agency means any governmental agency described below that has performed an audit in accordance with generally accepted government auditing standards to test compliance with the requirements of the Federal cost principles (as specified in 48 CFR part 31) and issued an audit report of the consultant's indirect cost rate, or any described agency that has conducted a review of an audit report and related workpapers prepared by a certified public accountant and issued a letter of concurrence with the audited indirect cost rate(s). A cognizant agency may be any of the following:

> (1) Federal agency;
> (2) State transportation agency of the State where the consultant's accounting and financial records are located; or
> (3) State transportation agency to which cognizance for the particular indirect cost rate(s) of a consulting firm has been delegated or transferred in writing by the State transportation agency identified in subparagraph (2) of this definition.

12.4 – WHEN MUST A CONTRACTING AGENCY ACCEPT A COGNIZANT APPROVED INDIRECT COST RATE?

23 CFR 172.11 (b), Allowable costs and oversight, provides the requirements for the acceptance of a Cognizant Approved Indirect Cost Rate.

> Elements of contract costs. The following requirements shall apply to the establishment of the specified elements of contract costs:
> (1) Indirect cost rates.
> (i) Indirect cost rates shall be updated on an annual basis in accordance with the consultant's annual accounting period and in compliance with the Federal cost principles.
> (ii) Contracting agencies shall accept a consultant's or subconsultant's indirect cost rate(s) established for a one-year applicable accounting period by a cognizant agency that has:
> (A) Performed an audit in accordance with generally accepted government auditing standards to test compliance with the requirements of the Federal cost principles and issued an audit report of the consultant's indirect cost rate(s); or
> (B) Conducted a review of an audit report and related workpapers prepared by a certified public accountant and issued a letter of concurrence with the related audited indirect cost rate(s).

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

Cognizant approved rates may be established using different methods, as listed below:

1. Indirect Cost Audit performed by the Consultant's Independent CPA:

   An indirect cost rate audit performed by an independent CPA (not part of the engineering consultant's organization) hired by the consulting firm will be used to establish a cognizant approved rate if one of the following conditions is met:

   - The Home State reviews the CPA's audit report and related workpapers and issues a cognizant letter of concurrence with the audit report.
   - A Non-Home State, in which cognizance has been transferred in writing from the Home State, reviews the CPA's audit report and related workpapers and issues a cognizant letter of concurrence with the report.

2. Indirect Cost Audit not performed by the Consultant's Independent CPA:
   - A Cognizant Agency either: (a) performs an indirect cost rate audit, or (b) contracts with, and directs the work of, a CPA who performs this work.
   - The Home State transfers cognizance in writing to a Non-Home State. The Non-Home State auditor, or CPA working under the Non-Home State's direction, issues an audit report, and the Non-Home State issues a cognizant letter of concurrence.

The process for voluntarily transferring cognizance from a Home State to a Non-Home State is as follows:

1. If a Federal agency is not the cognizant agency for a firm, firms rely on State DOTs for cognizant audit reviews. If a firm desires to receive a cognizant audit, the request first should be made to the firm's Home State agency.
2. The Home State agency, although encouraged to do so by FHWA, is not required to honor all requests for cognizant audit reviews. If the request for a cognizant audit review is not honored by the firm's Home State, the firm or another State may request that cognizant authority be transferred to another State that is willing to accept cognizant responsibility. The transfer of cognizance requires the Home State to issue a letter of transfer to the receiving State including the period of time in which the transfer applies. The Home State may not rescind its transfer of cognizance agreement as stated in the letter of transfer. The Home State should not reasonably deny the request for transfer if they have been requested to perform a cognizant review and have denied such request.

12.6 – DISPUTE BETWEEN ENGINEERING CONSULTANT AND COGNIZANT AGENCY

Disputes may arise between consulting firms and cognizant agencies during the cognizant review process in which an impasse is reached. In these situations, it is practical to engage in the dispute resolution process as early as possible. The consulting firm and cognizant agency shall engage all relevant participants actively and continually in collaborative problem solving during the cognizant review process. Helpful participant discussions of disputed issues should include the consulting firm, the cognizant agency, and the independent CPA firm. It may be necessary to obtain additional resources and information from AASHTO Audit Guide Committee members, the local FHWA division, and FHWA headquarters personnel for a final ruling.

With a properly executed dispute resolution process, there should be very few instances where the need arises for an agency to issue a letter of non-concurrence or adjustment. Involvement and notification of third parties and other agencies should be limited to the dispute resolution process and notification should not be made to other parties until the dispute resolution process has been fully completed.

When FHWA is involved to resolve disputes, the process should include (if warranted) formal opinions/rulings published by FHWA headquarters and clarification added to FHWA Q&A's section at: http://www.fhwa.dot.gov/programadmin/172qa.cfm.

12.7 – WHAT IF AN INDIRECT COST RATE APPROVED BY A COGNIZANT AGENCY IS IN DISPUTE?

23 CFR 172.11(b)(1)(vii), Disputed rates, provides a contracting agency additional options for performing its own audit or other evaluation if the cognizant approved rate is in dispute:

> Disputed rates. If an indirect cost rate established by a cognizant agency in subparagraph (1)(ii) herein is in dispute, the contracting agency does not have to accept the rate. A contracting agency may perform its own audit or other evaluation of the consultant's indirect cost rate for application to the specific contract, until or unless the dispute is resolved. A contracting agency may alternatively negotiate a provisional indirect cost rate for the specific contract and adjust contract costs based upon an audited final rate. Only the consultant and the parties involved in performing the indirect cost audit may dispute the established indirect cost rate. If an error is discovered in the established indirect cost rate, the rate may be disputed by any prospective contracting agency.

See FHWA FAQ Section 12.11 for further definition of errors.

12.8 – GUIDELINES FOR REVIEWING CPA INDIRECT COST RATE AUDITS

A link to a CPA Workpaper Review Program appears in Appendix A of this Guide. Government auditors should use the Program when performing overhead audits or when reviewing the workpapers of others, to determine whether it is appropriate to issue a cognizant letter of concurrence. The workpaper review program is a tool to assist in determining whether: (a) the CPA's audit was conducted in accordance with GAGAS, (b) the CPA adequately considered the auditee's compliance with FAR Part 31 and related laws and regulations, and (c) and the audit report format is acceptable. Chapter 11 of this Guide includes a recommended format for the audit report and required disclosures.

Government auditors should be familiar with GAGAS and current professional standards for workpaper development and maintenance. When performing the AASHTO Workpaper Review Program, government auditors should hold the performing engagement auditors to a similar standard and not to a self-imposed higher standard. Additional independent testing and auditing should only be performed where it is documented and substantiated that the engaged auditor has not met professional standards in performing their audit, workpaper development, and testing standards.

