

12

Chapter 12—Cognizance and Oversight

To avoid duplication of audit work, it is common practice for auditors to rely on the work of others. 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 impacted how some states paid consulting engineers for the overhead portion of their costs on Federally-participating contracts. Heretofore, approximately one-half of the State DOTs had self-imposed ceilings on overhead limits and/or maximum hourly rates associated with indirect labor. Section 307 of the NHSD Act prohibited the use of such limitations on 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?

A cognizant agency can be any of the following:

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

12.4—How Is a Cognizant Approved Indirect Cost Rate Established?

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

- A Cognizant Agency either: (a) performs an indirect cost rate audit, or (b) contracts with and directs the work of a CPA who performs this work.
- A Non-Home State auditor or CPA working under the State’s direction issues an audit report, and the Home State issues a cognizant letter of concurrence. If the Home State does not accept the indirect cost rate audit performed by another State, the Home State will have 180 days from receipt of the audit report to issue a cognizant approved rate; otherwise, the Non-Home State audit report will be used to establish a cognizant approved rate for the one-year applicable accounting period.
- An indirect cost audit performed by an independent CPA (not part of the engineering consultant’s organization) hired by the consulting firm will be used to establish a cognizant approved rate if one of the following conditions is met:
 - (a) The Home State reviews the CPA’s audit report and related workpapers, and the Home State issues a cognizant letter of concurrence with the audit report.
 - (b) A Non-Home State reviews the CPA’s audit report and related workpapers and issues a letter of concurrence with the CPA report, which is then accepted by the Home State. If the Home State does not accept the Non-Home State’s review, the Home State will have 180 days from receipt to complete a review of the CPA audit report and either concur with it, modify it, or reject it due to a material error requiring re-submittal; otherwise, the CPA audit report with which the Non-Home State has concurred will be used to establish the cognizant approved rate for the one year applicable accounting period.

12.5—Guidelines for Reviewing CPA Indirect Cost Audits

A CPA Workpaper Review Program appears in Appendix A of this guide. Government auditors should use the Program when performing overhead audits or when reviewing the workpapers of others, to determine whether 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) the audit report format is acceptable. Chapter 9 of this Audit Guide includes a recommended format for the audit report and required disclosures.

12.6—Attestations Engagements

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

12.7—Risk Analysis: Accepting Overhead Rates Without a Workpaper Review

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

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

Risk factors to be considered should include, if applicable:

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

Note: Each State DOT may develop its own risk analysis, but all State DOTs should maintain adequate documentation to support the acceptance of engineering consultants' indirect cost rate computations.

12.8—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.⁴⁶ 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

Q&A excerpts from Category III, Indirect Cost Rates and Audits, appear below:

1. Are audits required for FAHP funded engineering and design related services contracts?

No, audits are not required by Federal law or regulation for specific engineering and design related services contracts funded in whole or in part with FAHP funds.

However, contracting agencies must provide assurance that any indirect cost rate considered for acceptance and use in its contracts has been developed in accordance with the FAR cost principles (as specified in 23 U.S.C. 112(b)(2)(B), 23 CFR 172.7(a), and 48 CFR 31). A contracting agency may determine, in accordance with its established risk assessment process/risk management framework ([See Indirect Cost Rates and Audits Question and Answer No. 3](#)) and its approved written policies and procedures (as specified in 23 CFR 172.9(a)), when an audit is required and the scope of the audit to be performed. When contracting agency procedures call for audits of contracts or subcontracts, these audits shall be performed to test compliance with the requirements of the cost principles contained in the FAR.

⁴⁶ See <http://www.fhwa.dot.gov/programadmin/172qa.cfm>.

2. Are pre-negotiation/pre-award audits or reviews allowed for FAHP funded engineering and design related services contracts?

Yes, contracting agencies may perform pre-negotiation/pre-award audits or reviews and the costs to perform those audits or reviews are eligible for Federal-aid participation.

A contracting agency may determine, in accordance with its established risk assessment process/risk management framework and its approved written policies and procedures (as specified in 23 CFR 172.9(a)), when a pre-negotiation/pre-award audit is required and the scope of the audit to be performed. In some cases, a contracting agency may have to perform a pre-negotiation audit to ensure that the consulting firm has an acceptable accounting system, has adequate and proper justification for the various rates charged to perform work, and is aware of cost eligibility and documentation requirements. Costs of project related audits performed in accordance with GAGAS and benefiting Federal-aid highway projects are eligible for Federal participation (as specified in 23 CFR 140.803).

