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Chapter 11—Audit Reports and Minimum Disclosures

11.1—Generally

[Reference: GAGAS Reporting Standards for Financial Audits or Attestation Engagements]

Although auditors’ reports may be presented in a variety of formats and styles, in all cases these reports must meet the GAGAS Reporting Standards for Financial Audits or Attestation Engagements. Accordingly, CPAs must perform appropriate examination procedures before they opine on, or attest to, the reliability of the engineering consultant’s overhead rate.

GAGAS reporting standards first incorporate the AICPA reporting standards for each type and then require additional GAGAS standards. There are ten standards for financial audits and nine standards for attestation engagements. See Chapter 2 of this guide for a summary matrix of the standards. The complete text of the standards is available in the Yellow Book.

This chapter provides basic guidelines for reporting and minimum disclosures that must be made by the engineering consultant’s management and included in auditors’ reports. A typical report package contains the following:

- Independent Auditor’s Report on indirect cost rate schedule.
- Indirect cost rate schedule.
- Listing of unallowable account adjustments with FAR References.
- Notes to the indirect cost rate schedule, including minimum disclosures.
- Independent Auditor’s Report on Internal Control.

***Note**: The AASHTO Audit Subcommittee and the ACEC Transportation Committee have approved the report formats.*

11.2—Sample Audit Report on Indirect cost rate schedule

The following is an example of a typical audit report that would be issued by a CPA firm or a State or Federal agency on the indirect cost rate schedule for a consulting engineering firm. If the auditor performed an “attestation engagement examination,” then the report wording would be modified, but in both cases, an auditor’s opinion is required. The complete report would include the indirect cost rate schedule and footnote disclosures (see following pages).

INDEPENDENT AUDITOR'S REPORT ON THE
STATEMENT OF DIRECT LABOR, FRINGE BENEFITS, AND GENERAL OVERHEAD

Board of Directors
The Company

We have audited the Statement of Direct Labor, Fringe Benefits, and General Overhead (hereinafter referred to as "indirect cost rate schedule" or "the Schedule") for the fiscal year ended December 31, 2XXX. The Schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on the Schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the financial audit standards contained in the *Government Auditing Standards* issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the Indirect Cost Schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the Schedule. We believe that our audit provides a reasonable basis for our opinion.

The accompanying indirect cost rate schedule was prepared on a basis of accounting practices prescribed by Part 31 of the Federal Acquisition Regulation (FAR) and is not intended to be a presentation in conformity with generally accepted accounting principles.

In our opinion, the indirect cost rate schedule referred to above presents fairly, in all material respects, the direct labor, fringe benefits, and general overhead of the Company for the year ended December 31, 2XXX on the basis of accounting described in Note B.

In accordance with the *Government Auditing Standards* we have issued a report dated April 4, 2XXX on our consideration of the Company's internal controls and its compliance with laws and regulations.
This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulation and should not be used for any other purpose.

(Signature of Official Representative/CPA Firm)

DATE, 2XXX

Firm X, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead (with Field Rate)
For the year ended December 31, 201x

