Comments on audit[1] of compensation and overhead costs claimed by engineering and design firms on contracts awarded by state departments of transportation under federal-aid grants from USDOT Federal Highway Administration

[1] Audit conducted by USDOT Office of the Inspector General, with assistance from Defense Contract Audit Agency (USDOT OIG Project Number 04F3013F000)

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Executive Summary

The purpose of this white paper is to discuss possible solutions to the issues identified by the U.S. Department of Transportation (USDOT) Office of Inspector General (OIG) during the initial audits done of engineering and design firms' overhead costs on contracts awarded by state departments of transportation under federal-aid grants. The OIG has not yet discussed specific audit findings or conducted audit exit conferences with any of the audited firms; however, the OIG has advised representatives of The American Road and Transportation Builders Association (ARTBA) and the American Council of Engineering Companies (ACEC) that its audits of the firms disclosed a number of issues.

The issues disclosed by OIG and possible solutions recommended by the authors of this paper are discussed in this document. A summary is below.

- Executive compensation. Although FAR does provide guidance on the reasonableness of compensation, the firms representing our industry feel that current guidance relies heavily on individual judgment and interpretation. Possible solutions. Several actions could clarify the issue and offer better guidance on reasonableness. One step would be to define appropriate industry and non-industry surveys to be used in a compensation study, as well as define how the data should be used. Additionally, an appropriate methodology for defining reasonable compensation should be created that firms can rely on as they prepare a compensation study. This methodology should rely on a range rather than a single data point. Finally, risk can occur when compensation levels are influenced by employee owners. There should be review of the total compensation of employee owners who own stock equal to 50% or more of the outstanding shares.

- Unallowable indirect (overhead) costs. FAR-unallowable expenses fall into two groups: items that are expressly unallowable, and items that may be partially unallowable, but require professional judgment to make a final determination. Possible solutions. Preventing FAR-unallowable costs from entering the overhead pool should be a high priority in each firm. Firms should establish formal FAR compliance policies and procedures, train the appropriate staff to implement them, and develop review processes to ensure they are being followed. It should be clearly communicated to auditors that the firm has performed those steps. Also, firms should provide periodic training for accounting staff involved in the review of expenses to ensure they understand FAR requirements. Firms should engage an external FAR expert to provide this training if there are no resources available within the firm.

- CPA audit quality and independence. For the audits performed, issues related to poor audit quality were identified by the OIG. Those issues included: CPA audit firms' work paper files were incomplete, missing reviews or testing of reported expenses; and concern over the independence of the CPA audit firms, since those

same firms often produced the company financials, prepared the engineering firm's partner tax returns, and computed the overhead rate.
Possible solutions. The authors recommend required continuing education for auditors involved in FAR accounting; developing a process to insure audit competence so as to achieve a consistent knowledge set; providing a library of technical resources for assistance; requiring FAR audit work and reporting be subject to quality and peer reviews; and ensuring that CPA firms performing overhead audits are aware of and use the AASHTO Uniform Audit and Accounting Guide. The authors recognize that independence could be a concern. Rather than requiring CPA firms to give up consulting work with the engineering and design firms, a more reasonable solution is to require the CPA firm to provide a statement of disclosure of other work being performed, as well as signing a certification that the other engagements had no impact on the auditors. Additionally, it is suggested that the partner-in-charge of an audit be required to rotate off the engagement periodically.

- Deficient state DOT audit practices. Based on the experience of the authors, written and unwritten standards among states are inconsistent. (The definition of reasonableness is just one area of inconsistency.) Because of inconsistencies, few accept the concept of a single audit and because of this, rarely if ever is a cognizant agency determined. Because no cognizant agency is determined, firms are subjected to the burden of multiple audits. This is particularly burdensome to firms that work in multiple states and with multiple federal and non-federal government agencies.
  Possible solutions. To solve this issue, state and federal agencies need to agree on the definition of cognizance and how cognizance is determined. States need to conduct audits in accordance with FAR. States should provide oversight and review of the process. Once those steps happen, all parties—state DOTs, federal and non-federal government agencies, and engineering and design firms—must agree to the single audit concept. Then the audit of the cognizant agency must be allowed to stand as the cognizant audit, recognized by all agencies involved.

