

Basics: Preparing for an ADOT Cost Incurred Audit

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"TO MAKE A LONG STORY SHORT, THE GENERALLY
ACCEPTED ACCOUNTING PRACTICES WEREN'T
AS GENERALLY ACCEPTED AS I THOUGHT."

Agenda

1. Conceptual framework (FAR, CAS, AASHTO)
2. Costs
3. Tips and observations to prepare for cost incurred audit
4. Overview of the audit process
5. Common issues encountered

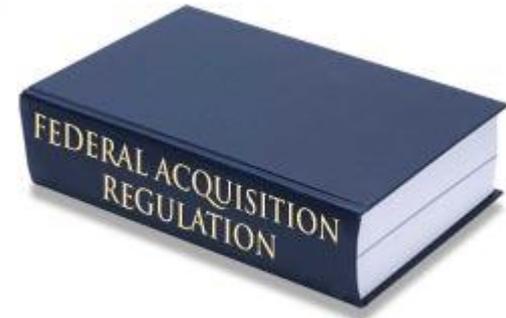
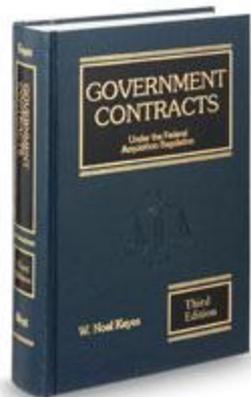


FAR v. CAS

What's the difference?

- FAR = ALLOWABILITY
- CAS = ALLOCABILITY

What is the FAR?



FAR: Background

- The Federal Acquisition Regulation (FAR), which had its beginnings in the Armed Services Procurement Regulation established in 1947, is a substantial and complex set of rules governing the federal government's purchasing process.
- The FAR was codified in Title 48 of the Code of Federal Regulations (CFR) in 1984 to create a uniform structure for many federal agencies.
- Its purpose is to ensure purchasing procedures are standard, consistent, and conducted in a fair and impartial manner.



FAR: Scope

- The FAR applies to most agencies in the Executive Branch (e.g. DOT, DOD, etc.). The Legislative and Judicial branches are not required to comply with the FAR, but tend to follow it in spirit and content.
- Executive Branch agencies issue supplemental regulations that include purchasing rules unique to these agencies. Examples include:
 - Department of Defense: Defense Federal Acquisition Regulations Supplement (DFARS)
- Some “quasi-governmental” agencies, such as the United States Postal Service and the Federal Deposit Insurance Corporation, are exempt from using the FAR.



FAR: Division of Acquisition Process

- The FAR is divided into 53 parts, each part dealing with a separate aspect of the acquisition process.
 - The first six parts cover general government acquisition matters.
 - The next six parts cover aspects of acquisition planning.
 - The rest of the FAR covers other topics, such as simplified acquisition thresholds, large dollar value buys, labor laws, contract administration, applicable clauses, and forms.
- The relevant parts for small businesses include Part 19, Small Business Programs, and Part 52, which contains the standard terms and conditions contained in a government contract.



FAR: Cost Principles Contracts

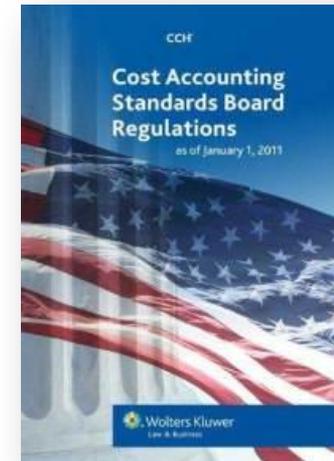
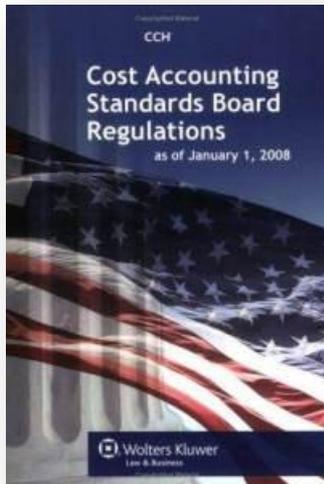
- The FAR Cost Principles
 - FAR Part 31 defines when and to what extent costs can be recovered under a government contract.
 - Before the contractor may recover a particular cost it must be (a) allowable, (b) allocable, and (c) reasonable.
 - Pursuant to a standard FAR clause, the government can recover any costs initially paid to the contractor but ultimately found not allowable, reasonable, or allocable to the contract.
- Government Audit Rights
 - Under certain circumstances, the government has the right to audit a contractor's price proposal prior to negotiations. ADOT = Pre award Process
 - The government may also audit pertinent records, books, and other data of the contractor at any time up to **five** years after the last payment . Please remember this is the **Prime Contractors** last payment. If you are a subcontractor, this could mean many years after you completed your phase.





