Updated Audit Guide Clarifies Guidelines for Audits of Architecture and Engineering (A/E) Firms

After two years of work, the American Association of State Highway and Transportation Officials (AASHTO) recently released its updated "Uniform Audit and Accounting Guide for Audits of Architectural and Engineering (A/E) Consulting Firms, 2016 Edition" (Audit Guide). This update provides clarifications and other refinements to the previous version of the Audit Guide (2012 Edition).

Before dissecting the improvements in the Audit Guide, first, you may be asking a few questions:

What is AASHTO?

The Organization's website (http://sp.www.transportation.org/Pages/Organization.aspx) provides key information about this organization:

- **Nature of Organization**: "AASHTO is a nonprofit, nonpartisan association representing highway and transportation departments in the 50 states, the District of Columbia, and Puerto Rico."
- **Mission:** "to foster the development, operation, and maintenance of an integrated national transportation system."
- **Strategy**: Educating the public, and key decision makers, regarding the importance of transportation and serving as a liaison between state departments of transportation (DOT) and the Federal government

What is the Audit Guide and why is it important?

The Audit Guide is a tool, published by AASHTO, that provides general guidance for state DOT auditors and public accounting firms that perform audits and attestations of A/E firms regarding examination, auditing and reporting policies, procedures and techniques related to audits of the costs incurred by A/E firms for engineering and design related services performed on various federal, state, and local transportation projects.

Specifically, the techniques described in the Audit Guide are designed for audits of an A/E firm's "indirect costs rate schedule", as well as the related accounting, job-costing and labor-charging systems that capture the costs used to develop this schedule. A/E firms prepare the "indirect cost schedule" to calculate a periodic "indirect cost rate", which is ultimately used in contract estimating, negotiations, administration, reporting and contract payments for the applicable period. Accordingly, the audit of the "indirect cost rate schedule", and the calculation of an audited "indirect cost rate" has a profound effect on the A/E firm, and is greatly influenced by the content of the Audit Guide.

How is the Indirect Cost Rate calculated?

The "indirect costs rate" typically represents the amount of "indirect" costs (those costs not applicable to a single project) incurred by the A/E firm in relation to each dollar of "direct" labor costs incurred (those applicable to a single project), after eliminating costs "disallowed" under federal cost principles (Federal Acquisition Regulation (FAR)), specifically FAR Part 31, which identifies specifically "disallowed" costs which the federal government does not wish to reimburse, such as entertainment costs, interest, expense, etc.

Section 112(b)(2) of Title 23 of the U.S. Code requires that contracts funded in whole or in part with federal-aid highway funds (even $1) be performed and audited in compliance with FAR cost principles (FAR part 31). The Audit Guide digests FAR Part 31 for auditors and provides them guidance on procedures to detect these "disallowed" costs as part of their audits of the "indirect cost rate schedule". A/E firms contracting with state DOTs that receive federal funding must consider FAR Part 31 as part of their "indirect cost rate" calculation.

Finally…what are the updates to the Audit Guide?

The 2016 edition of the Audit Guide provides several enhancements (key enhancements summarized below) to guide auditors and A/E firms in calculating the appropriate "indirect cost rate" and assessing systems that capture the costs that drive this rate:

- ***State and Local Cost Principles*** – section added to emphasize that costs principles guiding calculation of the "indirect cost rate" may vary (i.e. may be more restrictive) when contracts are not federally funded (and state DOTs do not have to follow FAR Part 31).
- ***Uncompensated Overtime***
  - A/E firms must evaluate and document the effect of uncompensated overtime on the "indirect cost rate" and may use materiality to determine whether the "indirect cost rate" needs to be adjusted for uncompensated overtime
  - Improvements made in the definition of methods to calculate uncompensated overtime
- ***Overtime (OT) Premium***
  - Emphasis that OT Premium should be accounted for consistently across all projects
  - Expands guidance on options for allocating OT Premium:
    - As an indirect cost allocated to all projects equally
    - As a direct or indirect cost (based on activity that caused overtime)
    - Build anticipated OT premium into established standard labor rates
- ***Field Office Rates*** – revised calculation for allocating costs between home and field offices
- ***Compensation***
  - Emphasis that compensation included in "indirect cost rate" calculation should be reasonable, by employee position, in total (including all elements of compensation)
  - Expressly disallowed costs (under FAR Part 31) must be removed first before performing the assessment of whether compensation is reasonable
  - Expressly disallowed compensation in excess of statutory limits established by Bipartisan Budget Act of 2013 (for contracts executed on/after June 24, 2014), initially set at $487,000 and designed to increase each year with the Employment Cost Index (calculated by the Bureau of Labor Statistics)
  - For bonus and incentive payments:
    - Added language indicating hiring and referral bonuses generally allowable if part of a standard business practice
    - Additional scrutiny placed on bonuses to owners of closely-held corporations to determine that these are not actually disallowed "distribution of profits"
    - Emphasis that A/E firms have clear policies and documentation regarding incentive plans, and guidance was given to auditors when documentation of these plans is not available

- ***Selected Cost Areas***
    - Costs "directly associated" (related – i.e. travel for company holiday party) to disallowed costs under FAR Part 31 should also be disallowed
        - These costs are identified in further detail
        - Guidance added to calculate disallowed "associated" costs as a percentage of total costs versus specifically identifying all the "associated" costs
    - Sale and leaseback transactions – new section that addresses whether rental costs and gains or losses related to these transactions are allowable (allowable costs generally include amortization of net book value of asset plus other costs of ownership)
    - Travel expenses
        - Language added to clarify that non-travel meals are allowed if properly supported, have valid business purposes and reasonable in amount
        - Disallow vehicle costs related to disallowed activities (i.e. lobbying)
        - Additional scrutiny placed on reasonableness of luxury vehicles
    - Legal costs – language added indicating an analysis of each legal scenario necessary before determining whether any costs should be disallowed
        - Identified costs expressly disallowed
        - Provided factors to consider when determining whether cost is allowable
        - Highlighted documentation necessary to support conclusion
- ***Auditor Labor Cost Testing*** – increased emphasis on auditors to trace all elements of employee time allocated to "direct" and "indirect" costs
- ***Disclosures*** – added to the recommended minimum disclosures
    - Disclosure of any state and/or local-specific policies applicable to A/E firms which may differ from FAR-compliant policies
    - Disclosure regarding A/E firm's cost-estimation process
- ***Cognizance and Oversight***
    - New section discussing requirements for acceptance of a "Cognizant Approved Indirect Cost Rate", includes:
        - how these are established
        - how they are transferred from the home state to other state DOTs
    - "Cognizant Approved Indirect Cost Rate" accepted by other state DOTs via:
        - Home state DOT (i.e. Maryland DOT) audits A/E firm "indirect cost rate"
        - Home state DOT reviews independent CPA audit of A/E firm "indirect cost rate"
    - Guidance provided on how to handle any disputes
        - between A/E firms and these "Cognizant Agencies" (i.e. Maryland DOT)
        - between rates approved by "Cognizant Agencies" (i.e. Maryland DOT) and other agencies (state DOTs – i.e. Pennsylvania DOT) - the disputing agency can perform their own audit or set a provisional rate to be adjusted once audited final rate available.

KatzAbosch will provide updates for any future significant revisions to the Audit Guide and is able to perform analysis of the reasonableness of "indirect cost rate" calculations and the systems used to derive these rates. Contact Terry Grant, CPA (tgrant@katzabosch.com) or Timothy Redmond, CPA (tredmond@katzabosch.com) for additional details.