What You Need to Know About the New AASHTO Audit Guide
New AASHTO Audit Guide

THE COST OF DOING TRANSPORTATION PROJECTS IS GOING UP

AGAIN!!!
What We Will Learn

- Reasoning behind this new guide
- Major changes since 2005
- Reasonable compensation changes
- Expanded audit guidance
- Cognizant agency rules
Who is AASHTO and Why an Audit Guide?

- American Association of State Highway and Transportation Officials
- Establish uniform audit guidance
- Update for current industry practice
- Incorporate OIG Audit and DOT Concerns
Adequacy of Accounting Records

- Significant additional discussion of management’s and auditor’s responsibility

- Management cannot rely on the CPA’s audit as the sole method of determining unallowable costs
Adequacy of Accounting Records

- Expanded discussion of directly associated costs
- Must be grouped with the main cost and disallowed if applicable
  - Incurred because of the main cost
  - Salary if material
Auditor Selection

- New section on auditor selection
  - Direct result of OIG report
  - Nine criteria –
    - Meet all GAGAS requirements including government CPE
    - Favorable peer review
    - 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
Auditor Selection

- Nine criteria –
  - Adequate experience in applying GAGAS
  - Experience and knowledge of industry
  - Knowledge of accounting practices and systems used by A/E firms
  - Direct supervisory staff with FAR audit experience
  - FAR audit experience
  - Design and execute audit program meeting professional standards and the requirements of the guide
Cost Principles

- Quantitative Analysis Required
  - Ratios
  - Trends
  - Variances

- Should be done or reviewed by the auditor

- Can’t be the only method to ID unallowable costs
Cost Accounting

- Direct Labor Base
  - All direct labor even if contractually limited

- Uncompensated Overtime
  - Effective Rate Method
    - Calculated weekly
  - Salary Variance Method
    - Done only at year end
Cost Accounting

- Labor transfers
  - Adequate Internal Controls
  - Documentation
Cost Accounting

- Field Office Indirect Costs
  - Preferred Methodology is defined in the guide
  - Other methods may be acceptable
    - Reasonable and determinable
    - Consistently Applied
  - Footnote disclosure
Cost Accounting

- Bid and Proposal Costs
  - Accumulate and identify by individual project
  - Same methodology as for contracts
  - Include same costs that would be considered direct costs for contracts
Cost Accounting

- Bid and Proposal Costs
  - Include allocable indirect costs other and G & A
  - Appears to require development of a separate indirect cost rate excluding G & A
Cost Accounting

☐ Selling Activities

■ Emphasis on documentation

“The consultant must regularly monitor the time recorded by all employees, including senior managers and executives, to determine the accuracy of efforts expended. Labor costs associated with selling activities must be easily identified and must be segregated from other indirect labor activities.”
Cost Accounting

☐ Labor Charging Checklist included in the guide
☐ Consultant should review and evaluate current system
☐ Auditor should review in planning stage
Compensation

- Biggest Area of Change
  - 2005 3 Pages
  - 2009 17 Pages
  - Reflects Concerns Raised by the OIG
Compensation

- Expanded references to FAR
  - Work performed in the current year
  - Reasonable by individual, or job classes
    - Specific restrictions can be applied to specific elements of compensation
  - Comply with established compensation plan or practice followed consistently
Compensation

- Expanded references to FAR
  - No presumption of allowability when there are major changes of existing plans
  - Cost not allowable under other regulations cannot be bootstrapped in because they are compensation
Allowability of Compensation

- Defined total compensation
  - Allocable and allowable wages and salaries
  - Bonus
  - Deferred compensation
  - Employer contributions to Defined Contribution Plans
- Must be reasonable in total
Reasonableness of Compensation

- Consultant is required to analyze the reasonableness of claimed compensation, typically focusing on executives
  - Consider only allowable individual elements of compensation
  - Consider factors based on practices of other firms
    - Of the same size
    - In the same industry
    - Geographic area
    - Similar non-government work under comparable circumstances
Reasonableness of Compensation

- Statutory Compensation Limit
  - Benchmark Compensation Amount (BCA)
  - Applies to Senior Executives at corporate offices and business segments
  - Not an entitlement or guarantee of recovery
  - Must be reasonable based on additional factors
  - No payment that is a distribution of profits can be claimed
Reasonableness of Compensation

- Certain individuals give rise to the need for special consideration
  - Owners of closely held companies, sole proprietors, or members of their immediate families
  - Persons who are contractually committed to acquire a substantial financial interest in the contractor’s enterprise
Reasonableness of Executive Compensation