3. What does a contracting agency audit risk assessment process/risk management framework consist of?

The primary objective of contracting agency evaluation and acceptance of consulting firm indirect cost rates is to ensure such rates are developed in accordance with the FAR cost principles (as specified in 48 CFR 31). A risk management framework may be employed by a contracting agency to provide reasonable assurance that consulting firm costs, including those stemming from indirect cost rates, are established in accordance with the FAR cost principles.

A contracting agency risk management framework may include, but is not limited to, the following tools: FAR compliant audits (which may result in cognizant approved indirect cost rates), desk reviews, reliance on work performed by other State DOTs (in accepting an indirect cost rate for use in their respective State), or other procedures, as appropriate. The scope of a risk management framework may include pre-award and post-award audits, where appropriate. The framework should consider the following risk criteria: dollar thresholds; history/reputation of the consulting firm; the number of States in which the consulting firm does business; audit frequency; experience of the CPA firm performing audits on the consulting firm's indirect cost rate; responses to the consulting firm's internal control questionnaire; and/or other risk criteria, as deemed appropriate.

An audit risk assessment process/risk management framework employed by a contracting agency should be established as a component of the contracting agency's approved written policies and procedures (as specified in 23 CFR 172.9(a)).

4. What are the Federal requirements for use and application of indirect cost rates of a consulting engineering firm on FAHP funded engineering and design related services contracts?

Contracting agencies shall accept cognizant approved indirect cost rates established in accordance with the FAR cost principles (as specified in 48 CFR 31) for a consulting firm's applicable one-year accounting period, if such rates are not currently under dispute (as specified in 23 U.S.C. 112(b)(2)(C) and 23 CFR 172.7(b)). Contracting agencies shall apply accepted (cognizant approved) indirect cost rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment; and the rate shall not be limited by administrative or de facto ceilings of any kind (as specified in 23 U.S.C. 112(b)(2)(D) and 23 CFR 172.7(b)).

Note that the States of Minnesota and West Virginia are granted exceptions from the audit and indirect cost rate requirements established in 23 U.S.C. 112(b)(2)(B)-(E) (as specified in 23 U.S.C. 112(b)(2)(F)). However, the allowability of consultant costs remains governed by the FAR cost principles (48 CFR 31) applicable to commercial, for-profit organizations (as specified in 49 CFR 18.22(b)). (See Indirect Cost Rates and Audits Question and Answer No. 5 for sub-consultant audit requirements and Nos. 17-32 for additional discussion regarding acceptance, use, and application of indirect cost rates)

5. Do the cognizant audit requirements (as specified in 23 U.S.C. 112(b)(2)(C)-(D)) apply to sub-consultant indirect cost rates?

No, the cognizant audit requirements do not apply to sub-consultant indirect cost rates.

Prime consultants, who were selected under a competitive negotiation/qualifications based selection (Brooks Act) procurement process, frequently hire sub-consultants to perform specialty work. Sub-consultants hired by the prime consultant do not fall under the requirements of 23 U.S.C. 112(b)(2)(C)-(D). As such, sub-consultant indirect cost rates would not be subject to establishment via cognizant agency audit. However, subcontracts must comply with the FAR cost principles (as specified in 23 U.S.C. 112(b)(2)(B), 48 CFR 31, and 49 CFR 18.22(b)). Should a sub-consultant have a cognizant approved indirect cost rate, a contracting agency may choose to accept and apply that rate. As required with all procurements for property and services under a Federal grant, State and local public agencies must follow all State and local laws, regulations, policies, and procedures which are not in conflict with applicable Federal laws and regulations (as specified in 49 CFR 18.4 and 18.36(a)).

Although an audit of an indirect cost rate of a sub-consultant on a FAHP funded contract is not required, State and local public agencies are not precluded from prescribing sub-consultant audit requirements in their laws, policies, and/or procedures. As such, and in accordance with a State's established audit risk assessment process/risk management framework, the requirement to audit or require sub-consultants to prepare an audit may be incorporated as an acceptable policy and/or procedure of a State or local public agency consultant services program. Such policies and procedures, which are subject to approval by FHWA (as specified in 23 CFR 172.9(a)), may be warranted to ensure sub-consultant costs are properly accumulated and allowable in accordance with the FAR cost principles. Care should be taken by contracting agencies to avoid placing an undue burden on small firms as a result of such policies and procedures.