*"Daddy doesn't know any magic tricks.
Daddy knows accounting tricks."*

What is the CAS?



CAS: History

- The CASB (“Cost Accounting Standards Board”) was established as an agency of Congress in 1968, dissolved in 1980, reinstated in 1988
- Authorized to develop cost accounting standards
- The CASB has issued 19 costing accounting standards (“CAS”) that have the full effect of law
- We will look at only seven of the CAS that would likely impact smaller A&E companies



CAS: Objective

- Uniformity and consistency in cost accounting



CAS is concerned with three areas in cost accounting:

- Measurement of cost
- Assignment of cost to cost accounting periods
- Allocation of cost to cost objectives

CAS and cost principles are not one in the same...

- CAS addresses cost accounting on government contracts
- The cost principles “FAR” - address cost allowability
- Cost allowability is a procurement matter and is a function of law regulation or contract
- Costs may be allocable but unallowable
- Let’s look at those seven CAS that would have an impact on you



CAS 401

- **Consistency in Estimating, Accumulating, and Reporting Costs**
 - Indirect cost pool practices must be consistent as to:
 - Classification as direct or indirect cost
 - Indirect cost pools
 - Methods of allocation to contract



CAS 402

- **Consistency in Allocating Cost for the Same Purpose**
 - Requires that each type of cost be allocated
 - only once, and
 - on only one basis,
 - to any contract



CAS 403

- **Allocation of Home Office Expenses to Segments**
 - Home office expenses shall be allocated on the basis of the beneficial or casual relationship between supporting and receiving activities.

CAS 405

- **Accounting for Unallowable Costs**
 - Costs mutually agreed to be unallowable shall be identified and excluded from billing to the government.

CAS 406

- **Cost Accounting Period**
 - Contractor shall use its fiscal year as the cost accounting period



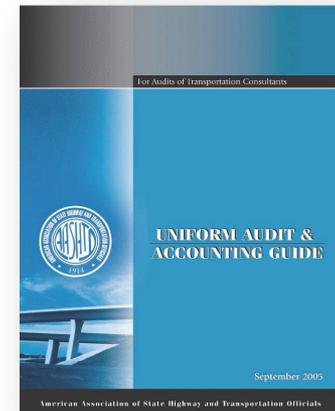
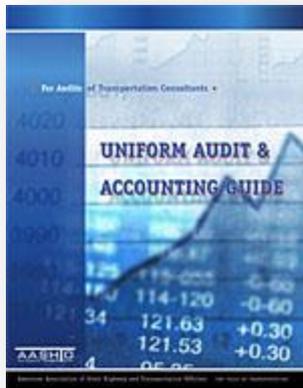
CAS 410

- **Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives**
 - Business unit G&A expenses shall be grouped into a separate indirect cost pool which shall be allocated only to final cost objectives.

CAS 418

- **Allocation of Direct and Indirect Costs**
 - Written and consistently followed accounting policies are required (e.g. CADD, Vehicles, etc..)
 - Indirect cost shall be accumulated in homogeneous cost pools
 - Pooled costs shall be allocated using casual relationships

What is the AASHTO Audit and Accounting Guide?



The Guide is a Tool for:

- State Auditors
- A/E Firms
- CPA Firms



Focus

- The Guide's focus is on accounting, auditing and reporting procedures applied to costs incurred by A/E firms for engineering and design related services on various federal, state, and local transportation projects.

Intention

- The Guide is not intended to be a detailed auditing procedures manual.
- Tool that consolidates relevant FAR and CAS principles as well as auditing standards
- Assist users in understanding terminology, policies, procedures, and audit techniques, along with Federal Regulations and their source.
- Users are cautioned to be aware that the FAR Cost Principles change frequently and the applicable version should be referenced in conjunction with the use of this Guide.