12.9 – ATTESTATIONS ENGAGEMENTS

Examination level engagements following GAGAS requirements are acceptable. Additionally, this Uniform Audit and Accounting Guide should be followed when performing attestation engagements.

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

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

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

Risk factors to be considered should include, if applicable:

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

As part of each State DOTs own Risk Analysis Program, many State DOTs have developed custom ICQs for development and capturing of data for analysis. To leverage the work of AASHTO and this Guide, and efficiencies for both the agency and consulting firm, development of additional ICQs should be done in a fashion to complement the AASHTO ICQ, *not in lieu of* the AASHTO ICQ. Supplemental ICQs should only contain data that is not included in the AASHTO ICQ and is specific to that agency's Risk Analysis Program.

***Note**: The AASHTO Risk Framework is available as a resource on the AASHTO Internal/External Subcommittee site: http://audit.transportation.org/Pages/default.aspx?siteid=43. Each State DOT may develop its own risk analysis, but all State DOTs should maintain adequate documentation to support the acceptance of engineering consultants' indirect cost rate computations.*

12.11 – FHWA GUIDANCE: QUESTIONS AND ANSWERS REGARDING COGNIZANCE

The FHWA maintains a web page with guidance to supplement Federal laws and regulations relating to the procurement, management, and administration of engineering and design related services using Federal-aid highway program (FAHP) funding. This guidance appears in the form of questions and answers (Q&A's) regarding the procurement, management, and administration of engineering and design-related services. The Q&A's are organized, by category, as follows:

I. Competitive Negotiation/Qualifications Based Selection Procurement Procedure
II. Other Procurement Procedures
III. Indirect Cost Rates and Audits
IV. Compensation (Payment) Methods
V. Contract Negotiation
VI. Contract Administration
VII. Disadvantaged Business Enterprise (DBE) Considerations
VIII. Conflicts of Interest
IX. Other Considerations

Note: *The complete list of Q&As is available from the following site: http://www.fhwa.dot.gov/programadmin/172qa.cfm.*

Note: The following letters are examples only; actual wording may differ.

EXAMPLE 1: COGNIZANT LETTER OF CONCURRENCE FOR CPA WORKPAPER REVIEW

[Use State DOT Letterhead.]
Date
(Firm name)
(Firm Address)

Dear:

We have performed a cognizant review of the audit, and supporting workpapers, of the [_ENGINEERING CONSULTANT NAME's_] Statement of Direct Labor, Fringe Benefits, and General Overhead (or whatever CPA titled the report) for the year ended [MM/DD/YY] in accordance with our role as Cognizant Agency as defined in 23 U.S.C. 112(b)(2)(c) and 23 CFR 172.3 and 172.7. The audit was performed by the independent CPA firm [CPA FIRM NAME]. The CPA represented that the audit was conducted in accordance with the *Government Auditing Standards*, as promulgated by the Comptroller General of the United States of America, and the audit was designed to determine that the indirect cost rate(s) was (were) established in accordance with Cost Principles contained in the Federal Acquisition Regulation, 48 CFR Part 31. We performed our cognizant review in accordance with the *AASHTO Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates*.

In connection with our cognizant review, nothing came to our attention that caused us to believe that the audit, and supporting workpapers for the Statement of Direct Labor, Fringe Benefits, and General Overhead (or whatever CPA titled report), and the related Auditor's Report(s), we reviewed did not conform in all material respects to the aforementioned regulations and auditing standards. Accordingly, we recommend acceptance of the following rate(s):

Combined/Corporate: (   ) OR Home Office: (   ) Field/Project Office: (   )

Facilities Capital Cost of Money (FCCM):

Yours truly,

[STATE DOT AUDIT OFFICIAL]

[TITLE]

c: [As identified]

EXAMPLE 2: COGNIZANT LETTER OF CONCURRENCE FOR CPA WORKPAPER REVIEW WHEN COGNIZANCE IS TRANSFERRED TO ANOTHER STATE DOT

[Use State DOT Letterhead.]
Date
(Firm name)
(Firm Address)

Dear:

On (Month, DD, 20XX), the (name of cognizant/home State department of transportation (DOT)), transferred cognizance to (name of non-home State DOT) to allow our cognizant review of the audit, and supporting workpapers, of the [_ENGINEERING CONSULTANT NAME's_] Statement of Direct Labor, Fringe Benefits, and General Overhead (or whatever CPA titled the report) for the year ended [MM/DD/YY] in accordance with our role as Cognizant Agency as defined in 23 U.S.C. 112(b)(2)(c) and 23 CFR 172.3 and 172.7. The audit was performed by the independent CPA firm [CPA FIRM NAME]. The CPA represented that the audit was conducted in accordance with the *Government Auditing Standards*, as promulgated by the Comptroller General of the United States of America, and the audit was designed to determine that the indirect cost rate(s) was (were) established in accordance with Cost Principles contained in the Federal Acquisition Regulation, 48 CFR Part 31. The cognizant review was performed in accordance with the *AASHTO Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates*.

In connection with the cognizant review, nothing came to our attention that caused us to believe that the audit, and supporting workpapers for the Statement of Direct Labor, Fringe Benefits, and General Overhead (or whatever CPA titled report), and the related Auditor's Report(s), we reviewed did not conform in all material respects to the aforementioned regulations and auditing standards. Accordingly, we recommend acceptance of the following rate(s):

Combined/Corporate: (   ) OR Home Office: (   ) Field/Project Office: (   )

Facilities Capital Cost of Money (FCCM):

Yours truly,

[STATE DOT AUDIT OFFICIAL]
[TITLE]

c: [As identified]

Appendices

A & B

<u>Appendix A</u>: Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates.

<u>Appendix B</u>: Internal Control Questionnaire (ICQ).

The Review Program and ICQ documents are available here: http://audit.transportation.org/Pages/default.aspx.

The Review Program and ICQ documents are available here:
http://audit.transportation.org/Pages/default.aspx.

