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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 framework²⁷ 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.

²⁷ 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.²⁸

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.²⁹ 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;

²⁸ See Chapter 10 for additional details regarding minimum recommended audit procedures.

²⁹ Appendix B contains the standard internal control questionnaire used by State departments of transportation.

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

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

9.7—Other Audits as a Resource

In planning for an audit, auditors may obtain information from the engineering consultant pertaining to other audits. Such audits may include FAR-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 and 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 contracts³⁰). 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.

³⁰ 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.

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.