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Chapter 2—Adequacy of Accounting Records

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

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

2.1—Indirect Cost Rate Schedule

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

A. Generally

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

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

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

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

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

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

B. Facilities Capital Cost of Money and Other Items

Other items, such as the computation of Facilities Capital Cost of Money (FCCM), must be disclosed separately in the notes to the indirect cost rate schedule. Although FCCM generally is computed as a rate based on direct labor cost, FCCM should *not* be included as part of the overhead rate. FCCM is not required, but if it is proposed, the engineering consultant should show the detailed computation of the FCCM rate. (See Section 11.4 for further details regarding FCCM and other recommended minimum audit report disclosures.)

C. Disclosure of Field Office Rates

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

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

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

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

D. Accounting Period: Application of Submitted Indirect Cost Rates

In accordance with 23 U.S.C. 112(D) and 23 CFR 172.7(b), indirect cost rates generally are applicable for a one-year period, and engineering consultants are required to update their indirect cost rates annually. However, once an indirect cost rate has been established for a contract, the rate may be extended beyond a one-year period, provided that all the contracting parties agree to the extension. This is only permissible on a contract-by-contract basis, and agreement to the extension of the one-year applicable period must not be a condition of contract award. (See Section 4.7 for further discussion regarding the base period for allocating indirect costs.)

2.2—Unallowable Costs

A. Generally

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

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

B. Directly Associated Costs

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

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

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

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

2.3—Financial Statements

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

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

2.4—Management Representations

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

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

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

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

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

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

2.5—Management and CPA's Roles and Responsibilities

A. Management Responsibilities

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

In conjunction with management's responsibility to certify⁵ that the indirect cost rate schedule includes only allowable costs in accordance with FAR Part 31, in preparation for an independent audit of the schedule, the engineering consultant should perform its own analysis of the high-risk accounts or line items and make appropriate adjustments to the indirect cost rate schedule. As management bears the ultimate responsibility for identifying, segregating, and removing unallowable costs, management should perform a preliminary review to assess whether internal controls are working effectively and whether all unallowable costs have been removed from the final, submitted indirect cost rate.

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

B. The CPA Auditor's Responsibilities

1. Generally

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

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

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

The CPA auditor is responsible for—

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

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

⁶ See sample opinion letter in Section 11.2.

⁷ See sample internal control report in Section 11.3.

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

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

2. The CPA's Responsibilities for Fraud Detection

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

- **GAGAS 4.17c and 5.18b.** Auditors must report deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse.
- **GAGAS 4.30 and 5.29.** When either of the following circumstances exists, auditors should report directly to parties outside the audited entity with respect to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse:
 - (a) When entity management fails to satisfy legal or regulatory requirements to report such information to external parties specified in law or regulation, auditors should first communicate the failure to report such information to those charged with governance. If the audited entity still does not report this information to the specified external parties as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the information directly to the specified external parties.
 - (b) When entity management fails to take timely and appropriate steps to respond to known or likely fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that (1) is likely to have a material effect on the financial statements and (2) involves funding received directly or indirectly from a government agency, auditors should first report management's failure to take timely and appropriated steps to those charged with governance. If the audited entity still does not take timely and appropriate steps as soon as practicable after the auditors' communication with those charged with governance, then the auditors should report the entity's failure to take timely and appropriate steps directly to the funding agency.
- **GAGAS 4.31 and 5.30.** Auditors should comply with the requirements discussed above even if the auditors have resigned or were dismissed from the audit prior to its completion.
- **GAGAS 4.32 and 5.31.** Auditors have a professional obligation to obtain sufficient evidence that management of the audited entity appropriately reported findings to outside parties.

C. Selection of CPA Firm as Overhead Auditor

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

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

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

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