Furthermore, on November 30, 2005, the Transportation Appropriations Act was passed. Section 174 of this act specifies that firms shall be audited in conformance with the Federal Acquisition Regulation, part 31. The act further states that state and local agencies will be required to use indirect cost (overhead) rates established by a cognizant agency audit based on FAR, part 31. In addition, this act reinforces the Brooks Act, which requires qualifications-based selection for engineering and design services related to construction projects funded with federal-aid highway funding. The solutions proposed in this paper are consistent with and support conformance with this act.

This white paper discusses these issues in greater detail on the following pages.

Background

In 2004, the USDOT OIG notified the Federal Highway Administration (FHWA) that it was initiating an audit of engineering and design firms' overhead cost audits on contracts awarded by state departments of transportation under federal-aid grants. In its audit notification to FHWA, the OIG stated that its audit objective was to evaluate the implementation and effectiveness of Section 307 audit requirements, including testing the allowability of compensation and other high cost overhead elements billed by these firms.

The OIG audit began in January 2005, when a letter requesting audit information was sent to nine large engineering and design firms that held federally-funded state DOT contracts. The letter explained that the objectives of the audit were to:

- Review the effectiveness of audit provisions in Section 307[1] of the National Highway System Designation Act and associated guidance issued by FHWA and American Association of State Highway and Transportation Officials (AASHTO).
- Review the reasonableness of compensation paid to top executives for fiscal years 2003 and 2004.
- Review the adequacy of the audit coverage performed by CPA firms and by state DOT auditors for those years, with emphasis on the reasonableness/allowability of compensation and other overhead costs included in rates charged by engineering and design firms.

OIG audit personnel and compensation audit specialists from the Defense Contract Audit Agency (DCAA) conducted onsite audits of five of the nine firms, using OIG audit personnel and compensation audit specialists from the DCAA. During the onsite audits, the OIG and DCAA auditors also met with the engineering and design firms' independent CPAs and reviewed the CPAs' audit work papers relating to their indirect cost (overhead) rate audits.

Based on the audit findings from the first phase of their audit, the OIG decided to expand the scope of the audit, retaining the initial audit objectives but looking at a larger number of engineering and design firms. Letters requesting audit information have been sent to 49 additional firms, and onsite audits of up to 10 of those firms are currently being conducted.

The OIG has not yet discussed specific audit findings or conducted audit exit conferences with any of the original five audited firms. However, several meetings were held between members of ARTBA, ACEC, DPC and the OIG. One was on

[1] The OIG's reference to Section 307 relates to that section of the National Highway System Designation Act of 1995 (Public Law 104-59), which addresses "Quality through Competition" and amends Section 112(b)(2) of Title 23, United States Code by adding audit requirements for recipients of federal-aid highway funds unless a state has opted out of Section 307 requirements by adopting an alternative process.

March 4, 2005 with Ken Mead, Curt Hyde, Mary Peters, Rick Capka, et al. One meeting was held on May 5, 2005 with Ted Alves, Ken Prather, and the audit team. A third meeting was held on November 5, 2005 with Rebecca Leng, Ken Prather, and the audit team. Additionally, representatives from ACEC met with Ted Alves, Ken Prather, Bob Anderson, and Terri Letko at the Washington headquarters of OIG on April 14, 2005 and another meeting between ACEC representatives and Ted Alves and Ken Prather on July 24, 2005 in Charleston, SC at the AASHTO Audit Conference. A follow up meeting was also held at the Washington Headquarters of the OIG on July 5th. Several members of ARTBA and ACEC have had numerous phone calls with members of the audit team. During these meetings and phone calls, OIG discussed the problems disclosed by the initial audits.

The issues disclosed were:

- Reasonableness of **executive compensation** in the determination of indirect cost (overhead) rates, based on the OIG/DCAA interpretation of the general cost principle on reasonableness.
- **Inclusion of specifically unallowable costs** in the determination of indirect cost (overhead) rates, based on specific FAR cost principles.
- **Poor quality of audits** performed by CPA firms engaged by the engineering and design firms, including a lack of understanding of the FAR cost principles and a perceived lack of independence.
- **Deficient state DOT audit practices** and audit oversight, specifically a lack of cognizance recognition by some state DOTs.

The purpose of this white paper is to discuss possible solutions to the problems identified by the OIG during the initial phase of audits.

Reasonableness of Executive Compensation

The OIG has expressed concern about the reasonableness of executive compensation in the determination of indirect cost (overhead) rates, based on the OIG/DCAA interpretation of the general cost principle on reasonableness.