Appendix

C

Keyword Index of 48 CFR Part 31 (Federal Acquisition Regulation, Part 31)

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(d)(1)	Accrual of Compensation Expenses (allowable).	YES†
31.201-2(d)	Adequate Recordkeeping (requirement for, and Contracting Officer's authority to disallow unsupported costs).	--
31.109	Advance Agreements: defined and requirements of (in writing, executed by both parties, stated duration).	--
31.205-1(b)	Advertising defined (generally, allowability is limited to recruitment costs).	YES - help wanted
31.205-1(d)	Advertising (allowable types of).	YES
31.205-1(f)	Advertising (unallowable types of).	NO
31.205-38(b)(1)	Advertising as a part of selling costs.	NO
31.205-51	Alcoholic Beverages.	NO
31.205-46(b)	Airfare, generally.	YES
31.205-46(c)	Aircraft owned by consultants.	YES†
31.201-4	Allocability (allowability, reasonableness, and allocability).	--
31.201-2 & 31.204	Allowability (reasonable, allocable, CAS Compliant, meets terms of contract, & not otherwise unallowable).	--
31.205-52	Asset Valuations Resulting from Business Combinations.	--
31.201-6(a)	Associated Costs, defined (costs associated with unallowables). See also CAS 405.	NO
31.205-46(a)(1)	Automobile: Mileage Costs.	YES
31.205-6(m)(2)	Automobile: Personal Use of (see also 31.205-46(d)). Includes commuting and other personal costs.	NO
31.205-6(f)(1)	Awards for Employees (Performance-Based Awards--bonus and incentive compensation).	YES
31.205-18(c)	B&P: Bid and Proposal Costs (allowability of).	YES
31.205-6(h)	Back pay (generally unallowable).	NO
31.205-3	Bad Debts (and directly-associated costs).	NO
31.205-6(p)	BCA (Benchmark Compensation Amount) - statutory limit on executive compensation. (Not a safe harbor or guaranteed amount of cost recovery.)	--
31.205-4	Bonding Costs (e.g., bid, performance, payment, infringement, and fidelity).	YES
31.205-6(f)	Bonuses and Incentive Pay, generally. (See 31.205-6(f)(1)(ii) for required basis and support.)	YES†

Key
† - See Exceptions.   (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-1(f)(5)	Brochures and Promotional Materials.	NO
31.201-3(a)	Burden of Proof on Consultant (determining reasonableness).	--
31.205-52	Business Combinations (asset valuations resulting from).	LIMITED DEPR.
31.205-16(a)	Business Combinations (gains and losses related to).	NO
31.205-11(h)	Capital Leases (full payment not allowable - limited to depreciation of property capitalized under the lease).	LIMITED DEPR.
31.205-11(h)(2)	Capital Leases: Related Parties.	LIMITED DEPR.
31.205-43(a)	Chambers of Commerce, Dues (but disallow portion of dues attributable to lobbying).	YES†
31.103	Commercial Organizations (contracts with).	--
31.205-36(b)(3)	Common Control of Leased Properties (e.g., between sub. and parent: limited to normal costs of ownership).	YES†
31.205-6(p)	Compensation, generally.	YES†
31.205-44(f)	College Savings Plans for Dependents of Company Employees.	NO
31.105 & 31.201-7	Construction and Architect-Engineer Contracts.	--
31.205-33	Consultant Service Cost and Professional Fees (outside accountants, lawyers, actuaries, and marketing consultants). Also known as "Professional and Consultant Service Fees" (PCS costs). See Retainer fees at 31.205-33(e).	YES†
31.205-7	Contingencies.	NO
31.205-42	Contract-Termination Costs.	VARIES
31.205-8	Contributions or Donations. (All cash donations are unallowable).	NO
31.205-1(e)(3)	Contributions or Donations: Community Service Activities (cash contributions unallowable; donation of time/labor is allowable).	YES
31.205-10	Cost of Money also known as "Facilities Capital Cost of Money" (FCCM).	YES
31.205-14	Country-Club Memberships.	NO
31.201-5	Credits (costs must be presented net of all applicable credits.)	OFFSET
31.205-47	Defense of Fraud (False Claims Act, Anti-Kickback Act, etc.).	NO†
31.205-18(d)	Deferred IR&D Costs: Allowability.	NO†

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.001	Definitions of Terms used in FAR Part 31.	--
31.205-44(f)	Dependents: Employee-dependent education plans	NO
31.205-11	Depreciation, generally.	YES
31.205-11(c)	Depreciation: Expense in excess of amount used for financial accounting.	NO
31.202	Direct Costs.	YES
31.205-38(b)(5)	Direct Selling Costs.	YES
31.201-6(a) & CAS 405-40	Directly-Associated Costs, defined (costs associated with unallowables).	NO
31.205-28(f)	Directors' Meetings	YES
31.205-6(a)(6)(ii)(B)	Distribution of Profits to Owners (unallowable for closely-held companies).	NO
31.205-8	Donations	NO
31.205-13	Dormitory Costs and Credits.	YES
31.202(a) & 31.203(b)	Double-Counted Costs (unallowable).	NO
31.205-43	Dues and Subscriptions.	YES
31.205-12	Economic Planning Costs.	YES
31.205-44	Education Costs (vocational training, part-time college, full-time college)	YES
31.205-6(f)	Employee Performance Awards (bonuses and incentive).	YES
31.205-6(n)	Employee Rebate and Purchase-Discount Plans.	NO
31.205-6(q)	Employee Stock Ownership Plans (ESOPs).	YES
31.205-14	Entertainment Costs (overrides all other cost principles).	NO
31.205-6(q)	ESOPs.	YES
31.205-6(q)(2)(i)(B)	ESOP: Current Funding Requirement.	YES
31.205-41(b)(1)	Excess Profits Taxes.	NO
31.205-6(p)(1)	Executive Benchmark Compensation Amount (reference to). Note that these costs are further limited by reasonableness--see National Compensation Matrix (Audit Guide Section 6.4) for details.	YES†
31.205-41(b)(1)	Federal Income Taxes.	NO

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-15(a)	Fines, Penalties, and Mischarging Costs Related to Violation of Laws.	NO
31.205-15(b)	Fines, Penalties, and Mischarging Costs Related to Improper Charging or Recording of Costs.	NO
31.102	Fixed-Price Contracts.	--
31.205-13(d)	Food Service, and Dormitory Costs and Credits.	YES
31.205-47(b), (f)(4) & (g)	Fraud, Defense of (including requirement to segregate and account for these costs separately--see 31.205-47(g)).	SEGREGATE
31.205-6(m)	Fringe Benefits.	YES
31.205-16	Gains and Losses on Disposition or Impairment of Depreciable Property or Other Capital Assets.	YES†
31.201-1	Generally Accepted Methods for Measuring Costs (requirement to use).	--
31.205-1(d)(2)	Gifts (to clients and the public as part of trade shows).	NO
31.205-13(b)	Gifts (to employees).	NO
31.205-6(l)(2)	Golden Handcuff Payments.	NO
31.205-6(l)(1)	Golden Parachute Payments.	NO
31.205-49	Goodwill.	NO
31.205-44(d)	Grants, Scholarships, and Fellowships to Educational or Training Institutions.	NO
31.205-13	Health, Welfare, Food Service, and Dormitory Costs and Credits.	YES
31.205-34(a)(1) & (b)	Help-Wanted Advertising Costs--Recruitment.	YES
31.205-35(a)(2)	House-Hunting Trip Costs (for employees with a permanent change of work location).	YES
31.205-17(b)	Idle Facilities Costs.	NO†
31.205-17(c)	Idle Capacity Costs.	YES
31.205-6(e)(1)	Income Tax Differential Pay (foreign assignments).	YES
31.205-6(e)(2)	Income Tax Differential Pay (domestic assignments).	NO
31.205-41(b)(1)	Income Taxes, Federal.	NO
31.205-41(a)(1)	Income Taxes, State and Local.	YES