6. What is a “cognizant agency”?

The term “cognizant agency” means any Federal or State agency that has conducted and issued an audit report of a consulting firm's indirect cost rate established in accordance with the FAR cost principles (48 CFR 31) (as defined in 23 CFR 172.3). When providing a cognizant indirect cost rate approval, a cognizant agency may either perform an audit and issue an audit report or review work papers related to an audit performed by a CPA and then issue a cognizant letter of concurrence. A cognizant agency may be any of the following: (1) Federal agency; (2) The Home State DOT (the State where the consulting firm's accounting and financial records are located); or (3) A Non-Home State DOT to whom the Home State has transferred cognizance in writing for the particular indirect cost rate audit of a consulting firm. (See Indirect Cost Rates and Audits Question and Answer Nos. 7-9)

7. Can a local public agency or some other non-State recipient or sub-recipient of FAHP funding be a cognizant agency?

No, the law requires the cognizant agency to be either a Federal or State government agency (as defined in 23 CFR 172.3).

8. What is a “cognizant approved indirect cost rate”?

The term “cognizant approved indirect cost rate” refers to the indirect cost rate established by an audit performed in accordance with GAGAS to test compliance with the FAR cost principles (as specified in 48 CFR 31) and accepted by a cognizant Federal or State agency.

9. How is a cognizant approved indirect cost rate established?

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

1. A cognizant agency performs an indirect cost rate audit and issues an audit report, or contracts with and directs the work of a CPA who performs the indirect cost rate audit and issues an audit report.
2. A Non-Home State auditor or CPA working under the Non-Home State's direction performs an indirect cost rate audit and issues an audit report, and the Home State issues a cognizant letter of concurrence. If the Home State does not accept the indirect cost rate audit performed by another State, the Home State will have 180 days from receipt of the audit report to issue a cognizant approved rate; otherwise, the Non-Home State audit report will be used to establish a cognizant approved rate for the one-year applicable accounting period.
3. 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:
 - i. The Home State reviews the CPA's audit report and related workpapers, and the Home State issues a cognizant letter of concurrence with the audit report.
 - ii. A Non-Home State reviews the CPA's audit report and related workpapers and issues a letter of concurrence with the CPA's report, which is then accepted by the Home State. If the Home State does not accept the Non-Home State's review, the Home State will have 180 days from receipt of the Non-Home State letter of concurrence to complete a review of the CPA audit report and either concur with it, modify it, or reject it due to a material error requiring re-submittal; otherwise the CPA audit report with which the Non-Home State has concurred will be used to establish the cognizant approved rate for the 1-year applicable accounting period.

10. How will a contracting agency know if a consulting engineering firm has a cognizant approved indirect cost rate?

In the consulting firm's cost proposal, the firm is responsible for providing the contracting agency with its indirect cost rate along with evidence of cognizant approval, if cognizance has been established. Additionally, a State DOT may consult with DOTs in other States where the firm is located or where the firm has worked for the past year to ascertain whether cognizant approval of indirect cost rates has been provided. However, if audited cost or rate data pertaining to a consulting engineering firm is shared between contracting agencies (as specified in 23 U.S.C. 112(b)(2)(E) and 23 CFR 172.7(d)), notice must be given to the affected firm. (See Indirect Cost Rates and Audits Question and Answer No. 11)

11. Must contracting agencies obtain permission from consulting engineering firms prior to sharing audit information with one another in complying with the cognizant audit requirements?

No, FAHP fund recipients and subrecipients may share audit information about a consulting firm with other recipients and subrecipients provided advance notice is given to the firm for each use or exchange of information (as specified in 23 U.S.C. 112(b)(2)(E) and 23 CFR 172.7(d)) to assist in complying with requirements for acceptance of indirect cost rates. The notification should include the name of the requesting contracting agency, the name, title, and contact information of the agency official requesting the audit information, and the proposal/project name, number, or other identification information.

However, audit information shall not be provided to other consultants or any other government agency for a purpose unrelated to compliance with FAHP requirements without the written permission of the affected consulting firm. If prohibited by law, audit information may not be shared under any circumstance, but should a release be required by law or court order, such release of audit information shall make note of the confidential nature of the data (as specified in 23 CFR 172.7(d)).

12. What may potentially trigger a cognizant indirect cost rate approval?

A consulting engineering firm that has had an indirect cost rate audit performed by a CPA firm or an agency contracting with the consulting engineering firm may request approval from a cognizant agency ([See Indirect Cost Rates and Audits Question and Answer No. 6](#)) or the cognizant audit agency may choose to provide approval as part of its audit risk assessment process/risk management framework ([See Indirect Cost Rates and Audits Question and Answer No. 3](#)).

13. What factors should a consulting engineering firm or contracting agency consider in procuring CPA services to perform an indirect cost rate audit?