Description	General Ledger Balance	Portion Unallowable	FAR Ref.	Total Proposed	Allocations: Home Office Costs	Allocations: Field Office Costs
Direct Labor	$ 12,500,000	$ 12,000	(1)	$12,512,000	$12,011,520	$ 500,480
Fringe Benefits						
Vacation/Holiday/Paid Leave..................	$ 1,700,000			$ 1,700,000	$ 1,632,000	$ 68,000
Payroll Taxes..	1,550,000			1,550,000	1,488,000	62,000
Group Insurance......................................	1,100,000			1,100,000	1,056,000	44,000
Pension and Profit Sharing.......................	1,016,000	(500,000)	(2)	516,000	495,360	20,640
Incentive Payments..................................	1,550,000			1,550,000	1,488,000	62,000
Seminars/Education..................................	400,000			400,000	384,000	16,000
Employee Welfare....................................	10,000	(4,000)	(3)	6,000	5,760	240
Total Fringe Benefits	$ 7,326,000	$ (504,000)		$ 6,822,000	$ 6,549,120	$ 272,880
General Overhead						
Non-Project Labor...................................	$ 4,900,000	$ (12,000)	(1)	$ 4,888,000	$ 4,808,000	$ 80,000
Recruiting..	190,000			$ 190,000	189,126	874
Building Costs (Rent)...............................	1,400,000	(20,000)	(4)	$ 1,380,000	1,380,000	-
Other Occupancy Costs............................	464,000			$ 464,000	464,000	-
Supplies..	380,000			$ 380,000	380,000	-
Field Supplies and Equipment.................	100,000			$ 100,000	-	100,000
Postage and Shipping...............................	78,000			$ 78,000	77,641	359
Equipment Rent/Maintenance..................	386,000			$ 386,000	384,225	1,775
Interest..	20,000	(20,000)	(5)	$ -	-	-
Telephone...	290,000			$ 290,000	288,667	1,333
Business Insurance....................................	194,000			$ 194,000	193,108	892
Legal & Other Professional Fees.............	376,000	(25,000)	(6)	$ 351,000	349,386	1,614
Administrative Travel...............................	597,000	(30,000)	(7)	$ 567,000	564,393	2,607
Dues, Memberships, and Registrations.....	173,000			$ 173,000	172,205	795
Subscriptions and Publications................	41,000			$ 41,000	40,811	189
Depreciation and Amortization................	628,000	(10,000)	(8)	$ 618,000	615,159	2,841
Outside Payroll Service............................	45,000			$ 45,000	44,793	207
State Income & Personal Property Taxes.	27,000			$ 27,000	26,876	124
Direct Cost Credit.....................................	(833,000)	-		$ (833,000)	(829,170)	(3,830)
Total General Overhead	$ 9,456,000	$ (117,000)		$ 9,339,000	$ 9,149,221	$ 189,779
Total Indirect Costs				$16,161,000	$15,698,341	$ 462,659
Percentage of Direct Labor				**129.2%**	**130.7%**	**92.4%**

FAR References:

(1) 31.202 - Uncompensated overtime for salaried employees considered to be direct labor and removed from indirect labor costs.
(2) 31.205-6(a)(6)(ii)(B) - Compensation paid to owners in excess of reasonable amount and considered distribution of profits.
(3) 31.205-14 - Costs of dues for social clubs are unallowable and considered entertainment.
(4) 31.205-36 - Adjusted rental costs to actual costs incurred to eliminate markups between subsidiaries under common control.
(5) 31.205-20 - Interest and other financial costs not allowable.
(6) 31.205-27 - Accounting and legal fees considered as organization costs are not allowable.
(7) 31.205-6(m)(2) - Portion of the cost of company-furnished automobiles that relates to personal use by employees.
(8) 31.205-49 - Amortization of acquisition intangibles (goodwill).

(See Section 11.4 for recommended Standard Notes to the indirect cost schedule.)

11.3—Sample Report on Internal Control and Compliance

The following is an example of a report on internal control with no reportable conditions, which is a GAGAS requirement for financial audits (see Chapter 2). For both financial audits and attestation engagements, auditors' reports should disclose deficiencies in internal control, fraud, illegal acts, violations of contracts or grant agreements, and abuse. (See the Yellow Book for specific reporting requirements.)

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE

Board of Directors
The Company

We have audited the indirect cost rate schedule of the Company for the fiscal year ended December 31, 2XXX, and have issued our report thereon dated (DATE, 2XXX). We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits (or examination level attestation engagements) contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Company's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the schedule, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control over financial reporting.

The management of the Company is responsible for establishing and maintaining internal control over financial reporting. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal controls over financial reporting. The objectives of internal control over financial reporting are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with Part 31 of the Federal Acquisition Regulation. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate. For the purpose of this report, we have classified significant internal controls over financial reporting into two categories: cash disbursement and payroll.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company's ability to initiate, authorize, record, process, or report financial data reliably in accordance with Part 31 of the Federal Acquisition Regulation such that there is more than a remote likelihood that a misstatement of the Company's indirect cost rate schedule that is more than inconsequential will not be prevented or detected by the Company's internal control. A material weakness is a significant deficiency, or combination of significant deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Company's indirect cost rate schedule will not be prevented or detected, and corrected, on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Company's indirect cost rate schedule is free from material misstatement, we performed tests of the Company's compliance with certain provisions of laws, regulations, contracts, and grant agreements, including provisions of the applicable sections of Part 31 of the Federal Acquisitions Regulation, noncompliance with which could have a direct and material effect on the determination of the amounts reported on the indirect cost rate schedule. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

We noted certain matters that we reported to management of the Company in a separate letter dated (DATE, 2XXX).