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-18	Independent Research and Development and Bid and Proposal Costs.	YES
31.110	Indirect Cost Rate Certification and Penalties on Unallowable Costs.	--
31.203	Indirect Costs.	--
31.205-19	Insurance and Indemnification.	YES
31.205-20	Interest and Other Financial Costs.	NO
31.205-18	IR&D and B&P: Independent Research and Development and Bid and Proposal Costs.	YES
31.205-21	Labor Relations Costs.	YES
31.205-19(e)(2)(v)	Key-Man Life Insurance (allowable to extent that costs is included in compensation of officers--not allowable when company is beneficiary of policy)	LIMITED†
31.205-36(b)(1)	Leases (operating leases for real property and personal property)	YES
31.205-47	Legal and Other Proceedings.	YES
31.205-19(e)(2)(v)	Life Insurance	YES
31.205-22	Lobbying and Political Activity Costs.	NO
31.205-46	Lodging, Meals, and Incidental Expenses.	YES†
31.205-35(c)(1)	Loss on Sale of Home (for employees with a permanent change of work location).	NO
31.205-23	Losses on Other Contracts.	NO
31.205-25	Manufacturing and Production Engineering Costs.	YES
31.205-1; 31.205-38	Marketing Costs. (Note: FAR Part 31 does not expressly use the term "marketing," but public relations, advertising costs, and selling costs are widely referred to as marketing by many individuals. Within the FAR, *selling costs* are the most analogous to marketing costs - see 31.205-38.)	NO
31.205-38(b)(4)	Market Planning.	YES
31.205-26	Material Costs (direct costs, primarily).	YES
31.205-46(a)(2)	Meals, Lodging, and Incidental Expenses.	YES
31.205-1(f)(7)	Memberships in Civic and Community Organizations.	NO
31.205-46(d)	Mileage Costs: Automobile.	YES

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-13	Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits (subject to limitations in 31.205-13(b) through (e)).	YES†
31.205-35	Moving Costs Paid to Employees.	YES†
31.205-25	M&PE Costs (Manufacturing and Production Engineering Costs).	YES
31.205-19(e)(2)(v)	Officers' Life Insurance.	NO†
31.205-1(e)(4)	Open Houses (subject to limitations in 31.205-1(f)(5): costs unallowable for promotional materials, videos/films, handouts, magazines, etc.).	YES
31.205-36	Operating Leases (real property and personal property).	YES
31.205-27(a)	Organization/Reorganization Costs.	NO
31.205-28	Other Business Expenses, generally.	YES
31.205-30(c)	Patent Costs.	NO
31.205-15(a)	Penalties, Fines, and Mischarging Costs.	NO
31.205-6(j)	Pension Costs, generally.	YES
31.205-6(j)(1)(i)	Pension Costs: Current Funding Requirement.	YES
31.205-6(j)(4)	Pension Costs: Defined Contribution Plans.	YES
31.205-6(j)(4)(i)	Pension Costs: Contribution Limits.	YES†
31.205-6(f)	Performance Awards to Employees.	YES
31.205-6	Personal Services (compensation for).	YES
31.205-6(m)(2)	Personal Use of Automobiles.	NO
31.205-29	Plant Protection Costs.	YES
31.205-31	Plant Reconversion Costs.	NO
31.205-32	Precontract Costs (direct costs).	YES
31.205-43	Professional Activity Costs.	YES
31.205-33	Professional and Consultant Service Costs (e.g., external accountants, lawyers, actuaries, and marketing consultants).	YES
31.205-19	Professional Liability and General Insurance.	YES

Key
† - See Exceptions. (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(a)(6)(ii)(B)	Profits to Owners, Distribution of (unallowable for closely-held companies).	NO
31.205-1	Public Relations and Advertising Costs.	NO†
31.205-6(n)	Purchase-Discount Plans for Employees.	NO
31.205-1(f)(5)	Promotional Materials.	NO
31.205-35(a)(3)	Real Estate Brokers' Fees and Commissions (for employees with a permanent change of work location).	YES
31.201-3	Reasonableness. (No presumption of reasonableness exists.)	--
31.205-31	Reconversion Costs.	NO
31.201-2(d)	Recordkeeping Requirements (engineering consultants' responsibility to maintain adequate records).	--
31.205-13(c)	Recreation for Employees.	NO†
31.205-34	Recruitment Costs.	YES
31.205-36(b)(3)	Common Control of Leased Properties (e.g., between sub. and parent).	YES†
31.201-6(a)	Related Costs (Costs Related to Unallowable Costs). See also CAS 405.	NO
31.205-36(b)(3)	Related Party Transactions: Rental Costs (common control).	YES†
31.205-35	Relocation Costs Paid to Employees.	YES
31.205-36	Rental Costs: Operating Leases.	YES
31.205-27	Reorganization Costs.	NO
31.205-48	Research and Development (R&D) Costs.	YES
31.205-37(a)	Royalties and Other Costs for Use of Patents (direct costs).	YES
31.205-11(h)(1)	Sale and Leaseback.	YES†
31.205-38	Selling Costs (marketing the engineering consultant's services).	LIMITED†
31.205-1(f)(3)	Seminars, Symposia, and Meetings (unallowable portion of these costs).	NO
31.205-39	Service and Warranty Costs (direct costs).	YES
31.205-42	Settlement Costs Associated with Contract Terminations.	VARIES

Key
† - See Exceptions.   (*) - Requires advance agreement or verifiable methodology.