As there is some inconsistency between various agencies and consultants, it is appropriate to review how FAR defines compensation. According to FAR 31.205-6, compensation "includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance." The section further states that compensation "includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options, stock appreciation rights, and stock ownership plans; employee insurance; fringe benefits; contributions to pension, annuity, and management employee incentive compensation plans; and allowances for off-site pay, incentive pay, location allowances, hardship pay, severance pay, and cost of living differential."

Regarding executive compensation, there are four central issues that require consideration: the definition of reasonableness; the appropriateness of survey data and its use in defining reasonableness; the identification of risk that the government needs to manage; and education for engineering and design firms.

The Definition of Reasonableness

The documented guidance in FAR 31.201-3, "Determining Reasonableness," states that: "A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints."

According to FAR, a cost is reasonable if it would be incurred by a "prudent person." Arguably, a prudent person purchasing professional services does not desire to purchase average or below average services, but will instead strive to purchase above average, value added services. Similarly, since a relationship exists between skill, performance, quality, value delivered, and compensation, firms that provide above average levels of skill, performance, quality, and value generally receive above average levels of compensation.

The ambiguity of the current guidance places audit agencies in a difficult situation. In many cases, the determination of reasonableness falls to the judgment and discretion of an audit agency and the contractor, of which neither may have the appropriate background, access to information, or methodology to determine reasonable compensation. If a compensation level is declared unreasonable, the burden of proof

lies with the contractor, which again will challenge the judgment of the firm against the judgment of the audit agency.

The Appropriateness of Survey Data and its Use in Defining Reasonableness
FAR 31.205-6(b) in addressing compensation reasonableness states, "Among others, factors which may be relevant include general conformity with the compensation practices of other firms of the same size, the compensation practices of other firms in the same industry, the compensation practices of firms in the same geographic area, the compensation practices of firms engaged in predominantly non-government work, and the cost of comparable services obtainable from outside sources. The appropriate factors for evaluating the reasonableness of compensation depend on the degree to which those factors are representative of the labor market for the job being evaluated. The relative significance of factors will vary according to circumstances."

There are several salary surveys available to our industry; however, determining the appropriateness of a survey is difficult. Generally, there is a lack of reliable data and no agreement on the best surveys to use in preparing a salary study. Within these studies, there is no consensus on what characteristics or factors (such as geography, size of firm, disciplines, practices, etc.) are relevant from a data presentation perspective. Additionally, industry surveys reflect the majority of the A/E industry, which consists primarily of small, local firms. In other words, current surveys are particularly insufficient in accurately representing larger, multi-discipline firms with a regional or national footprint; therefore, compensation data on larger, publicly traded firms within our industry should be considered as well. In addition, it should be noted that according to the guidance in FAR, it is appropriate to consider non-government contractor survey data as well.

To further exacerbate the issue, there is no widely accepted model that can be applied across the varied characteristics of the industry firms and there is no defined methodology for applying salary survey data to prepare a salary study; however, the proper use of the survey data is as important as the survey selection. In order to prepare a proper salary study, several sources should be considered to account for specific characteristics that may exist in a firm. It would seem reasonable that the smaller and more local the firm, the more heavily weighted criteria would be from the industry and out-of-industry, local survey. The more national the firm, the more important criteria would be from the national survey data. Due to a lack of guidance and appropriate surveys, firms and audit agencies must rely on their best judgment as to the appropriate data and methodology. This uncertainty with the data and the application of the data leads some firms to make no compensation elimination because they are not confident that their action will be correct.

Some public agencies responsible for ensuring the reasonableness of a firm's compensation rely on the survey mean as the reasonableness standard. As an example, assume there is a reliable survey with appropriate factors considered. If there are multiple compensation data points for a particular classification, many times

the mean of these data points becomes the reasonable compensation benchmark. This approach makes a flawed assumption that compensation levels below the mean are reasonable while those above are unreasonable. Again, given the unique characteristics of firms, this creates an unfair standard to gauge reasonableness as it is unlikely that 50% of the data points above the mean are unreasonable.

Other public agencies, including DCAA, use the survey median as the reasonableness standard, which also leads to a flawed assumption as median compensation tends to be much lower than average. Like the mean, the median figure is not an appropriate standard for gauging reasonableness if, as it often does, equates to less than average.