This report is intended solely for the use and information of the Company and government agencies or other customers related to contracts employing the cost principles of the Federal Acquisition Regulation. This report should not be used for any other purpose.

(Signature of Official Representative of Firm)

(DATE, 2XXX)

11.4—Minimum Audit Report Disclosures

The following subsections describe disclosures that should be included with audit reports, regardless of whether the audits reports are generated from financial audits or attestation engagements. In cases where examples are included, they are for illustrative and explanatory purposes only and are not intended to be comprehensive regarding rules and regulations. Some of the recommended disclosures may not be appropriate or necessary for certain firms. Conversely, additional disclosures may be required for firms with unusual or complex issues. Disclosures should be included with the overhead audit report for each fiscal year and may either be included in the notes to the indirect cost rate schedule or as a separate section within the report. The standard recommended disclosure notes are listed and discussed below in Sections 11.4.A through 11.4.I.

A. Description of the Company

Provide an overview of the company including when the company was formed, type of organization (e.g., corporation, LLC, or LLP), major business activities, primary customer groups, type of ownership (e.g., subsidiary of corporation, division of another company, privately held firm) and any other pertinent general company information.

B. Basis of Accounting

The basis of accounting practices should be clearly stated, as described below.

> EXAMPLE 11-1. The Company's indirect cost rate schedule was prepared on the basis of accounting practices prescribed in Part 31 of the Federal Acquisition Regulation (FAR). Accordingly, the indirect cost rate schedule is not intended to present the results of operations of the Company in conformity with accounting principles generally accepted in the United States of America.

C. Description of Accounting Policies

Describe the financial accounting system (i.e., cash, accrual, or hybrid) and job cost accounting system (e.g., job order, modified job order, standard, or hybrid). Include a description of accounting policies and procedures governing the classification of costs as direct or indirect. Describe how project costs are accumulated and assigned to projects.

D. Description of Overhead Rate Structure

Disclosures should include language to—

- Identify the *reporting unit*. (e.g., company wide; business segment; or technical specialty such as design, construction administration, geotechnical, or environmental; and/or geographical location pertaining to the overhead rate or rates).
- Identify the company's overall rate structure in terms of the base(s) for allocation. Describe if more than one base is used, depending on the customer (e.g., different bases used for Federal and State projects).

  EXAMPLE 11-2:

  Single Base
  – All costs are allocated based on Direct Labor cost.

  Multiple Bases
  – Fringe benefits costs allocated based on Direct + Indirect Labor.
  – Office overhead costs allocated based on Direct Labor + Fringe Benefits.
  – General and administrative costs allocated based on Value Added Costs (all company costs, excluding subconsultants).
- Identify whether a dual rate structure exists for field office projects and home office projects. Specify the allocation methods used.
- Identify cost allocation practices between related business entities (e.g., parent company allocating costs to subsidiaries or divisions, allocations between subsidiaries or divisions, and/or allocations to specific product lines).

E. Description of Labor-Related Costs

The disclosures associated with labor costs must include details regarding—

3. ***Project Labor***. Describe how the company allocates labor to all projects (i.e., actual, average, or standard hourly rates).
4. ***Variances***. Describe how and when variances are recorded if using other than actual labor costs.
5. ***Paid Time Off***. Explain the company's policy and accounting practice as to paid vacation, sick leave and comp time. Include the engineering consultant's policy as to accounting for accrued sick leave upon termination.
6. ***Paid Overtime and Uncompensated Overtime***. Indicate where the premium portion of overtime pay is recorded in the cost accounting system. Detail the procedures for recording uncompensated overtime incurred by employees charging direct project time.

   EXAMPLE 11-3.

   Premium Overtime costs are incurred in meeting certain deadlines. If an employee is eligible for overtime, they have their choice of a cash payment equal to time and a half (premium portion), or compensatory time off at time and a half. The premium portion of paid overtime is included in the indirect cost pool.

   Uncompensated Overtime: The Company did not pay certain salaried employees for time worked in excess of 40 hours per week. The time in excess of 40 hours was credited to the indirect cost pool. The credited amount ($xx,xxx) consisted of hours worked in excess of 40, times the employee's standard hourly rate.