KEYWORD INDEX: 48 CFR Chapter 1, Part 31 (Federal Acquisition Regulation Part 31)

Citation	Key Words	Generally Allowable?
31.205-6(g)	Severance Pay, generally.	YES
31.205-14	Social and Dining Club Memberships (entertainment).	NO
31.205-40	Special Tooling and Special Test Equipment Costs (direct costs).	YES†
31.205-41(a)(1)	State Income Taxes.	YES
31.201-6(c)(2)	Statistical Sampling for Unallowable Costs.	ONLY IF(*)
31.205-28(a)	Stock Issue Costs.	YES
31.205-43(b)	Subscriptions and Dues (net of incidental lobbying costs).	YES
31.205-41	Taxes.	YES†
31.205-42	Termination Costs (direct costs).	VARIES
31.201-1(a)	Total Cost, defined.	--
31.205-43	Trade, Business, Technical and Professional Activity Costs.	YES
31.205-1(f)(2)	Trade Shows.	NO
31.205-44	Training and Education Costs (subject to limitations listed in 31.205-44(a) through (f)).	YES†
31.205-46	Travel Costs.	YES†
31.201-6	Unallowable Costs (and related costs).	--
31.205-13	Welfare, Food Service, and Dormitory Costs and Credits.	YES

Appendix

D

Appendix D – Listing of Resource Materials

This section provides a listing of resource materials commonly used by auditors who perform Government contract audits. The listing is not comprehensive; instead, it merely highlights the most frequently used materials. While paper copies are available, most of the publications also are available on the Internet.

Accounting Standards - Current Text

Published by:

Financial Accounting Standards Board

Format:

- Hard-copy 3 volume set
- Website address: http://www.fasb.org

Purpose:

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

American Institute of Certified Public Accountants (AICPA) Publications

Published by:

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

Formats:

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

Relevant Materials:

- AICPA Professional Standards (Two Volume Set)
- Audits of Federal Government Contractors - Audit and Accounting Guide

- Auditing Recipients of Federal Awards: Practical Guidance for Applying OMB Circular A-133, Audits of States, Local Governments and Non-Profit Organizations
- Codification of Statements on Auditing Standards. See for example, *SAS 99: Consideration of Fraud in a Financial Statement Audit* (October 2002).
- Accounting Trends and Techniques -CD-ROM
- Audit Sampling - Auditing Practice Release
- Auditing in Common Computer Environments - Auditing Practice Release
- Codification of Statements on Standards for Attestation Engagements

Cost Accounting Standards (CAS)

Published by:

Cost Accounting Standards Board (CASB), a section of the Office of Federal Procurement Policy within the U.S. Office of Management and Budget. The CASB has the exclusive authority to issue and amend cost accounting standards and interpretations designed to achieve uniformity and consistency in the cost accounting practices governing the measurement, assignment, and allocation of costs to contracts that involve Federal funds. The CAS are codified in 48 CFR Chapter 99.

Format:

Available in hard copy, and on the Internet at: http://www.whitehouse.gov/omb/procurement_casb and http://www.gpo.gov/fdsys/browse/collectionCfr.action?collectionCode=CFR.

Purpose:

> The standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with pricing and administration of, and settlement of disputes concerning, all negotiated prime contract and subcontract procurement with the United States in excess of $700,000, provided that, at the time of award, the contractor or subcontractor is performing any CAS-covered contracts or subcontracts valued at $7.5 million or greater.

DCAA Contract Audit Manual

Published by:

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

Formats:

- Two-volume set of hard-copy manuals, published semiannually.
- Available on the Internet at: http://www.dcaa.mil/cam.htm.

Purpose:

As stated in the foreword:

> The DCAA Contract Audit Manual (DCAA Manual 7640.1) is an official publication of the Defense Contract Audit Agency (DCAA). It prescribes auditing policies and procedures and furnishes guidance in auditing techniques for personnel engaged in the performance of the DCAA mission.

Federal Acquisition Regulation (FAR)

Published jointly by:

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

Format:

Available in hard copy, and on the Internet at: https://www.acquisition.gov/FAR/.

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 determining allowable and unallowable costs.

Federal Travel Regulation (FTR)

The FTR is the regulation contained in 41 Code of Federal Regulations (CFR), Chapters 300 through 304, which implements statutory requirements and Executive branch policies for travel by Federal civilian employees and others authorized to travel at Government expense. The FTR is available at: http://www.gsa.gov/portal/content/104790.

Government Auditing Standards - 2011 Revision ("Yellow Book")

Published by:

United States Government Accountability Office (GAO), by the Comptroller General

Format:

Available in hard copy, and on the Internet at http://www.gao.gov/yellowbook.

Purpose:

Quote from introduction (paragraph 1.04):

> The professional standards and guidance contained in this document, commonly referred to as generally accepted government auditing standards (GAGAS), provide a framework for conducting high quality audits with competence, integrity, objectivity, and independence. These standards are for use by auditors of government entities and entities that receive government awards and audit organizations performing GAGAS audits. Overall, GAGAS contains standards for audits, which are comprised of individual requirements that are identified by terminology as discussed in paragraphs 2.14 through 2.18. GAGAS contains requirements and guidance dealing with ethics, independence, auditors' professional judgment and competence, quality control, performance of the audit, and reporting.

Appendix

E

Appendix E – Sample Management Representation Letter

[Company Letterheard]

Management Representation Letter – Contract Audit

[Insert Month Day, Year]

[AGENCY]
[ADDRESS]
[ADDRESS]
[ADDRESS]

We are providing this letter in connection with your examination of our job cost records for contract ***[insert contract number]***. We confirm that we are responsible for the fair presentation of job cost records in conformity with: generally accepted accounting principles; contractual provisions; and Federal Acquisition Regulation, Subparts 9900, 31.105 and 31.2. We are also responsible for adopting sound accounting policies, establishing and maintaining internal control, and preventing and detecting fraud.

We confirm to the best of our knowledge and belief, as of ***[insert date]***, the following representations made to you during your examination.

1. The financial information referred to above are fairly presented in conformity with generally accepted accounting principles.
2. We have made available to you all the financial records requested and
   A. These records were prepared from ***[insert company name]*** official records.
   B. The job cost ledger provided for examination contains actual direct costs and quantities incurred for contract ***[insert contract number]***.
3. There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
4. There are no material transactions that have not been properly reported in the accounting records underlying the job cost accounting system.
5. There has been no:
   A. Fraud involving management or employees who have significant roles in internal control.
   B. Fraud involving others that could have a material effect on the financial statements.

6. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

7. The following have been properly recorded or disclosed in the financial job cost records:

   A. Related party transactions and related accounts receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

   B. Guarantees, whether written or oral, under which the company is contingently liable.

8. There are no:

   A. Violations or possible violations of laws or regulation whose effect should be considered for disclosure in the financial statements or as a basis for recording a contingency loss.

   B. Unasserted claims or assessments that our legal staff has advised us are probable of assertion and must be disclosed in accordance with *Statement on Financial Accounting Standards No. 5*.