In accepting annual indirect cost rates as part of its risk assessment process/risk management framework and approved procurement policies and procedures, some contracting agencies require CPAs to conduct audits on overhead schedules that are prepared and submitted by consulting engineering firms. A best value determination that takes into account cost, experience, past performance, and proficiency should govern the selection of a CPA firm to perform an indirect cost rate audit. Procurement of CPA services by a contracting agency must follow State laws, regulations, policies, and procedures related to the procurement of such services (as specified in 49 CFR 18.36(a)).

There are many factors for a consulting engineering firm or contracting agency to consider in selecting a CPA to perform an indirect cost rate audit to test compliance with the FAR cost principles (as specified in 48 CFR 31). The following list, although not comprehensive, provides important factors for consideration. Consulting firms and contracting agencies are encouraged to use competition and qualifications in the solicitation, evaluation, and selection of CPA related services. 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 and pursue continuing education on GAGAS, the FAR cost principles (48 CFR 31), Cost Accounting Standards (CAS), related laws and regulations (e.g., the Internal Revenue Code, the Federal Travel Regulation, 23 U.S.C. 112, and 23 CFR 172), and the guidelines and recommendations set forth in the [AASHTO Uniform Audit & Accounting Guide](#),
- Have adequate experience in applying GAGAS,
- Have a working knowledge of the consulting engineering industry, including common operating practices, trends, and risk factors,
- Be well versed in job-cost accounting practices and systems used by consulting engineering firms,
- Assign direct supervisory staff to the engagement who have prior experience performing overhead audits designed to provide assurance regarding compliance with the FAR cost principles,
- Have experience performing audits to test compliance with the FAR cost principles and have knowledge of Government procurement with regard to various types of contracts and contract payment terms affecting the development and/or application of an allowable overhead rate, and
- 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 the [AASHTO Uniform Audit & Accounting Guide](#).

14. What work should be performed by a State DOT to accept an audit performed by a CPA firm (hired by the consulting engineering firm or contracted and directed by the State DOT) and issue a cognizant letter of concurrence making the indirect cost rate cognizant approved?

Regardless of who contracted for the work of the CPA firm, the State DOT should perform a review of the CPA's workpapers, using the Review Program for CPA Audits of Consulting Engineers' Indirect Cost Rates identified in Appendix A of the [AASHTO Uniform Audit & Accounting Guide](#), in order to issue a cognizant letter of concurrence, making the rate cognizant approved. Inquiries, discussions, or other information provided by the CPA firm may be useful, but are not an acceptable substitute to a review of the CPA's workpapers.

15. Are consulting engineering firms required to certify the allowability of costs used to establish indirect cost rates for FAHP funded 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)), FHWA's policy is 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 for application to FAHP funded engineering and design related services contracts, unless the costs have been certified by an official of the consulting firm as being allowable in accordance with the applicable FAR cost principles (as specified in 48 CFR 31).

The policies, procedures, requirements, and forms implemented to address FHWA's cost certification policy are specific to each contracting agency and subject to FHWA approval (as specified in 23 CFR 172.9(a)). (See [FHWA Order 4470.1A](#) and [Indirect Cost Rates and Audits Question & Answer No. 16](#))

16. Are consulting engineering firms required to certify that "all known material transactions or events affecting the firm's ownership, organization and indirect cost rates have been disclosed" for FAHP funded engineering and design related services contracts?

No. However, this language was included in the example contractor cost certification provided for illustrative purposes in Appendix A of [FHWA Order 4470.1A - 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](#). Although included in the example cost certification provided with the Order, this sample language was not prescribed within the directive itself.

A contracting agency may choose to include this sample language in its cost certification requirements, but if used, additional clarifying language may be necessary related to the definition of "material," as well as to the time period covered under such certification. This type of statement may be better placed in an internal control questionnaire, as the subject language is effectively an element of an assessment of internal controls with respect to changes in a firm's ownership and organizational structure and subsequent development of its indirect cost rate(s).

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

No, States are not required to perform cognizant approvals of indirect cost rates. However, States are encouraged to perform cognizant audits or issue cognizant letters of concurrence since this will ultimately lead to a more efficient indirect cost rate approval process across all States.

Contracting agencies must accept indirect cost rates established in accordance with the FAR cost principles (48 CFR 31) by a cognizant Federal or State agency, if such rates are not under dispute (as specified in 23 U.S.C. 112(b)(2)(C) and 23 CFR 172.7(b)). There is no statutory or regulatory requirement for issuance of a cognizant approved rate, only acceptance and application of an established cognizant approved rate, if one exists.

