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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.³¹

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 31.2.³²

³¹ 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.

³² 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.

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

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

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

After gaining an understanding of the consultant's business and evaluating the client's internal control structure, the auditor should develop a plan for substantive testing. This plan may include both statistical and non-statistical sampling techniques which, when combined with other audit procedures, must be designed to provide sufficient, appropriate audit evidence to support the auditor's opinion on the compliance of the 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 items³³ 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.³⁴

³³ See the following sections for recommended testing procedures to be applied to large-dollar or sensitive (LDS) items.

³⁴ See Section 8.30 for additional cost items that are ineligible for reimbursement.

10.2—Audit Sampling

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

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

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

A. Audit Objectives and Sampling Methods

Appendix B of the DCAA CAM provides the following guidance:

B-302.a: A prerequisite to the application of any sampling process is the need to identify the specific audit objectives to be attained by examination of the area under evaluation. Prior to initiation of the sampling process, the auditor should definitively set forth in the sampling plan the characteristics and values to be examined during the audit. The auditor's sampling objective should satisfy the audit objectives of the area being audited.

B-302.g: When the auditor has reason to believe that a cost category includes a significant amount of unallowable expenses, the purpose in taking a sample will generally be to estimate the total amount of unallowable expenses. On the other hand, if the auditor has no reason to believe the costs being audited include unallowable amounts, the purpose will generally be to obtain additional assurance that the costs do not, in fact, include a significant amount of unallowable expenses. In either case, the auditor should seek to develop a sampling plan that will provide maximum support for conclusions in return for the time spent in the selection, examination, and evaluation of the sample. In addition, the sample size should provide a reasonable balance between: (1) the amount of support the sample will provide for audit conclusions and (2) the expenditure of auditor resources the sample will require.

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

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

B. Sampling for Attributes and Sampling for Variables

Based on the sampling objective and purpose of the test, it is critical for the auditor to consider when it is 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)³⁵ [footnote added] in order to properly evaluate the sample results.

³⁵ DCAA CAM Appendix B-504 discusses precision and confidence level, two interrelated parameters used to develop reliability parameters for variable sampling.

Note: Consistent with DCAA CAM Appendix B-304, before selecting a statistical audit sample using variable sampling techniques to test for unallowable cost items, auditors are expected to scan the engineering consultant's general ledger so that large dollar or sensitive (LDS) transactions can be removed/stratified³⁶ for complete examination, including verification to source documents. Accordingly, the sampling universe should be limited to the group of items that remain after the LDS items have been removed.

C. Determining Sample Size

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

Auditors are encouraged to consult the AICPA's *Audit Sampling* guide,³⁷ 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>.³⁸

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.³⁹ 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.

³⁶ 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."

³⁷ See https://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/TopicSpecificGuidance/PRDOVR-PC-012530/PC-012530.jsp.

³⁸ 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.

³⁹ 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.

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

10.3—Testing Labor Costs

A. Generally

For the majority of engineering consultant contracts, labor is the largest single component of cost. Labor costs are composed of direct labor assigned to contracts (regardless of whether the labor is billable) and indirect labor charges allocated to contracts through an overhead rate. Verification of labor costs should begin with the examination of the engineering consultant’s internal control structure and testing of those controls, as discussed in Section 9.2. Based on the assessed level of control risk, the auditor should determine an appropriate labor sample with a *minimum of 26 timesheets* chosen for testing across an appropriate mix of direct-charge employees,⁴⁰ including supervisors and/or project managers. The following examples are presented for illustrative purposes only and are not meant to encompass the full range of acceptable labor testing. The sample size should increase appropriately based on the size of the labor population and conclusions drawn from the risk assessment for labor testing.

EXAMPLE 10-1.

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

EXAMPLE 10-2.

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

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.)

⁴⁰ 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.

3. The overall labor costs recorded in the general ledger accounts must be reconciled to:
 - The job cost system.
 - The payroll reports submitted to the Internal Revenue Service (i.e., Form 941s—Employer’s Quarterly Federal Tax Return).
4. Audit procedures also must be performed to determine if the labor accounts and individual time card entries sufficiently screen labor to:
 - Determine the allowability of payroll cost. Do the timecards identify time spent on unallowable activities?
 - Determine the proper allocation of labor. Do the records charge all labor performed on similar tasks the same way?
 - Determine if labor is posted in a manner from which the labor base can be computed. If the base is direct labor costs excluding premium overtime, do the records accumulate direct labor and direct premium overtime?

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

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-dollar⁴¹ 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 10.2.⁴² 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

⁴¹ 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.

⁴² A 95-percent confidence level with a precision level (materiality threshold) in the range of 2 to 5 percent.

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.

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) and (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) and (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.⁴³ 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.

⁴³ See <http://www.fhwa.dot.gov/legregs/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 and indirect costs in summary accounts that appear on the indirect cost rate schedule.⁴⁴ 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.

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.

⁴⁴ For example, the consultant might use single *Travel* account for both direct and indirect costs.

- If the reviewing DOT rejects the audited overhead rate, the engineering consultant will be afforded the opportunity to correct the defects in the audit. Generally, this will require more extensive testing by the auditor.
- Before the engineering consultant resubmits the audited 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 were included in the submitted overhead rate. The reviewing DOT may be required to perform additional audit procedures before an acceptable overhead rate can be established.

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