   C. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by *Statement of Financial Accounting Standards No. 5*.

9. We have complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

No events have occurred subsequent to the job cost ledger date and through the date of this letter that would require adjustment to our contract costs or require any further disclosure.

Printed or Typed Name: ______________________________

Signature: ______________________________

Title: ______________________________

Appendix

F

Appendix F – FHWA Order 4470.1A (Cost Certification)

U.S. Department of Transportation
Federal Highway Administration

Memorandum

Subject: **ACTION:** FHWA Policy for Contractor Certification of Costs in Accordance with Federal Acquisition Regulations (FAR) to Establish Indirect Cost Rates on Engineering and Design-related Services Contracts

Date: October 27, 2010

In Reply Refer To: HIPA-20

From: King W. Gee
Associate Administrator for Infrastructure

Elissa K. Konove
Chief Financial Officer

To: Division Administrators

This memorandum is to inform you of a new policy which has been issued as FHWA Order 4470.1A dated October 27, 2010, regarding contractor certification of the costs used to establish indirect cost rates for application to Federal-aid engineering and design-related services contracts (as defined in 23 U.S.C. §112(b)(2)(A), 23 CFR §172.3, and State/local laws and regulations). The Order is attached and is available on FHWA's Consultant Services web site at http://www.fhwa.dot.gov/programadmin/consultant.cfm.

The subject Order directs Federal-aid Division Offices to encourage contracting agencies to incorporate a certification of cost requirement for contractor indirect cost rate proposals submitted for agency acceptance, whereby an official of a contractor shall certify that the indirect cost rate submitted does not include any costs which are expressly unallowable and that the indirect cost rate was established only with allowable costs in accordance with the applicable cost principles contained in the Federal Acquisition Regulations (FAR) of 48 CFR part 31. Proposed indirect cost rates should not be accepted or approved by a contracting agency for use in contract estimation, negotiation, administration, reporting, or payment, unless the costs have been certified by an official of the contractor as being allowable in accordance with the applicable FAR cost principles. This policy is issued in support of existing audit and certification provisions specified in 23 U.S.C. §112(b)(2), 23 CFR §172.7, 49 CFR §18.22(b) and 48 CFR §31.110.

The policy for contractor cost certification reflects FHWA's commitment to improve the stewardship and oversight of the procurement, management, and administration of engineering and design-related Federal-aid consultant services contracts. The policy also addresses recommendations contained in the Office of Inspector General's Audit Report entitled, "Oversight of Design and Engineering Firms' Indirect Costs Claimed on Federal-aid Grants" (http://www.oig.dot.gov/library-item/4710).

Application of this policy is expected to:

- Increase audit quality and consistency;
- Increase compliance with FAR cost principles;
- Reduce risk of payment of unallowable costs and waste in the consultant services program; and
- Reinforce the responsibility and accountability of consultants/contractors to comply with Federal laws and regulations.

FHWA Order 4470.1A containing the policy for contractor cost certification became effective upon signature by the Administrator on October 27, 2010. January 1, 2011, is the date by which State DOTs and local public agencies are encouraged to have integrated the contractor cost certification into their policies, procedures, and consultant services contracting practices. Engineering and design-related consultant services contracts procured, awarded, or modified after January 1, 2011, should include a contractor certification of the allowability of costs used to establish the final indirect cost rate for the applicable term of the contract, or verification that this certification was previously submitted and accepted by the contracting agency.

As provided in the Order, Federal-aid Division Offices are directed to work with State DOTs and other contracting agencies, as appropriate, to integrate a contractor cost certification whereby:

- Indirect cost rate proposals submitted on an annual basis, or proposals to modify previously accepted rates, should include a contractor certification of the allowability of costs in accordance with the FAR cost principles as described in the Order, prior to contracting agency acceptance and/or agreement to finalize an indirect cost rate.
- Contract cost proposals to provide engineering and design-related services on specific Federal-aid projects should include a contractor certification of the allowability of costs in accordance with the FAR cost principles as described in the Order, or a verification indicating this certification was previously submitted and accepted by the contracting agency for the appropriate accounting period.

We appreciate your support with implementation of this policy and collaboration to incorporate a contractor cost certification requirement into the policies, procedures, and consultant services contracting practices of your State DOT and local public agencies to improve the effectiveness of Federal-aid funds expended on engineering and design-related consultant services.

If you have any questions regarding the policy for contractor cost certification, please contact Mr. Scott Wolf at scott.wolf@dot.gov or Mr. David Bruce at david.bruce@dot.gov.

Attachment

U.S. DEPARTMENT OF TRANSPORTATION

Federal Highway Administration

Order

Subject

FHWA Policy for Contractor Certification of Costs in Accordance with Federal Acquisition Regulations (FAR) to Establish Indirect Cost Rates on Engineering and Design-related Services Contracts

Classification Code	Date	OPI
4470.1A	October 27, 2010	HIPA-20 HCFM-10

Par.

1. **What is the purpose of this directive?** This directive establishes the Federal Highway Administration's (FHWA) policy for contractor certification of the costs used to establish indirect cost rates in accordance with the applicable cost principles contained in the Federal Acquisition Regulations (FAR) for engineering and design-related service contracts funded with Federal-aid highway program (FAHP) funding and administered by State departments of transportation (State DOTs), local public agencies, and other grantees and subgrantees of FAHP funding (as specified under Section 112(b)(2) of title 23 of the United States Code (U.S.C.) (23 USC §112(b)(2)) and defined in Section 172.3 of title 23 of the Code of Federal Regulations (CFR) (23 CFR § 172.3).

2. **Does this directive cancel an existing directive?** No, this is a new directive.

3. **What is the background of this directive?**

a. Grantees and subgrantees of Federal grants are required to apply the FAR cost principles (48 CFR, part 31) to determine the allowable costs for contracts with commercial, for-profit organizations (as specified in 49 CFR §18.22(b)).

b. The provisions of Section 307 of the National Highway Systems Designation Act (NHSDA), passed by Congress in 1995, require the use of the FAR cost principles (48 CFR, part 31) as the basis to determine the allowance of incurred costs when performing indirect cost rate audits of design and engineering contractors, eliminated duplicate audits of design and engineering contractors by multiple entities, and removed ceilings established by certain States for indirect cost rates, direct salaries, and bonuses. These changes in law, as well as other subsequent changes made by Section 174 of the Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act in 2006, were incorporated into 23 U.S.C. §112(b)(2). As such, grantee and subgrantee contracts funded with FAHP funds are required to use the indirect cost rate of a contractor established by a cognizant agency audit in accordance with the FAR cost principles.

c. The FHWA's commitment to improve the stewardship and oversight of the procurement, management, and administration of engineering and design-related consultant service contracts prompted the need for development and implementation of guidance to improve the quality of consultant contracting procedures, increase audit quality, and enhance consistency in FAR cost principles interpretation and compliance.

d. Although compliance with the cost principles of 48 CFR, part 31 is tested through performance of audits and other evaluation and analytical procedures, as appropriate, it is the responsibility of the design and engineering contractor to account for costs appropriately and maintain adequate records and supporting documentation to demonstrate costs claimed have been incurred, are allocable to a contract, and comply with applicable cost principles (as specified in 48 CFR §31.201-2(d)). Requesting certification by an executive or financial official of a contractor's organization regarding the allowability of costs used to establish indirect cost rates in accordance with the applicable FAR cost principles reinforces the responsibility and accountability of the contractor to comply with Federal laws and regulations.