LET'S TALK ABOUT COSTS



Total Contract Cost (FAR 31.201-1)

- ...is the sum of the direct & indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits, plus any applicable cost of money

Direct Costs (FAR 31.201-1)

- **Definition:** Direct costs are identifiable to a final cost objective (a particular contract)
 - Examples: direct material and direct labor
- All costs identified specifically with a contract are direct costs for that contract and shall not be charged to another contract directly, or indirectly.



Indirect Costs (FAR 31.203)

- **Definition:** Indirect costs are **not** directly identifiable with a final cost objective (e.g. a particular contract), but identified with two or more final cost objectives.
- The distribution of indirect costs to various contracts should roughly be based on the benefits received on each contract.
- No cost shall be charged to a contract as an indirect *cost* if other costs incurred for the same *purpose in like circumstances* have been charged

Reasonableness (FAR 31.201-3)

- **Definition:** A cost is reasonable if, in its nature and amount, it does not exceed what a prudent person would pay in the conduct of competitive business.
- **Considerations**
 - Is the cost necessary?
 - Is the cost consistent with sound business practice and law?
 - Are the contractor's purchases done on an "*arm's-length basis*"?
 - Burden of Proof is on Contractor



Allocability (FAR 31.201-4)

- **Definition:** A cost is allocable to one or more cost objectives (e.g., contracts) if it is charged based on the relative benefits received or some other equitable relationship.
- A cost is **Allocable** to a Government contract if:
 - It is *incurred* specifically for the contract, or
 - It benefits the contract and other work (e.g. it's an overhead cost), and can be fairly distributed based on benefits received, or
 - It is necessary to overall operation of the business (e.g. certain G&A expenses).



FAR Cost Principles

FAR 31.201-2 Determining Allowability

- Costs are allowable if –
 - Reasonable
 - Allocable in accordance with CAS
 - In accordance with contract terms
 - Within any limitations of FAR 31.2
- Contractor Responsibilities–
 - Accounting for costs appropriately
 - Maintaining records and supporting documentation adequate to demonstrate that costs claimed:
 - Have been incurred
 - Are allocable to the contract, and comply with applicable cost principles

FAR Cost Principles

FAR 31.201-6 Accounting for Unallowable Costs

- Identify and exclude unallowable costs from representations applicable to a government contract, billing, claim or proposal.
- Directly associated and like costs in like circumstances are also unallowable
- CAS 405-Accounting for Unallowable Costs
- Salaries associated with unallowable costs/activities are also unallowable



FAR Cost Principles

FAR Part 31.205 Contains about 50 selected costs

- Expressly Allowable
- Expressly Unallowable
 - Costs specifically classified as unallowable
 - Government won't pay under any condition
- Conditionally Unallowable
 - Costs that may be partially allowable, or require special consideration depending on particular conditions or circumstances



FAR Cost Principles

Examples of Expressly Unallowable Costs

- ⊘ alcoholic beverages
- ⊘ entertainment - games, shows
- ⊘ contributions / donations
- ⊘ legislative lobbying
- ⊘ fines & penalties
- ⊘ bad debts
- ⊘ club dues - social or health
- ⊘ flowers (any reason)
- ⊘ spousal expenses (except relocation)
- ⊘ lost money / luggage (sometimes arguable)
- ⊘ clothing rentals
- ⊘ golf, tennis, fishing
- ⊘ dinner tickets
- ⊘ over per diem expenses
- ⊘ traffic tickets
- ⊘ non business subscriptions
- ⊘ animal kenneling
- ⊘ baby sitting



FAR Cost Principles

FAR Part 31.205 does not cover every element of cost

- If a cost is not mentioned it does not imply that it is either allowable or unallowable
- Determination of allowability is analogously based
- Use cost principle that most specifically addresses or best captures the essential nature of the cost at issue





"Hey, we're government accountants.
These numbers aren't supposed to add up."