- Senior Executives
  - The five most highly compensated employees in management positions at
    - Each home office and each segment
    - Whether or not the home office or segment reports directly to headquarters
Reasonableness of Executive Compensation

- Compensation policies and procedures
  - How established
  - Who approves
  - Eligibility criteria for
    - Base
    - Cash bonuses
    - Long-term perks
    - Benefits
    - Incentive bonuses
Reasonableness of Executive Compensation

- Procedures for Determining Reasonableness
  - Based on FAR and two court cases
    - Techplan Corp.
    - Information Systems and network Corp.
  - Nine step process
Reasonableness of Executive Compensation

- Step 1 - Examine all elements of compensation and eliminate from those elements defined as unallowable
- Step 2 - For executives or classes of employees to be examined, prepare a schedule listing all allowable components of compensation and the amount paid for each
  - Compensation includes wages, salary, bonuses, incentive compensation, deferred compensation, and employer contributions to defined contribution pension plans.
Reasonableness of Executive Compensation

- Step 3- Obtain nationally-published compensation surveys to match revenue, industry, geographic location, and other relevant factors
  - Should use a primary survey and two secondary surveys to corroborate primary results
  - National surveys identify the mean, median or percentile amounts of salary, bonus and other compensation elements by revenue ranges, number of employees, or discipline
Reasonableness of Executive Compensation

- Step 4- Develop an estimated reasonable compensation amount for each executive position
- Step 5- Apply appropriate escalation factors to adjust survey data to a common date of July 1 of the same year or the mid-point of the fiscal year. The escalation factor used should be supported by survey data.
Comp Analysis in Compliance with FAR 31-205-6

- Step 6- Develop a composite median amount by averaging the median total compensation amounts from each survey, after application of any necessary escalation factors

- Step 7- Increase the composite median by 10 percent, based on DCAA guidance which allows for a 10 percent range of reasonableness
Reasonableness of Executive Compensation

- Step 8- Compare total actual compensation for each executive to the estimated reasonable compensation
- Step 9- Determine amount to be disallowed if any. Consider if superior performance is demonstrated
Demonstrating Superior Performance

- Could permit executive compensation up to the 75th percentile
- Prepare and document an analysis of the firm’s performance in comparison to selected performance measures from the list on the next slide.
Demonstrating Superior Performance

Superior performance in comparison to three or more of these measures

- Revenue Growth
- Net Income
- Return on Shareholder’s Equity
- Return on Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

Expectation that non-financial performance metrics would be included did not materialize
Demonstrating Superior Performance

- Measures chosen must be representative of the executive’s performance
  - Consider competitive environment
  - Executive must be able to effect the measure
    - Can't be primarily related to status as a Government contractor
    - Generally need to excel at more than one metric
    - Apply consistently
    - Result in both increases and decreases in compensation
Demonstrating Superior Performance

The analysis methodology steps include the following:

- Step 1- Calculate a minimum of three financial performance measures using the actual financial data for the same periods
- Step 2- Calculate the firm’s composite financial performance measure
- Step 3- Identify the same financial performance measures used in the analysis
  - In SIC code 87
  - In the same revenue range; and
  - For the same time period
Demonstrating Superior Performance

- Step 4- Calculate the proxy composite financial performance measure
- Step 5- Compare the composite financial performance measure to the proxy to identify the consultant’s applicable percentile
- Step 6- Provide a copy of each executive’s position description, job duties, and the relationship between executives’ performance and the firm’s performance
Demonstrating Superior Performance

- If the engineering consultant can successfully demonstrate superior performance, then the analysis performed should be performed using survey data at the applicable percentile.
National Compensation Matrix (NCM)

- If you do not prepare an appropriate, compliant compensation analysis, State DOT’s may use the NCM.
- To be prepared by Federal Highway Administration (FHWA).
- PennDOT requires use of ERI.
Executive Compensation

- Compensation schedule must be submitted to the consultant’s home state and CPA
  - Name or employee ID number
  - Position title
  - Total wages/salaries paid including taxable fringe benefits
  - Total bonuses paid
Executive Compensation

- Compensation schedule
  - Total employer contributions to defined contribution pension plans
  - Total of wages, bonuses and contributions
  - The applicable amount from the consultant’s analysis or the NCM
  - The excess compensation required to be disallowed from the indirect labor or bonus line item.
Consideration for Closely-Held Firms