4. **What authorities govern this directive?**

a. Title 23, CFR, Section 1.32 provides the following: "The Administrator shall promulgate and require the observance of policies and procedures, and may take other action as he deems appropriate or necessary for carrying out the provisions and purposes of Federal laws, the policies of the Federal Highway Administration, and the regulations of this part. The Administrator or his delegated representative, as appropriate, is authorized to issue (Orders). Orders are directives limited in volume and contain permanent or long lasting policy, instructions, and procedures."

b. Title 23, U.S.C., Section 112(b)(2)(B) to (D) provides the following: "Any contract or subcontract (engineering and design related service contracts directly related to a construction project subject to 23 U.S.C §112(a)), whether funded in whole or in part with Federal-aid highway funds, shall be performed and audited in compliance with cost principles contained in the Federal Acquisition Regulations of part 31 of title 48, Code of Federal Regulations. Instead of performing its own audits, a recipient of funds under a contract or subcontract shall accept indirect cost rates established in accordance with the Federal Acquisition Regulations (48 CFR, part 31) for 1-year applicable accounting periods by a cognizant Federal or State government agency. Once a firm's indirect cost rates are accepted, the recipient of the funds shall apply such rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment and shall not be limited by administrative or de facto ceilings of any kind."

c. Title 23, CFR, Section 172.7(b) provides the following: "Contracting agencies shall use the indirect cost rate established by a cognizant agency audit for the cost principles contained in 48 CFR part 31" for application to engineering and design related service contracts funded with Federal-aid highway program funds and directly related to a construction project subject to 23 U.S.C §112(a). "Contracting agencies shall apply these indirect cost rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment and the indirect cost rates shall not be limited by any administrative or de facto ceilings."

d. Title 49, CFR, Section 18.22(b) provides the following: "Allowable costs will be determined in accordance with the cost principles applicable to the organization incurring the costs. For the costs of a for-profit organization, use the principles in 48 CFR part 31." This provision also specifies the applicable Federal cost principles for each kind of organization that receives payment under a Federal grant. Consultant engineering firms performing under a personal services contract are considered commercial, for-profit organizations for determination of applicable cost principles.

e. Title 48, CFR, Section 31.110 provides the following: "Certain contracts require certification of the indirect cost rates proposed for final payment purposes."

5. **What definitions are used in this directive?**

a. **Allowability/allowable costs**. See FAR 48 CFR §31.2 for definition of allowable costs and cost principles for determination of allowability.

b. **Certification**. A document attesting to the truth of a fact or statement.

c. **Consultant/Contractor**. The individual or firm providing engineering and design-related services as a party to the contract (as defined at 23 CFR §172.3).

d. **Contracting agency**. State DOTs, local public agencies, or other grantees and subgrantees that are responsible for the procurement, management, and administration of engineering and design related services (as defined at 23 CFR §172.3).

e. **Engineering and design-related services**. Program management, construction management, feasibility studies, preliminary engineering, design, engineering, surveying, mapping, or architectural-related services with respect to a construction project subject to 23 U.S.C. §112(a) (as defined at 23 U.S.C. §112(b)(2)(A) and 23 CFR §172.3). Also, professional services of an architectural or engineering nature, as defined by State law, which are required to or may logically be performed or approved by a person licensed, registered, or certified to provide the services (as defined at 40 U.S.C. §1102(2)).

f. **Indirect costs (rates and proposals)**. See FAR 48 CFR §31.203 for definition of indirect costs.

g. **Official (of the contractor)**. An individual executive or financial officer of the contractor's organization at a level no lower than a Vice President or Chief Financial Officer, or equivalent, who has the authority to represent the financial information utilized to establish the indirect cost rate proposal submitted in conjunction with the contract.

6. **What is FHWA's policy for contractor certification of costs in accordance with FAR to establish indirect cost rates on engineering and design-related services contracts?** To ensure overall compliance with cost principles of the FAR (as specified in 23 U.S.C. §112(b)(2)(B)-(D), 23 CFR

§172.7(b), and 49 CFR §18.22(b)), it is FHWA's policy that an indirect cost rate proposal should not be accepted and no agreement should be made by a contracting agency to establish final indirect cost rates, unless the costs have been certified by an official of the contractor as being allowable in accordance with the applicable FAR cost principles of 48 CFR, part 31. This contractor certification of costs policy applies to:

a. all indirect cost rate proposals submitted, whether on an annual basis, on a contract basis, or as an amendment to contracts or the contractor's approved indirect cost rate, for acceptance by a contracting agency;

b. indirect cost rate proposals by the prime contractor and any sub-contractors; and

c. all grantee and subgrantee contracts for engineering and design-related services (as defined in 23 U.S.C. §112(b)(2)(A), 23 CFR §172.3, and State/local laws and regulations) that are funded in whole or in part with FAHP funds, and directly related to an ultimate highway construction project (as specified in 23 U.S.C. §112(a)).

7. **Will a standard contractor cost certification form or language be required?** No. Federal-aid Division Offices are encouraged to work with contracting agencies to develop contractor cost certification language, forms, and implementation procedures to address the FHWA policy. Whether submitted on an annual basis, on a contract basis, or as an amendment to modify a previously accepted rate, indirect cost rate proposals should not be accepted for application to Federal-aid engineering and design-related services contracts, as defined in this Order, unless certified by the contractor as allowable in accordance with the FAR cost principles of 48 CFR, part 31. An example contractor cost certification is provided for reference in Appendix A of this Order.