However, if a cognizant approved rate does not exist, contracting agencies must provide assurance that any indirect cost rate considered for acceptance and use in its contracts has been developed in accordance with the FAR cost principles (as specified in 48 CFR 31). A contracting agency may determine, in accordance with its established risk assessment process/risk management framework ([See Indirect Cost Rates and Audits Question and Answer No. 3](#)) and its approved written policies and procedures (as specified in 23 CFR 172.9(a)), when an audit is required and the scope of the audit to be performed. When contracting agency procedures call for audits of contracts or subcontracts, these audits shall be

performed to test compliance with the requirements of the cost principles contained in the FAR (as specified in 23 U.S.C. 112(b)(2)(B) and 23 CFR 172.7(a)).

Contracting agencies should also require a consulting firm to certify the allowability of costs used to establish an indirect cost rate prior to acceptance and application to engineering and design related services contracts. ([See Indirect Cost Rates and Audits Question and Answer Nos. 15-16](#))

18. May a State accept and use an indirect cost rate submitted by a consulting engineering firm if such rate has not received cognizant approval?

Yes, a State may accept an indirect cost rate audit performed by a CPA firm or another State if a cognizant approved rate does not exist.

If a cognizant approved rate does not exist, contracting agencies must provide assurance that any indirect cost rate considered for acceptance and use in its contracts has been developed in accordance with the FAR cost principles (as specified in 48 CFR 31) as evaluated through an established risk assessment process/risk management framework ([See Indirect Cost Rates and Audits Question and Answer No. 3](#)) and its approved written policies and procedures (as specified in 23 CFR 172.9(a)). When contracting agency procedures call for audits of contracts or subcontracts, these audits shall be performed to test compliance with the requirements of the cost principles contained in the FAR (as specified in 23 U.S.C. 112(b)(2)(B) and 23 CFR 172.7(a)).

Contracting agencies should also require a consulting firm to certify the allowability of costs used to establish an indirect cost rate prior to acceptance and application to engineering and design related services contracts. ([See Indirect Cost Rates and Audits Question and Answer No. 15-16](#))

19. What should a contracting agency do if an audit of a consulting engineering firm has not been performed to establish an indirect cost rate for the applicable one-year accounting period?

A contracting agency may perform its own audit or other evaluation of the consulting firm's indirect cost rate. A contracting agency may alternatively establish a provisional indirect cost rate and subsequently adjust contract costs based upon an audited final rate. The process employed by a contracting agency for providing assurance of compliance with the FAR cost principles must be consistent with the established risk assessment process/risk management framework ([See Indirect Cost Rates and Audits Question and Answer No. 3](#)) and its approved policies and procedures (as specified in 23 CFR 172.9(a)).

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

No, unless the rate is currently under dispute (as specified in 23 CFR 172.7(c)). ([See Indirect Cost Rates and Audits Question and Answer Nos. 28-30.](#))

Contracting agencies shall use and apply a cognizant approved indirect cost rate established in accordance with the FAR cost principles (as specified in 48 CFR 31) for the purposes of contract estimation, negotiation, administration, reporting, and contract payment, and the rate shall not be limited by administrative or de facto ceilings of any kind (as specified in 23 U.S.C. 112(b)(2)(C) - (D) and 23 CFR 172.7(b)).

Federal agencies can and do perform cognizant agency audits for indirect cost rate establishment and may not share their audit background information. In some cases, the cognizant agency may provide several rates, representing the various cost pools and business segments of the firm under audit. The result is still a cognizant approved indirect cost rate and must be used, as long as the audit was performed in accordance with GAGAS to ensure compliance with the FAR cost principles, covers the business segment applicable to contracts administered under the FAHP, and represents an equitable distribution of allowable costs to the benefiting cost objective (contract).

A contracting agency may accept an indirect cost rate lower than the cognizant approved rate, but only if voluntarily offered by a firm. ([See Indirect Cost Rates and Audits Question and Answer No. 21.](#))

If a consulting firm does not currently have a field indirect cost rate or does not propose such a rate for a field-based contract, it may be appropriate to negotiate the use of a field indirect cost rate to reflect an equitable distribution of allowable costs to a field-based contract (as specified in 48 CFR 31.203(f)). ([See Indirect Cost Rates and Audits Question and Answer No. 27.](#))

21. May a contracting agency request or negotiate a lower indirect cost rate than was established by a cognizant approved audit?

No, a contracting agency shall not request or start negotiations of a lower indirect cost rate than was established by a cognizant approved audit (as specified in 23 U.S.C. 112(b)(2)(C) - (D)).