TIPS AND OBSERVATIONS TO PREPARE FOR A COST INCURRED AUDIT



Planning for the Audit

- Review all policies and procedures
 - Are they current?
 - Have you changed any during period under audit?
 - Are you following them?
 - Identify any that the auditors may challenge.
- Review contract & any modifications prior to audit
 - Are you in compliance with all clauses?
- Review your internal controls
 - Labor distributions
 - Indirect cost structures
 - Purchasing system
 - Accounting system



Planning for the Audit (cont'd)

- Don't treat your audit as a burden or as an inconvenience
- Be proactive, rather than reactive
- **BE PREPARED!** Each audit is a separate engagement



Planning for the Audit (cont'd)

- Review the FAR / CAS standards
- Documentation & audit trails
 - Are the schedules requested complete?
 - Is your documentation readily available
- Perform a “Devil’s Advocate” review prior to their arrival.
- If it’s not in writing, it didn’t happen!!!



Working with ADOT Auditors

- **Be Honest**
 - Furnish current, complete & accurate information
 - If you don't know, say so
 - Remember – Dishonesty leads to investigation
- **Be Prompt**
 - Schedule meetings in advance
 - Be on time
 - Required attendees present
- **Be Responsive**
 - Available
 - Return calls promptly
 - Furnish information timely as agreed
 - Time frame on obtaining other items
 - Listing of key personnel to contact

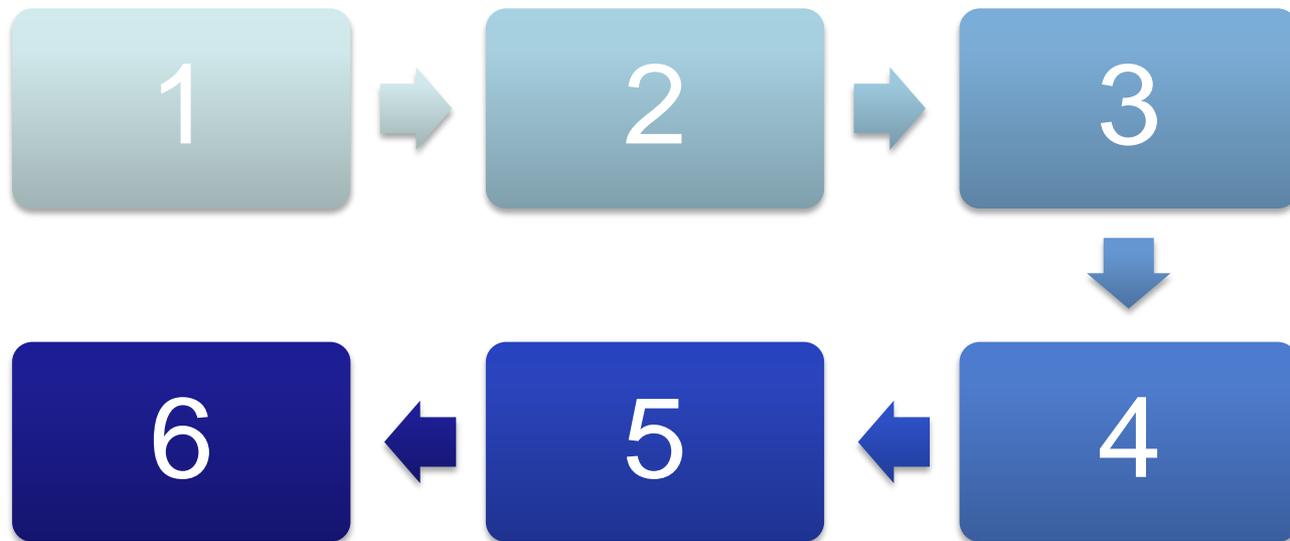


Working with ADOT Auditors

- **Don't Ignore Requests**
 - Discuss for clarification & ID of problem requests
 - Set time for furnishing information
 - If needed, ask for requests in writing
- **Don't say NO or you can't**
 - If you must, explain why
 - If auditor's request cannot be completed or complied with – explain why and provide alternative solutions
 - PLEASE DO NOT BE CONFRONTATIONAL



OVERVIEW OF THE AUDIT PROCESS



Audit Process

In General – Four Phases



**Relevant sources of guidance: FAR,
CAS and AASHTO Audit Guide**

Audit Process

Planning Phase

- Review results of pre-award reviews done by ADOT
- Entrance conference call
- Scheduling out payment reports
- Drawing sample to audit
- Analyzing financial information – overhead expenses
- Risk assessment



Audit Process

Direct Cost Audit Phase

- Audit sample selected
- Direct labor – time sheet and payroll register
- Subcontractor – invoices, agreements
- ODC's – invoices and/or expense reports



Audit Process

Overhead Rate Audit

- Audit sample of costs charged to overhead
- Cost Allocability
- Cost Allowability



Audit Process

Exit Conference

- With owner(s) and senior management
- Review all findings
- Review all questioned costs
- All viewpoints considered and evaluated





"Good news: I spoke with our accounting department — two plus two does equal five."