7. ***Highly Compensated Employees/Officers/Owners.*** As discussed in Section 7.5, the engineering consultant must perform appropriate procedures to evaluate the allowability and reasonableness of executive compensation. These procedures should include an examination of the allowability of the forms of compensation paid to the Company's executives and an evaluation as to whether any of the compensation was related to unallowable activities such as entertainment, lobbying, etc. After eliminating unallowable forms of compensation and compensation amounts related to unallowable activities, the engineering consultant should then evaluate the reasonableness of total allowable elements of compensation, for each executive, by either: (1) performing an analysis using independent survey data as prescribed in Section 7.5, or (2) by examining executive compensation using the National Compensation Matrix (NCM). If the engineering consultant performs its own analysis, care should be taken to properly consider the Benchmark Compensation Amount (BCA), as discussed in Section 7.4.

   The audit report footnote should include the following:

   - A description of the procedures used by the engineering consultant to evaluate allowability of the elements of executive compensation and the activities performed by executives.
   - A statement as to whether the consultant performed its own analysis of executive compensation reasonableness or used the NCM instead. If the consultant performed its own analysis, a description of the procedures performed should be included. This should include a list of any independent compensation surveys used in the consultant's analysis.
   - A statement regarding how the BCA was considered in evaluating executive compensation, noting the applicable amount of the BCA.
   - The total amount of executive compensation disallowed as a result of the evaluation of allowability and reasonableness, preferably as separate amounts for each executive.

   EXAMPLE 11-4. The Company performed an analysis of executive compensation in accordance with Chapter 7 of the *AASHTO Audit Guide*. The analysis included an examination of the activities performed by Company executives, and the forms of compensation paid to executives. A total of $25,796 was eliminated from overhead related to unallowable entertainment activities and compensation related to changes in the Company's stock price. The analysis also included an evaluation of compensation reasonableness as described in *AASHTO Audit Guide* section 7.5, using information from the following independent compensation surveys: X, Y, and Z. The reasonable compensation amounts developed using survey data did not exceed the applicable Benchmark Compensation

Amount of $XXX,XXX. As a result of the analysis of executive compensation reasonableness, a total of $42,512 of executive compensation was disallowed.

8. ***Pension Plans, Deferred Compensation Plans, and ESOPs***. If pension and/or deferred compensation costs (as defined by FAR 31.205-6(j) and 31.205-6(k), respectively) are included in indirect costs, identify whether the plan(s) meet the above regulations and explain how the costs were determined (e.g., cash contribution, stock or options to purchase stock of the engineering consultant, or assets other than cash). For Employee Stock Option Purchase (ESOP) plans, identify the dollar amounts of principal, interest, and administrative costs of the contribution to the Employee Stock Option Trust (ESOT). Identify any other significant impacts from market valuations.

   EXAMPLE 11-5. The Company operates a 401(k) retirement plan that meets the requirements of FAR 31.205-6(j). During the year, the Company made a cash contribution of 2 percent of participating employees' salaries.

   In addition, the Company has a leveraged deferred compensation ESOP started in 1984. The plan provides for cash payments of the appraised value of the stock (held by the ESOT for the employee) upon retirement, leaving the Company after 10 years of service, or death. Since CAS 9904.415(a)(3) has not been satisfied, the Company assigns the payments to the period in which the compensation is paid to the employee. The amount of the company's share of ESOP expense included in the overhead pool for the year was $xxx,xxx.

9. ***Contract/Purchased Labor***. Provide the methodology used by the engineering consultant to account for contract labor (not sub-contracts). In some cases, this labor will be considered to be a direct cost item invoiced to the project, but in other cases the firm may choose to have this labor treated the same as employee labor and include it in the direct labor base.

   EXAMPLE 11-6. The Company uses contract labor for engineering related services, and bills this labor as if it were for regular employees. The Company provides office space, administrative support, and controls the contract laborers. Therefore, contract laborers are considered employees, and their labor costs ($52,000 for the period audited) have been included in the direct labor base.

F. Description of Depreciation and Leasing Policies

Policies regarding costs related to acquisition and disposition of assets should be clearly identified along with the related depreciation methods. Costs and accounting treatment for capital and operating leases should be disclosed.