Additionally, both the mean and the median represent single data points. The standard for reasonableness cannot be expressed as a single data point due to unique factors or characteristics of a firm, so a more appropriate approach is for reasonable compensation to be expressed as a range and not a specific number.

The Identification of Risk that the Government Needs to Manage

The A/E industry is a large, mature industry that is highly competitive. Market forces require the industry to be competitive. So, what risk does unreasonable compensation pose to the government? What risk is the government trying to manage by defining unreasonable compensation? The risk arises where there is undue influence of executives over their own compensation. If ownership by executives is more than 50%, there is risk when compensation levels are influenced by these owners.

This leads us to the question: Whose compensation should be reviewed for reasonableness? To address the issue of risk related to control, there should be review of the total compensation of employee owners who own stock equal to or greater than 50% of the outstanding shares. To address this risk, it would seem logical that the compensation of a minimum of the top 5 employee owners would be reviewed, with a maximum allowable review of 2% of employee owners in companies with 250 employees or greater. Compensation would be unallowable to anyone in excess of the current federally-defined limit of $473,318 or those that fall above the 90th percentile of the survey data for their specific level.

Conclusions and Recommendations

FAR does provide guidance on the reasonableness of compensation, but the firms representing our industry feel strongly that the guidance relies too heavily on individual judgment and interpretation, as shown by the many ways in which multiple state DOTs have interpreted reasonableness. This is a significant issue to our public agency clients and our industry. There are actions that should be considered to clarify the issue while offering more definitive guidance on reasonableness.

- DCAA, FHWA, AASHTO, and our industry should work together to define appropriate surveys for use in a compensation study, and define how the data should be used. An appropriate survey would segregate compensation data based

on the size of a firm and its national or local footprint. The surveys also should identify salary ranges by appropriate executive classifications since factors that influence total compensation may vary by classification. Our recommendation is to identify and support an industry specific compensation survey that is statistically representative. Our goal would be to aid in ensuring that data capture and data presentation are consistent with the makeup of the A/E industry. The professional organizations in our industry will endorse and support surveys that are comprehensive, consider the appropriate forms of compensation, and segregate data based on appropriate demographics and metrics. There are several possible surveys that should be considered, including but not limited to PSMJ, Abbott Langer, and Dietrich Associates.

In addition, FAR states that in a test for reasonableness, the compensation practices of firms engaged in predominantly non-government work and the cost of comparable services obtainable from outside sources should be considered as well.

- DCAA, FHWA, AASHTO, and our industry need to work closely to provide guidance on the appropriate method that firms can rely on as they prepare a compensation study. If comprehensive survey data is available that clearly recognizes differences in demographics and characteristics of firms, the methodology to prepare a salary survey will be a better-defined process. With a reliable industry and a reliable non-industry survey, we should define a range of reasonable compensation. The courts decided in *Edwins, Inc. v. U.S.* that a range rather than a single point must be used in determining reasonableness. As the government is best served by firms that do not compensate too low or too high, a suggested option would be for compensation to be unallowable to anyone in excess of the federally-defined limit of $473,318 or those that are above the 90th percentile of survey data. Any firm proposing compensation above this range would bear the burden of justifying it.

- Possible risk arises to the government when there is undue influence of executives over their own compensation. If ownership of executives is more than 50%, there can be risk when compensation levels are influenced by those owners. To address the issue of risk related to control, there should be review of the total compensation of employee owners who own stock equal to or greater than 50% of the outstanding shares. As a guideline, the compensation of a minimum of 5 employee owners would be reviewed, with a maximum allowable review of 2% of employee owners in companies with 250 employees or greater.

Unallowable Indirect (Overhead) Costs

In completing the annual schedule of indirect costs, a consulting firm's most important responsibility is the identification of unallowable costs and the elimination of those costs from the overhead rate. FAR-unallowable expenses fall into two groups: items that are completely unallowable, and those expenses or accounts that may be partially unallowable, but require professional judgment to make the determination of allowability. Completely unallowable items are the easier of the two groups to identify and eliminate from overhead. For example, interest costs, bad debts, lobbying costs, and advertising should be relatively easy to recognize, and each should have its own general ledger account that is designated as FAR-unallowable. Instructions provided to accounting staff should explain how to identify these unallowable items for proper account coding. A periodic process of general ledger review should be used to help verify that the instructions are being followed.