Common Issues Encountered

1. Owner compensation
2. Bonuses
3. Cost reasonableness
4. Vehicle costs
5. Commute
6. Uncompensated overtime
7. Related-party leases
8. Professional and consulting fees
9. Field office rates



Owner's Compensation

FAR 31.205-6 Compensation for Personal Services

Definition-

- Compensation for personal services means all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employee to the contractor

General-

- Must be for work performed in the current year
- Total compensation must be reasonable for the work performed
- Compensation must be based upon established plan or

Owner's Compensation

FAR 31.205-6 Compensation for Personal Services

- Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total
- Reasonableness determination to consider only allowable compensation elements. If bonus plan not compliant, not allowable and not considered here.



Owner's Compensation

FAR 31.205-6 Compensation for Personal Services

- Factors relevant to determine reasonableness when comparing to other firms
 - Same size
 - Same industry
 - Same geographic area
 - Engaged in similar non-government work under comparable circumstances
 - Not be a distribution of profits
- Benchmark Owner and Top Executive compensation to survey(s)



Owner's Compensation

FAR 31.205-6 Compensation for Personal Services

- Costs unallowable elsewhere in the FAR not allowable solely on the basis that they constitute compensation for personal services (for example Commute)
- Special consideration required for-
 - Owners of closely held corporations
 - Members of Limited Liability corporations
 - Partners
 - Sole Proprietors, and members of their immediate families
 - Persons who are contractually committed to acquire a

Bonuses

FAR 31.205-6

- Bonuses and incentive compensation are allowable provided
 - Awards are paid or accrued under an employee-employer good faith advance agreement known or established before services are rendered
 - Pursuant to an established plan consistently followed
 - Basis for the award is supportable



Cost Reasonableness

- Look at FAR 31.201-3
- Look at relevant benchmarks
- Look at your cost trends
- Potential costs to review:
 - Compensation – we covered
 - Marketing and selling costs FAR 31.205-38
 - Space costs – idle facilities FAR 31.205-17
 - Indirect salaries – compare in relation to direct salaries



Vehicle Costs

- Keep detailed mileage logs (project, administrative, commute and other personal)
- If you bill as direct, then should exclude costs from overhead
- Crediting overhead costs for billing amounts is not compliant



Commute

What is commute?

- Mileage driving from home to and from work
- Includes the driving from home to and from a job site – look for a possible ADOT exception

Unallowable – FAR 31.205-6(m)(2)



Uncompensated Overtime

- Required to account for ALL hours worked
- Two methods
 - Effective rate method
 - Salary variance method
- See AASHTO Audit Guide Section 5.4 F(2)
- Accounting and billing system should be designed to correctly account for uncompensated overtime



Related Party Leases

- Limited to charging Government contracts to actual cost of ownership
- Had the Contractor owned the facility, what costs would have been allowable?
- Even if rent is “market”, limited to actual, allowable cost of ownership including a FCCM cost component.



Professional and Consulting Fees

- Generally allowable
- Common unallowable professional fees
 - Bad debt collections
 - Corporate restructuring/reorganization
 - Defense and/or settlement costs when fraud and/or violation of law or contract and likelihood of success is remote
- FAR Section 31.205–3 and 47



Field Office Rates

- Extensive work in more than one discipline -
For example design and construction administration (two disciplines)
- Policy and method is needed to allocate overhead costs to field office
- Complex area: refer to AASHTO Audit Guide Section 5.4



Takeaways

- **Know the rules and your contract**
 - FAR
 - CAS
 - AASHTO Audit and Accounting Guide
- **Have a good financial infrastructure**
 - Policies and procedures
 - Accounting system – tracks unallowables
 - Job cost system
- **Be proactive and prepared**



Thank you for your time.

To find out more about KLK, please visit us at www.klkcpa.com, or call Tony Kenon at **(520) 884-0176**, email: tkenon@klkcpa.com



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