However, a consulting firm may wish to voluntarily offer a lower rate than was established by a cognizant approved audit. As such, a contracting agency is free to accept a lower rate if offered by a consulting firm on its own volition. A lower indirect cost rate may be accepted and used only if offered/submitted voluntarily by a consulting firm as part of a cost proposal during contract negotiations. A consulting firm's offer of a lower indirect cost rate shall not be a condition or qualification to be considered for the work or contract award (as specified in 23 CFR 172.7(b)). ([See Contract Negotiation Question and Answer Nos. 3 and 4](#))

22. May a contracting agency adjust or modify a consulting engineering firm's cognizant approved indirect cost rate, such as through disallowance of certain cost items?

No, unless such rate is currently in dispute. The allowability of a consulting engineering firm's costs is governed by the FAR cost principles (48 CFR 31) (as specified in 23 U.S.C. 112(b)(2), 23 CFR 172.7, and 49 CFR 18.22(b)).

Contracting agencies are not permitted to place limitations on indirect cost rates established in accordance with applicable FAR cost principles and must apply the firm's cognizant approved indirect cost rate for estimation, negotiation, administration, and payment of contracts for engineering and design related services that utilize FAHP funding and directly relate to a construction project (as specified in 23 U.S.C. 112(b)(2)(C) - (D) and 23 CFR 172.7(b)).

Exclusion of cost elements that are allowable under the FAR cost principles from calculation or application of the indirect cost rate effectively places a ceiling on the firm's rate, and is in direct conflict with 23 U.S.C.112(b)(2)(D).

For firms required to submit a CASB Disclosure Statement, contracting agencies may not request reclassifications between direct and indirect cost elements. Consulting firms required to comply with the CAS must disclose their cost accounting practices in writing and follow them consistently (as specified in 41 U.S.C. 422). Therefore, any such request/requirement to reclassify costs between direct and indirect cost categories may cause a CAS compliant consulting firm to be in violation of Federal statutes.

A contracting agency shall not request or start negotiations of a lower indirect cost rate than was established by a cognizant approved audit, but may accept a lower rate only if voluntarily offered by a consulting engineering firm. ([See Indirect Cost Rates and Audits Question and Answer No. 21.](#))

If a consulting firm does not currently have a field indirect cost rate or does not propose such a rate for a field-based contract, it may be appropriate to negotiate the use of a field indirect cost rate to reflect an equitable distribution of allowable costs to a field-based contract (as specified in 48 CFR 31.203(f)). ([See Indirect Cost Rates and Audits Question and Answer No. 27.](#))

23. Are State and local income taxes an allowable cost item in accordance with the FAR cost principles for inclusion in the development of a consulting engineering firm's indirect cost rate for application on FAHP funded engineering and design related services contracts?

Yes, in accordance with 48 CFR 31.205-41(a)(1), required Federal, State, and local taxes paid by a consulting firm are allowable except as provided in paragraph (b) of the same part which expressly disallows Federal income and excess profits taxes. While Federal income taxes are expressly disallowed, State and local income taxes are not specifically identified as disallowed within the FAR cost principles. As such, the FHWA has determined these types of taxes are allowable cost items and therefore must be accepted as allowable by a contracting agency when submitted in a consulting firm's indirect cost rate proposal for application to FAHP funded engineering and design related services contracts.

Exclusion of cost elements that are allowable under the FAR cost principles from calculation or application of the indirect cost rate effectively places a ceiling on the firm's rate, and is in direct conflict with 23 U.S.C.112(b)(2)(D).

When procuring property and services under a Federal grant, States and local public agencies must use their own procurement procedures, except if a Federal statute or regulation has more specific

requirements in conflict with State procedures (as specified in 49 CFR 18.4 and 18.36(a) - (b)). When FAHP funds are involved and State or local procedures are in conflict with Federal requirements, the Federal requirements prevail. As such, even if State and local income taxes are disallowed under State or local laws and regulations, these taxes must be treated as allowable for participation of FAHP funding in the contract.

24. May a contracting agency use a definition of compensation that differs from the FAR to determine what costs are to be allowed under compensation?

No, compliance with the FAR cost principles (48 CFR 31) is required in the procurement, management, and administration of engineering and design related service contracts that utilize FAHP funding (as specified in 23 U.S.C. 112(b)(2), 23 CFR 172.7, and 49 CFR 18.22(b)).