- The following practices could lead to a disproportionate distribution/allocation of principals’ labor to the direct and indirect labor pools:
  - Infrequent draws in lieu of taking regular salaries
  - Low salaries coupled with high bonuses
  - Compensation based on year end profits and remaining cash surplus
Bonus and Incentive Pay Plans

- Bonus Plans (Allowable)
  - Typically applicable to a broad class
  - Eligibility requirements
  - Based on productivity, team or overall company performance
  - Percent of compensation or available pool of money
Bonus and Incentive Pay Plans

☐ Profit-Distribution Plans (Unallowable)
  ■ Distributions of net earnings to owners
  ■ Based on some factor linked to ownership
    □ Capital account balance
    □ Ownership percentage
    □ Level of partner (Junior or Senior)
Bonus and Incentive Pay Plans

- Documentation of Bonus Plans include:
  - Eligibility criteria
  - Period of bonus plan
  - Performance criteria (e.g., individual expectations – must be measurable and verifiable criteria)
Bonus and Incentive Pay Plans

- Documentation of Bonus Plans
  - Incentives awards/spot bonuses must be related to performance
  - Form of payment
  - Distribution timeline

- Consider documentation of distribution plan
Fringe Benefits

- Deferred Compensation
  - Measured allocated and accounted for in compliance with CAS
    - Assigned to period when obligation arises (Vested) or
    - Payment if earlier
    - Present value of future benefit
Fringe Benefits

- Pension Plans
  - Generally allowable
  - Must be funded by due date of Federal return
  - Termination or curtailment of DB plans are complex
Fringe Benefits

- **ESOPs**
  - Annual outside valuation required
  - Must be funded by due date of Federal return
  - ESOPs meeting definition of pension plan
    - Allowable cost calculated same as other plans
  - Other ESOPs
    - Allowable when allocated to employees
Fringe Benefits

- Severance Pay
  - Must be required by
    - Law
    - Employer – employee agreement
    - Established policy or
    - Circumstances of the particular employment
  - Abnormal (Mass) severance
    - Allowable on a case-by-case basis
Fringe Benefits

- Supplemental benefits
  - Supplemental Executive Retirement Plans
    - Consider as part of overall compensation and pension regulations
  - Golden Parachutes and handcuffs
    - Unallowable
Selected Areas of Cost

- Facilities Capital Cost of Money (FCCM)
  - Must be shown as a separate line item or
  - Disclosed in the footnotes
  - No fee or profit on FCCM
Selected Areas of Cost

Depreciation

- Can use tax lives and methods if you also use for financial reporting except
- Tax deduction methodologies, such as I.R.C. Section 179, are not allowable
Selected Areas of Cost

- Gains and Losses on Depreciable Property
  - Considered as an adjustment of depreciation taken
  - Gain limited to original cost
  - Include insurance proceeds on involuntary conversion
  - Does not apply to like kind exchanges when accounted for as such
Selected Areas of Cost

☐ Precontract Costs
  ■ Excluded from Overhead
  ■ Labor must remain as Direct Cost even if it is not billable
Selected Areas of Cost

- Idle Facilities and Idle Capacity Costs
  - Idle Facilities - completely unused facilities that exceed the consultant’s current needs
  - Unallowable unless
    - Necessary to meet workload fluctuations, or
    - Were necessary when acquired but now idle due to unforeseeable causes
      - Limited for a reasonable period of time (One year)
Selected Areas of Cost

- Key Personnel Life
  - Allowable if
    - Included in compensation
    - Reasonable
    - Company or its owners are not the beneficiaries
Selected Areas of Cost

- Professional Liability Insurance
  - Generally allowable
  - These costs are not allowable
    - Correcting own defects
    - Settle claims in lieu of correcting defects or similar acts
Selected Areas of Cost

- Losses and Deductibles
  - Unallowable unless specifically provided for in the contract
  - Allowable for
    - Nominal deductibles on purchased insurance
    - Minor losses such as breakage or disappearance of small items
Selected Areas of Cost

- Self insurance
  - Cost plus insurance administration costs must not exceed
    - Cost of comparable insurance if purchased plus associated administration costs
  - Preapproval required in certain circumstances
    - 50% and $200,000
  - Also applies to Captives
Selected Areas of Cost

- Retainer Agreements
  - Outside Engineering & Technical Consultants generally allowable
  - Specific Documentation Required
    - Details of all agreements
    - Details of time expended and nature of the actual services provided.
    - Consultant work products and related documents
Selected Areas of Cost