Other accounts and transactions will require a detailed review to determine what portion, if any, is allowable in overhead. For example, the following areas typically require a detailed review:

- Meals and entertainment expenses
- Travel
- Client relations
- Employee morale, health, and welfare
- Insurance
- Compensation
- Unusual or infrequently occurring transactions
- Related party transactions
- Legal costs
- Marketing/bid and proposal costs

Some firms may lack the FAR training programs and internal controls to adequately identify FAR-unallowable costs. Areas of cost like those listed above may require substantial review by staff knowledgeable in FAR principles. In some cases, firms may not have devoted the resources to develop the necessary level of in-house knowledge to properly evaluate such costs.

Conclusions and Recommendations

As an industry, the integrity of our systems of internal control and financial reporting is our utmost concern. There is no tolerance for firms that purposely include unallowable costs in their allowable overhead, or that take a careless approach to compliance with the FAR. Such actions by even a single firm can damage the reputation of all the firms in our industry, and jeopardize the public's trust in us. Honesty and integrity are, and must continue to be, the cornerstones of our relationships with our public and private sector clients, and the citizens they serve.

FAR-unallowable costs entering the overhead pool should rank as a high priority in each firm and consultants must acknowledge the importance of the risk of undetected FAR-unallowable costs entering their overhead pool. Firms should be as diligent in identifying unallowable costs as they are in preventing errors in financial statements. To accomplish this goal, firms should establish formal FAR compliance policies and procedures, train the appropriate staff to implement them, and develop review processes to ensure they are being followed. A key aspect of these policies and procedures should be the establishment of separate general ledger accounts to capture FAR-unallowable expenses. Review procedures should be performed, regularly during the year and at year end, to ensure that FAR-unallowable expenses have been identified and segregated to the appropriate FAR-unallowable accounts in preparation for the overhead audit. It is the consulting firm's responsibility to identify unallowable expenses in their general ledger accounts, and each firm must take this responsibility seriously. Additionally, it should be communicated clearly in writing to the auditor that the firm has addressed appropriately the segregation of accounts, sampling techniques, and review procedures. Auditors are responsible for testing the work that the firm has performed throughout the year, but it is not appropriate to expect that auditors will find all unallowable costs through audit sampling.

These established procedures should further ensure that unallowable costs are identified and properly classified as unallowable. Firms should communicate with their auditors regarding any accounts and transactions that require a greater level of diligence, judgment, and are open to an element of interpretation. This should facilitate proper audit planning and ensure the effectiveness of audit testing. Internally, firms should perform periodic training for accounting staff involved in the review of expenses to ensure they understand the FAR requirements. If there are no resources available within the firm to provide the necessary training, firms should engage an external FAR expert to provide this training. Most importantly, consultants need to embrace the responsibility to identify FAR-unallowable costs as a key role of internal accounting and financial reporting functions, not solely as the responsibility of external auditors.

Lack of CPA Audit Quality and Independence

A number of issues with CPA audit quality and independence were uncovered by the OIG when they reviewed the work of five CPA firms that conducted overhead audits. Issues found included:

- Audit CPA firm work paper files were incomplete and missing reviews or checks of reported expenses.
- Concern over the independence of the CPA audit firm, since they produced the company financials, prepared the engineering firm's partner tax returns, and computed the overhead rate.

Generally, engineering firms engage an independent CPA firm to prepare an annual compilation, review or audit of overhead. A suggestion has emerged that would require CPA firms performing overhead audits to give up other engagements with the firm such as consulting, tax or financial statement preparation. This would not be desirable for several reasons. First, this would create higher costs for the firm having the work completed and, ultimately, for the government agency because of the inefficiency of having multiple firms provide these services. Currently, many smaller engineering firms do not have an annual certified audit of their financial statements because of cost considerations. Second, if CPA firms derive only a small percentage of revenue from overhead audits, if required to choose between overhead audit services and other client services, it is likely they would gravitate away from overhead audits to pursue more lucrative and higher revenue opportunities. This could drive many qualified CPA firms away from this particular practice expertise.