The allowability of contract costs is governed by the FAR cost principles. As such, deviations from the definition of compensation and how total compensation is calculated, and more importantly, deviation from the basis for disallowance of associated costs as specifically provided for in the FAR cost principles is not permitted on contracts utilizing FAHP funding.

Consistent with the reasonableness provisions contained in the FAR cost principles (as specified in 48 CFR 31.201-3 and 31.205-6(b)(2)), a contracting agency may limit or benchmark total compensation. (See Chapter 7 of the [AASHTO Uniform Audit and Accounting Guide](#).)

25. What is the Benchmark Compensation Amount (BCA) and how does it apply to compensation on FAHP funded engineering and design related services contracts?

An engineering consultant is permitted to charge reasonable compensation to FAHP funded contracts as either a direct cost, indirect cost, or a combination of both (as specified in 48 CFR 31.205-6). The BCA is a statutory limitation on allowable total compensation for senior executives which may be charged to FAHP funded contracts (as specified in 48 CFR 31.205-6(p)). While the BCA is established based on the compensation of executives of publicly-owned U.S. corporations with annual sales over \$50 million for the fiscal year, it applies to the compensation of executives of firms at all sales levels, regardless of whether the firm is publicly or privately held.

The BCA must not be construed as an entitlement or guaranteed amount which may be claimed and charged to a FAHP funded contract. Instead, individual elements of compensation must be reviewed for allowability in compliance with the FAR cost principles. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total (as specified 31.205-6(b)(2)). (See Chapter 7 of the [AASHTO Uniform Audit and Accounting Guide](#))

26. May a consulting engineering firm choose to develop a national (company-wide), a State/regional/branch, or a business segment/discipline indirect cost rate(s)?

Yes. The consulting firm decides on the rate structure and it is up to the consulting firm to propose an indirect cost rate(s). There may be multiple rates for a single firm; however, once the firm develops its indirect cost rate(s), the rate(s) must be consistently and fairly applied. Regardless of the consulting firm's organization, consistency in allocating costs to cost objectives is critical.

While a firm may choose its accounting practices, those practices must meet applicable Federal requirements, including the FAR cost principles and applicable cost accounting standards. Specifically, a firm's indirect cost rate structure must result in an allocable distribution of indirect costs to the benefiting cost objectives on the basis of relative benefits received (as specified in 48 CFR 31.201-4).

27. If engineering and design related services require establishment of a field office or performance of services in an office provided by the contracting agency, may the contracting agency require establishment of a field indirect cost rate?

For projects where the consulting firm employees do not work out of their established home or branch offices, some of the indirect costs incurred by the home or branch office may not equitably benefit the field-based contract. The purpose of a field rate is to pay the consulting firm for the fringe benefits, project employee management, and home/branch office administrative support provided to the field employees. Negotiation and application of a field rate, where appropriate to ensure only allocable indirect costs are charged to a contract, is not an administrative or de-facto ceiling (prohibited in 23 U.S.C.

112(b)(2)(D) and 23 CFR 172.7(b)). Rather, it may help to achieve an appropriate allocation of costs to the project, based on the benefits received.

If a consulting engineering firm has a cognizant approved field indirect cost rate, the contracting agency may require its use on a field-based contract. If a consulting firm does not currently have a field indirect cost rate or does not propose such a rate for a field-based contract, it may be appropriate to negotiate the use of a field indirect cost rate to reflect an equitable distribution of allowable costs to the contract (as specified in 48 CFR 31.203(f)). However, a contracting agency may not unilaterally require establishment of a field indirect cost rate as part of a solicitation/advertisement for field-related services, pre-award audit process, or for a consulting firm to become pre-qualified to perform field-related services. Application of any field rate must remain consistent with the firm's CASB Disclosure Statement, if applicable.

Regardless of the consulting firm's organization, consistency in allocating costs to benefiting cost objectives is critical. While a firm may choose its accounting practices, those practices must meet applicable Federal requirements. Indirect cost rate proposals must reflect an equitable distribution of allowable costs to the benefiting contract(s) in accordance with the FAR cost principles. Once a consulting firm has an established field rate, the rate must be consistently applied across all business segments and disciplines, as appropriate. For consistent cost accounting application, a single company-wide rate should not be used when home and field office indirect cost rates have been established and are in use.

28. What parties may dispute a cognizant approved indirect cost rate, and under what conditions may a rate be disputed?

Except in the case of error or the failure to follow GAGAS, in which case the contracting agency may raise concerns, only the consulting firm may dispute the established cognizant approved indirect cost rate. If either an error is discovered in the established indirect cost rate, or if GAGAS were not followed in the establishment of the rate, any contracting agency may dispute the rate (as specified in 23 CFR 172.7(c)). The term "error" does not refer to differing and legitimate interpretations of the FAR cost principles (as specified in 48 CFR 31). Errors may consist of complete misinterpretation or misapplication of the FAR cost principles or simple mathematical errors of calculation.