8. **What are the consequences if a contractor knowingly charges unallowable costs on Federal-aid funded contracts?**

a. A contractor found to have knowingly charged unallowable costs to a Federal-aid funded contract is subject to suspension and debarment actions by the FHWA (as specified in FHWA Order 2000.2A, FHWA Nonprocurement Suspension and Debarment Process (Federal-Aid Program), dated June 19, 2000, and 2 CFR §180). Suspension and debarment actions protect the Federal Government by excluding certain firms or persons from participation in Federal programs government wide. This ensures that the Federal Government does not conduct business with a person or firm that has an unsatisfactory record of integrity. In addition, the FHWA will consult with the Department of Justice to pursue a potential cause of action under the False Claims Act (as specified in 31 U.S.C. §§3729-3733) or prosecution for making a false statement (as specified in 18 U.S.C §1001).

b. In addition to Federal suspension and debarment actions, the contractor cost certification will allow States and local public agencies to establish a framework, or strengthen an existing framework, to pursue a range of civil actions and penalties permitted under State and local laws, regulations, policies, and procedures when a contractor knowingly charges unallowable costs, contrary to the cost certification statement on State or other grantee or subgrantee awarded contracts funded with Federal-aid funds. In accordance with State and local laws, regulations, policies, and procedures, the range of actions and penalties a contracting agency may consider could include fines, cost recovery, contract termination, suspension, debarment, and criminal false statement actions.

9. **What are FHWA's roles and responsibilities with implementing this directive?** Federal-aid Division Offices are directed to work with the State DOTs and other contracting agencies, as appropriate, to encourage integration of a contractor cost certification requirement for engineering and design-related services contracts as follows:

a. **Stewardship (cost certification):** Encourage/work with State DOTs and other contracting agencies, as appropriate, to incorporate a requirement for contractor certification of the allowability of costs with each indirect cost rate submitted for engineering and design-related services contracts whereby:

(1) an official of the contractor shall certify that, to the best of the certifying official's knowledge and belief, the indirect cost rate developed includes only allowable costs in accordance with the applicable cost principles contained in the FAR of 48 CFR, part 31, and that it does not include any costs which are expressly unallowable in accordance with the same part cost principles (an example contractor cost certification is provided for reference in Appendix A of this Order); and

(2) proposed indirect cost rates, whether submitted on an annual basis, on a contract basis, or as an amendment to modify a previously accepted rate, should not be accepted or approved by a contracting agency, unless the costs have been certified by an official of the contractor.

b. **Stewardship (policies and procedures):** Encourage/work with State DOTs and other contracting agencies, as appropriate, to amend consultant procurement and audit (if applicable) policies, procedures, and practices to incorporate a contractor certification of the allowability of costs as follows:

(1) **Policies and procedures:** Contracting agencies should amend written consultant procurement and audit (if applicable) policies and procedures to incorporate a contractor certification of the allowability of costs in accordance with FAR cost principles (48 CFR, part 31) prior to acceptance of a final indirect cost rate for application to engineering and design-related service contracts funded in whole or in part with FAHP funds (as specified in 23 CFR §172.9(a)). Depending on the organizational structure and currently approved processes and procedures, amendments to incorporate contractor certification of costs should consider/address the following:

(a) **Indirect cost rate proposals (annual basis):** Contractor certification of the allowability of costs used to establish indirect cost rates submitted for contracting agency acceptance on an annual basis (or shorter cycle in accordance with the fiscal accounting period of the contractor) or proposals to modify a previously accepted rate;

(b) **Indirect cost rates included in contract proposals:** Contractor certification of the allowability of costs used to establish a contractor's indirect cost rate, or a verification indicating this certification was previously submitted and accepted by the contracting agency, included in contract proposals submitted for contracting agency acceptance in conjunction with response to request for proposals (RFPs) to provide engineering and design related services on specific Federal-aid projects or contracts; and

(c) **Adequacy of contract documentation:** A copy of the contracting agency indirect cost rate approval letter (including cognizant agency approvals as appropriate) and contractor cost certification should be included within the documentation for each Federal-aid contract to substantiate the final indirect cost rate established for the term of the applicable accounting period of the contractor and applied to each contract and subsequent contract modification.

(2) **Contractor notification:** Contracting agencies should notify contractors of the changes to be implemented regarding cost certification procedures through memorandums, amended policies

and procedures, amended instructions for contracting with the agency, RFP response instructions, and/or other appropriate methods of communication. Contracting agencies should incorporate notice of contractor cost certification requirements in RFPs for Federal-aid engineering and design-related services contracts. Contractors that do not already have an accepted, or cognizant approved, indirect cost rate and certification of the allowability of costs for the appropriate accounting period may be required to submit the applicable cost certification in conjunction with a response to the RFP or within a specified time following selection as the most highly qualified contractor. Instructions for contracting with the agency and/or for responding to RFPs should clearly indicate contractor requirements with respect to providing a certification of the costs used to establish indirect cost rates.

c. **Oversight:** Incorporate the need for contractor cost certification into the Division Office's risk assessment of contracting agency procurement, management, and administration of consultant services. Inclusion within risk assessments and Standard Operating Procedures will support reviews of full-oversight projects, future program or process reviews of the State DOT's consultant services program, and the State DOT's stewardship and oversight of local public agency consultant services programs. It will also assist Division Offices in the review and approval of future updates to a State DOT's consultant services policies and procedures (as specified in 23 CFR §172.9(a)).

10. **Where can I find additional information?** Additional information about this policy and FHWA's consultant services program is available at http://www.fhwa.dot.gov/programadmin/consultant.cfm, or by contacting FHWA's Office of Infrastructure Pre-Construction Group (HIPA-20) or Office of the Chief Financial Officer Federal-aid Financial Management Team (HCFM-10).

Victor M. Mendez
Administrator

Appendix A. Example Contractor Cost Certification

Certification of Final Indirect Costs

Firm Name: ________________________________

Indirect Cost Rate Proposal: ____________________

Date of Proposal Preparation (mm/dd/yyyy): ____________________

Fiscal Period Covered (mm/dd/yyyy to mm/dd/yyyy): ____________________

I, the undersigned, certify that I have reviewed the proposal to establish final indirect cost rates for the fiscal period as specified above and to the best of my knowledge and belief:

1.) *All costs included in this proposal to establish final indirect cost rates are allowable in accordance with the cost principles of the Federal Acquisition Regulations (FAR) of title 48, Code of Federal Regulations (CFR), part 31.*
2.) *This proposal does not include any costs which are expressly unallowable under the cost principles of the FAR of 48 CFR 31.*

All known material transactions or events that have occurred affecting the firm's ownership, organization and indirect cost rates have been disclosed.

Signature: ________________________________

Name of Certifying Official (Print): ________________________________

Title: ________________________________

Date of Certification (mm/dd/yyyy): ____________________

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AMERICAN ASSOCIATION
OF STATE HIGHWAY AND
TRANSPORTATION OFFICIALS
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