EXAMPLE 11-7. Certain assets are purchased and depreciated, while others are leased and considered operating leases, and the annual lease costs are included in the overhead pool. The depreciation reflected on the Company's financial statements differs from the acceptable depreciation for Federal income tax purposes. Since the financial statement amounts included in the overhead pool are lower than the amounts used for Federal purposes, the amounts included on the indirect cost rate schedule are allowable under FAR 31.205-11(e).

G. Description of Related-Party Transactions

1. ***Building Rent***. Identify any related parties considered to have common control, to the extent that audit adjustments are required per FAR 31.205-36.

   EXAMPLE 11-8. The Company rents part of an office building owned by the ABC Real-Estate Partnership (ABC). ABC's owners include a Company shareholder, his spouse, and an unrelated third party. (The spouse is not a Company employee or owner.) This shareholder owns only one third of the ABC partnership, but he has effective control over ABC's operating and financial policies.

   ABC incurred $350,000 of expenses to maintain the building, including $45,000 of interest expense. The building has 15,000 total square feet, and the Company occupied 12,750 square feet (85 percent of the total building). ABC rents the remaining building space to an unrelated business. Additionally, ABC's Facilities Capital Cost of Money (FCCM) for the building was $22,500 for the year.

   The rent expense recorded in the Company's financial records includes $400,000 in payments to ABC. The Company excluded $121,625 of the rent expense from the indirect cost schedule, as follows:

ABC's allowable cost of ownership for the property:

Total expenses	$350,000
Less: Unallowable interest expense	(45,000)
Plus: Facilities Capital Cost of Money	22,500
Equals: Cost of ownership	$327,500
Multiplied by: Allocation factor	85%
Equals: Cost of ownership	$278,375

Company's adjustment for costs in excess of allowable cost of ownership:

Total rent expense recorded by Company	$400,000
Less: Cost of ownership	(278,375)
Adjustment required by FAR 31.205-36(b)(3)	$121,625

2. ***Personal Use of Company Vehicles***. The officers of the Company have personal usage of Company vehicles, which is tracked through vehicle logs. Amounts attributable to this personal use ($xxxx for 20xx) were disallowed in compliance with FAR 31.205-6(m)(2).

H. Facilities Capital Cost of Money (FCCM)

Provide the FCCM rate, as calculated in accordance with FAR 31.205-10.

EXAMPLE 11-9. The FCCM rate was calculated in accordance with FAR 31.205-10, using average net book values of equipment and facilities multiplied by the average Federal Prompt Payment Act Interest Rate (Treasury Rate) for the applicable period. Equipment and facilities include furniture and fixtures, computer equipment, vehicles, and leasehold improvements. The calculation follows:

Net Book Value of Assets - Prior Year	$ 600,000
Net Book Value of Assets - Current Year	700,000
Average Net Book Value	$ 650,000
Multiplied by: Average Treasury Rate	3.19%[45]
Equals: Facilities Capital Cost of Money	$ 20,735
Divided by: Direct Labor Cost	3,250,250
Equals: Facilities Capital Cost of Money Rate	0.63%

Note: *Additionally, if the engineering consultant computes home office and field office indirect cost rates, to allocate project costs appropriately, it may be necessary to compute separate FCCM rates based on the assets and direct labor used in the home office and field, respectively.*

I. List of Other Direct Cost Accounts and Charge Rates

Identify whether Nonsalary Direct Project Costs, sometimes referred to as Other Direct Costs (ODCs) are consistently allocated/costed to all projects, and not just projects that reimburse for ODCs (e.g., computer costs, reproduction, equipment charges, and vehicle usage). Include a listing of cost items generally charged directly to projects.

Additionally, if charge rates were established for any of these costs (e.g., CADD), the rates should be fully disclosed in this note, along with a general description of the audit procedures used to verify the accuracy of the rates.

J. Management's Evaluation of Subsequent Events

The Company has evaluated subsequent events through _________, 20xx, the date upon which the Statement of Direct Labor, Fringe Benefits, and General Overhead was available for issuance.

[45] The year-2010 average Treasury Rate was used this example, and the engineering consultant was assumed to have a December 31 fiscal year end (FYE). Companies with FYEs other than December 31 must appropriately prorate the Treasury Rate. For current Treasury Rates, see http://www.treasurydirect.gov/govt/rates/tcir/tcir_opdprmt2.htm.