29. What steps may be included in a dispute resolution process for a disputed cognizant approved indirect cost rate?

The cognizant agency, consulting firm, and its CPA/auditor, as applicable, should work together to resolve any issues. Involvement of the FHWA Division Office in discussions with the parties to a dispute may be a final step in dispute resolution, if necessary. In resolving such disputes, the FHWA Division Office may, at times, consult with FHWA Headquarters, as deemed necessary.

States may choose to employ dispute resolution policies and procedures to establish the dispute resolution processes within their respective jurisdictions. Such processes likely will include provisions for appeal within the State DOT audit organization, within the State DOT chain of command, and, as stated, to the local FHWA Division Administrator. Those policies and procedures may either be referenced or specifically cited within the provisions of a State's written procurement policies and procedures approved by FHWA (as specified in 23 CFR 172.9(a)), and/or they may be referenced specifically within the contract document itself.

States should work to develop a level of confidence in the audit work performed by other States. In the case where a contracting agency believes that there are obvious errors in the calculation of the cognizant indirect cost rate, or that GAGAS may not have been followed in the performance of the audit, that contracting agency should contact the cognizant agency to discuss its concerns. The contracting agency's objection to the cognizant approved rate must be based upon objective criteria and a reasonable factual basis.

30. How may an indirect cost rate be obtained if the cognizant approved rate is under dispute?

If a cognizant approved indirect cost rate is under dispute ([See Indirect Cost Rates and Audits Question and Answer No. 28](#)), the contracting agency does not have to accept the rate. A contracting agency may perform its own audit or other evaluation of the consulting firm's indirect cost rate for application to a specific consultant contract, until or unless the dispute is resolved. A contracting agency may alternatively establish a provisional indirect cost rate and subsequently adjust contract costs based upon an audited final rate. The process employed by a contracting agency for providing assurance of compliance with the FAR cost principles must be consistent with the established risk assessment process/risk management framework and its approved policies and procedures (as specified in 23 CFR 172.9(a)).

31. How long is an audited indirect cost rate valid?

One year. The one-year applicable accounting period means the annual accounting period for which financial statements are regularly prepared for the consulting engineering firm (as defined in 23 CFR 172.3). However, once an indirect cost rate is established for a contract, it may be extended beyond the one-year applicable accounting period provided all concerned parties agree (as specified in 23 CFR 172.7(b)). Extension of the one-year applicable accounting period shall be only on a contract-by-contract basis where all concerned parties agree and shall not be a condition of contract award or requirement of the contract.

32. What happens if a cognizant approved indirect cost rate expires during the contract period?

In general and in accordance with the FAR cost principles (as specified in 48 CFR 31.203(e)), a new indirect cost rate should be established by a cognizant agency. However, once an indirect cost rate is established for a contract, it may be extended beyond the one-year applicable accounting period provided all concerned parties agree (as specified in 23 CFR 172.7(b)). Extension of the one-year applicable accounting period shall be only on a contract-by-contract basis where all concerned parties agree and shall not be a condition of contract award or requirement of the contract.

Note: The following letter is an example only, actual wording may differ.

EXAMPLE: 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 examination, and supporting workpapers, of the Indirect Cost Rate(s) of [_ENGINEERING CONSULTANT NAME_] as presented in the Statement of Direct Labor, Fringe Benefits, and General Overhead for the year ended [Month dd, 20XX] in accordance with our role as Cognizant Agency as defined in 23 U.S.C. 112(b)(2)(c) and 23 CFR 172.3 and 172.7. The [_examination or audit_] was performed by the independent CPA firm [_CPA FIRM NAME_]. The CPA represented that the [_examination or audit_] was conducted in accordance with the *Government Auditing Standards*, as promulgated by the Comptroller General of the United States of America, and the [_examination or 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. Our cognizant review was performed 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 examination, and supporting workpapers for the Indirect Cost Rate(s), and the related Accountant's Report(s), we reviewed did not conform in all material respects to the aforementioned regulations and auditing standards.

Accordingly, we recommend acceptance of the following rate(s):

Combined/Corporate:
Home Office:
Field/Project Office:
Facilities Capital Cost of Money (FCCM):

Yours truly,

[STATE DOT AUDIT OFFICIAL]
[TITLE]

c: [As identified]