Conclusions and Recommendations
A significant element of the solution is to provide better educational programs for CPA firms. We also recognize that solutions need to be based on collaboration between our industry and AASHTO, FHWA, and the Inspector General's office. Possible solutions include:

- Have a responsible organization conduct FAR training and make it a part of the continuing education for any individual CPA or the audit firm that prepares the FAR overhead rates.
- Consider a process by which a certain level of FAR competence could be established to ensure a consistent knowledge set.
- Have a library of technical resources for assistance regarding specific overhead issues related to any FAR audit. This could be on-line and overseen by ACEC's Finance Forum.
- Have all FAR audit work and reporting be subject to quality and peer reviews.
- Ensure that CPA firms performing overhead audits are aware of and use the AASHTO Uniform Audit and Accounting Guide.
- To address the issue of independence, a proposed solution is for the CPA firm to provide an acknowledgement and disclosure of other consulting, accounting

or tax work being done by the auditor and a signed certification that the other work had no impact or influence on the auditors.

- To further address independence, it is suggested that, similar to Sarbanes-Oxley requirements, the partner-in-charge of an audit would be required to rotate off the engagement every five years.

Deficient State DOT Audit Practices

The OIG expressed concern about state DOT audit practices and oversight of federally funded state DOT engineering and design contracts. Problems with cognizance and inconsistency among states were discovered.

Based on the experience of the authors, written and unwritten standards among states are inconsistent. (The definition of reasonableness is just one area of inconsistency.) Because of inconsistencies, few accept the concept of a single audit and because of this, rarely if ever is a cognizant agency determined. Because no cognizant agency is determined, firms are subjected to the burden of multiple audits. This is particularly burdensome to firms that work in multiple states and with multiple federal and non-federal government agencies.

There are several issues relating to state DOT audits that need to be resolved:

- State and federal agencies in alliance need to agree on the definition of cognizance and how cognizance is determined.
- States need to conduct audits in accordance with FAR.
- As part of the audit, the state should provide oversight and review of the process to assure conformance.
- If a state conducts an audit in strict conformance with FAR, then the audit should be acceptable to any state receiving federal funds.

Cognizance
There appears to be much confusion among state DOTs, and among engineering and design firms with state DOT contracts, in determining which agency is cognizant. In amending Section 112(b)(2) of Title 23, the United States Code, Section 307 of the 1995 National Highway Act states, “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 Regulations for 1-year applicable accounting periods by a cognizant federal or state government agency, if such rates are not currently under dispute.”

The intent of this provision of Section 307 is to require the single audit of a contractor by a single cognizant agency. The contributors to this white paper support this single audit concept and believe that the concept eliminates redundant and possibly conflicting audits, reduces the audit burden on contractors, and speeds the audit process and reduces the audit costs for government agencies by eliminating duplicate audits.

The single audit concept discussed in Section 307 is consistent with the requirements of FAR 42.703-1(a), which states: “A single agency (see 42.705-1) shall be responsible for establishing final indirect cost rates for each business unit. These rates

shall be binding on all agencies and their contracting offices, unless otherwise specifically prohibited by statute."

FAR 42.705-1 indicates that, in most cases, the federal agency contracting officer or cognizant federal agency official is responsible for establishing final indirect cost rates. Unfortunately, while FAR Part 42, "Contract Administration and Audit Services," discusses "cognizant federal agency," FAR does not define "cognizant" or clarify how a contractor's "cognizant federal agency" should be identified. Similarly, neither Section 307 nor Section 174 of the 2006 Appropriations Act defines the term or clarifies how to identify the "cognizant federal or state government agency."

Because of the confusion over the determination of a firm's cognizant agency and cognizant audit, AASHTO sought to define these terms. Definitions of the terms are included in the *Uniform Audit and Accounting Guide for Audits of Transportation Consultants' Indirect Cost Rates*, which was developed by AASHTO with assistance from FHWA and ACEC, issued in December 2001, and updated in September 2005.

The definition from the guide states:

A cognizant agency is any one of the following:

- Federal agency
- The home state transportation or highway department (i.e., state where the firm's accounting and financial records are located)
- 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 firm

A consensus on the cognizance issue among federal and non-federal government agencies may not be achieved easily; however, it is important that the guidance on cognizance contained in FAR and in the AASHTO audit guide be revisited by AASHTO, ACEC, and FHWA. Review of the guidance is needed because of the impact that cognizant agency and cognizant audit definitions have on the broad spectrum of engineering and design firms engaged in government contracting across the federal, state, and municipal markets, as well as those firms that deal only with state DOTs.