- Taxes
  - Federal income taxes are unallowable
  - Taxes on income passed thru to shareholders are unallowable
  - Penalties and interest assessed on late payments are unallowable
Audit Considerations and Procedures

- Audit is to be risk based
- CPA firms may use lower materiality rates
- Procedures in the guide are the minimum requirement
- Deviation is allowed but must be documented and justified
- All expressly unallowable costs must be removed even if immaterial
Audit Considerations and Procedures

- Audit sampling:
  - 95% confidence level with 2-5 percent precision (Results in larger samples)
  - Additional testing is dependent on type of error detected and its possible effects on entire pool
Audit Considerations and Procedures

- Testing Labor Costs:
  - At least 26 direct-charge employees
    - More if risk is not low
  - Trace thru the system
    - Payroll records
    - Cost system
    - General ledger
Testing Labor Costs:
- Reconcile GL to job cost system and IRS payroll reports
- Determine if system is sufficient to determine
  - Allowability
  - Allocation and consistency
  - Correct labor base
Audit Considerations and Procedures

☐ Testing Indirect Costs:
  ■ Determine high risk accounts
    □ Printing/ Reproduction
    □ Dues and Subscriptions
    □ Travel
    □ Seminars and Conventions
    □ Insurance
    □ Professional and Consultant Services
Audit Considerations and Procedures

□ Testing Indirect Costs:
  ■ Determine high risk accounts
    □ Rent
    □ Depreciation
    □ Employee Morale
    □ “Miscellaneous” and “Other” Type Accounts
    □ Subconsultants / outside consultants
    □ Gain/Loss on Sale of Assets
Audit Considerations and Procedures

Based on risk assessment

- Large dollar items and sensitive transactions should be tested 100%
- If coverage is not adequate sampling is required
  - Follow guidance discussed previously
  - Test a minimum of 2 to 20 transactions for each high risk account
- Trace to GL and vouch
Audit Considerations and Procedures

- Allocated Costs
  - Allocability
    - Direct vs. indirect
    - Function
    - Cost center
  - Allowability
    - Include interest or profit
  - Consistency
    - Assignment of similar charges in the same way
Audit Considerations and Procedures

- ODCs
  - Should use dedicated accounts
  - Additional testing required if comingled with overhead
Audit Considerations and Procedures

- Examine indirect cost accounts to determine:
  - Proper reduction of ODC’s billed to projects
  - Proper allocation to projects when costs were incurred for similar purposes
  - If costs were charges consistently to direct and indirect cost objectives
Audit Considerations and Procedures

- Failure to meet minimum audit procedures:
  - CPA’s face referral to the appropriate Board of Accountancy
  - Rejection of audited overhead rate
  - Additional testing by CPA to meet requirements
  - If follow-up submittal is rejected, DOT may disallow audit fees
What is a cognizant agency?

- A federal agency
- The Home State Transportation or Highway Department
- A Non-Home State Transportation or Highway Department granted cognizance in writing from the Home State
Cognizant approved rates may be established by

- Cognizant Agency performs, or directs work of a CPA, who performs audit
- Indirect Cost audit performed by an independent CPA and home state reviews the CPA report and workpapers and issues a letter of concurrence
Cognizant approved rates may be established by

- Non-Home State reviews the CPA report and workpapers and issues a letter of concurrence with the CPA report (Home state has 180 days to concur, modify or reject)
Cognizant Agency

- Generally a cognizant approved indirect cost rate may not be modified by subsequent contracting agencies.
- Contracting agencies are free to cap indirect cost rates on contracts for Preliminary Engineering project activities/phases not funded with Federal-aid funds.
Cognizant Agency

- There is some question related to caps and limitations established by state statute.
- New guidance provides more uniformity in testing procedures
- Adopts a uniform audit review process
- Applies to CPAs and state auditors
The Next Step

- Effective January 1, 2010
- FHWA to incorporate in regulations (or Transportation legislation) beginning after January 2010
- Consultants review your process and make any required changes
- Auditors redesign audit plans
The Next Step

- States to start following up on OIG report for “cost recovery”
  - Apparent plan is to have Home State do audit and then refer overhead findings to other states where firm worked in 2003
Benefits of the Guide

- New guidance provides more uniformity in testing procedures
- Adopts a uniform audit review process
- Applies to CPAs and state auditors
- Introduction of more judgment decisions in compensation and reasonableness
Expected Issues

- Timeliness of cognizant audits
- Two sets of rules
  - Applying new rules to old years
- Superior performance criteria
- Updating guide to incorporate FAR changes
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