Conformity of Standards and Acceptance of the Single Audit Concept

In theory, the concept of the single audit seems reasonable. Determine the cognizant agency and have the cognizant agency conduct or approve the audit. Once that audit is completed, it should be accepted by any other state agencies. In practice, however, the concept of the single audit does not work consistently. This is due to lack of conformance to FAR standards, as well as regulations that are open to interpretation and are thus interpreted differently by states.

The absence of a single audit for engineering and design firms has resulted in redundant and sometimes conflicting audits, and a significant audit burden on engineering and design firms that provide services to numerous agencies and state DOTs. Audit findings are frequently conflicting, with agencies establishing multiple FAR-based indirect cost (overhead) rates for a single audit period, due to differing audit approaches and different interpretations of the FAR cost principles. In addition, the acceptance of a single audit format also would eliminate issues of timeliness. Currently due to resource restraints the review and acceptance of audits is a relatively slow process.

The successful application of the "single audit" concept to an engineering and design firm presumes several things:

- That a cognizant agency has been identified and is acknowledged to be cognizant by all parties
- That a cognizant audit has been conducted by or at the direction of the cognizant agency
- That cognizant audit findings, specifically indirect cost (overhead) rates established in accordance with FAR, are shared with all of the audited firm's federal and non-federal government clients
- That cognizant audit findings are useful to and will be accepted by all of the audited firm's federal and non-federal government clients

For these presumptions to be true, the issues discussed above (cognizance and conformity) will have to be addressed and resolved. Once they are adequately addressed, the concept of single audit should be more easily accepted by all agencies.

Furthermore, in November of 2005, the Transportation Appropriations Act, 2006 was passed. Section 174 of the act addressed issues relating to the award of engineering and construction projects using federal-aid highway funding. Among those issues, Section 174 addressed opt-out status by eliminating that status for all but two states. In addition, the act provided a continued endorsement of the Brooks Act and a qualification-based selection process. Section 174 of the Transportation Appropriations Act can only be accomplished with audits prepared consistently in conformance with FAR.

Conclusions and Recommendations

FAR should provide a better definition and guidance on cognizance. The definition contained in the AASHTO Uniform Audit Guide could be a starting point for discussion. However, it should be amended so that there is clear responsibility for cognizance. Furthermore, a determination of cognizance should be structured so that the cognizant agency does not change on an annual basis. A suggested hierarchy is to apply in the following order.

- A Federal agency or DCAA would be the cognizant agency if a firm has been audited by DCAA or other federal agency.
- A state agency should be cognizant if a firm does not meet the federal agency standard for cognizance defined above. To determine the appropriate state agency for cognizance, a three-fiscal-year reporting period would be considered. The state that has the largest dollar volume for the combined previous three-year period would be cognizant. This approach potentially would eliminate the cognizance shifting from agency to agency on an annual basis. There is benefit in an agency maintaining cognizance over a longer period of time due to experience gained from working with a firm and its CPA firm on a regular basis.
- Once an agency becomes the cognizant agency, they should remain cognizant for a period of no less than three years.

Once the cognizant agency is determined and an audit is performed in compliance with FAR, then the single audit for engineering and design firms should relieve the audit burden on engineering and design firms that provide services to numerous agencies and state DOTs, as well as the costs of duplication of effort. If a state can rely on the cognizant state to perform an audit in conformance with FAR, they could accept it without additional effort or review on their part.

The contributors to this white paper believe that a dialogue between AASHTO representatives and engineering and design firms on cognizance, conformity between agencies, and the single audit concept could be helpful, and the contributors are eager to participate in such a dialogue.

Other Considerations

Education

Throughout this paper, we have discussed the importance of education and training for public agencies, our staff, and CPA firms. A/E firms strive to adhere to the regulations prescribed by the FAR. Our industry has a long history of providing exceptional service to our clients and recognizes our continued strong relationships will be built and maintained on the philosophy of service and compliance. However, there are cases where our firms can benefit from the continued exchange of information from the various audit agencies and formalized programs that educate our firms on the various regulations with which we need to comply.

As an industry, we are committed to providing better education to those within our firms responsible for auditing indirect costs, those reviewing compensation studies, and CPA firms involved in these processes. Development of training and educational opportunities should be a joint effort of DCAA, FHWA, AASHTO, and our industry. If appropriate training and educational opportunities were available, we would endorse a process within our industry whereby employees responsible for compilation of data and audit preparation could achieve a documented level of competence. To

achieve the status, an employee would be required to complete defined educational requirements.