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# Understanding FAR Overhead Rates and Audits

Presented by:  
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# Charla A. Roth, CPA

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# Navigating Through the Complexity of FAR Overhead Rates and Audits

## ... More A/E Firms Need FAR Overhead Audits

- In recent years, more and more architectural and engineering (“A/E”) firms are finding that they must have an audited overhead rate in accordance with the Federal Acquisition Regulation (“FAR”).
- Trends leading to this include the economic downturn that reduced development projects thereby causing more firms to seek work from the government.
- The issuance of the updated AASHTO Uniform Audit & Accounting Guide in 2009 also resulted in an increased focus on properly calculated and audited FAR overhead rates rather than the use of estimates by A/E firms and different rates in various states.

# Guidance for FAR OH Rate Calculations

- FAR is an acronym for The Federal Acquisition Regulation
  - FAR Part 31 – Contract Cost Principles and Procedures and more specifically, Subpart 31.2 – Contracts with Commercial Organizations
  - Overall, the FAR is nearly 1,900 pages, but FAR Part 31 is very manageable at approximately 50 pages!
- Defense Contract Audit Agency (DCAA) Resources
  - FAR Cost Principles Guide
  - DCAA Contract Audit Manual
- Federal Cost Accounting Standards (CAS)
- AASHTO Uniform Audit & Accounting Guide

## What is AASHTO?

- AASHTO stands for the American Association of State Highway and Transportation Officials.
- In September 2001, AASHTO and its Audit Subcommittee issued the initial Uniform Audit & Accounting Guide (the “Guide”).
- The Guide is designed to assist engineering consultants, independent CPAs, and state Department of Transportation (“DOT”) auditors with the preparation and/or auditing of Statements of Direct Labor, Fringe Benefits, and General Overhead.
- These Statements are commonly referred to as FAR Overhead Statements or FAR Overhead Audits as their main purpose is to calculate an A/E firm’s overhead rate in accordance with the provisions of FAR Part 31.

## ... AASHTO Audit Guide Updates

- During 2007, the members of the AASHTO Audit Subcommittee approved the establishment of a Task Force to update the guide.
- The work of the Task Force resulted in a major update of the guide in 2010 (the 2010 Edition), which was further refined and updated in 2012 (the 2012 Edition).
- These revisions were necessary to ensure that the guide was consistent with current auditing standards and procedures, accounting principles, and Federal regulations.
- The 2010, 2012, 2016 and 2024 revisions also addressed questions and concerns expressed by various parties, including the FHWA, state DOT audit agencies, Architectural and Engineering design firms.
- The most recent 2024 Edition of the guide incorporates several updates, refinements, and clarifications necessary to reflect changes in the statutory and regulatory framework applicable to *A/E* contracts that have occurred since the publication of the 2016 Edition.

# ... AASHTO Audit Guide

- States will give up state-specific rules –
  - Many states previously had their own rules for various items, including limits on the allowability of certain expenses and limits on compensation expense.
  - The updated Guide solidifies the agreement among states to follow the Guide's common interpretation of a FAR-based audit and, in turn, give up their state-specific overhead audit rules.
- Increased reliance on CPA FAR audits –
  - Previously, firms operating in multiple states prepared calculations specific to each state, and these state-specific rates were either audited by a CPA firm or tested by the respective state.
  - Now, the majority of A/E firms will have one CPA firm FAR overhead audit that will hopefully be recognized and accepted by all states.
  - Developed the concept of a cognizant audit assigning primary responsibility for an audit to a single cognizant agency.

# ... AASHTO Audit Guide

- Small firms may be exempt from a CPA audit if the home state DOT conducts a risk assessment and ensures rates were established in accordance with the FAR.
- New guidance in determining reasonable compensation costs.
  - A/E firms should prepare their own independent compensation analysis.
  - The Guide provides a model for demonstrating reasonableness that includes the use of national compensation surveys of A/E firms.
  - The 2010 guide introduced the National Compensation Matrix (NCM), which was issued on May 8, 2012.
  - The NCM is generally updated on an annual basis and the 2025 NCM (to be used with 2024 data).

## ... AASHTO Audit Guide

- Recognizing the unique nature and complexity of FAR audit engagements, the Guide provides specific criteria to be considered in selecting a CPA firm to perform your FAR audit.
- Guidance and tools for management:
  - The Guide is very specific in indicating management's responsibility for determining a firm's overhead rate in accordance with the FAR.
  - To assist management, tools are provided to help in determining allowable or unallowable costs.

## ... Understanding FAR in Establishing Contract Terms

- Determining a FAR overhead rate is nothing new for engineering firms that have long been performing work for state DOTs.
- For other A/E firms that are beginning to perform services for the government, the complexities of the FAR can be confusing.
- Without proper guidance, firms can be at a disadvantage in negotiating contracts and can leave money on the table in their dealings with government customers.
- It is obviously critical to understand the FAR in order to prepare your firm's FAR overhead statement.
- It is equally important to understand the FAR in determining and utilizing a FAR overhead rate in establishing terms for government contracts.

## ... Don't Get Stuck with an Estimated Rate

- Many firms inexperienced in dealing with the FAR do not have a thorough understanding of their overhead rate and do not calculate disallowances under the FAR.
- Rather than properly determining an overhead rate under the FAR, these firms may end up using an estimated FAR overhead rate.
- These rates might be estimated internally or by clients such as state DOTs.
- You can be sure that, in either case, the estimates will be conservative and in favor of the client or else the client would not agree to the estimated rate!

## ... Maximizing Your FAR Overhead Rate?

- We hear many people in the industry, A/E firms, CPAs, and consultants alike talk about maximizing a firm's FAR overhead rate. But does this really make sense?
- Sure, it is critical that you properly calculate your FAR overhead rate using the correct direct labor base, including all allowable overhead, and not disallowing any items that should be allowable, thereby maximizing your firm's FAR rate within the confines of your firm's overhead rate structure.
- However, remember that on cost plus fixed fee jobs, you are only being reimbursed for your overhead and are not profiting from it, and, on some jobs, there may even be caps on your overhead rate.



## Maximizing Your FAR Overhead Rate?

- For lump sum contracts, additional overhead will definitely reduce your firm's profitability.
- Keep in mind that your goal should always be to control your firm's overhead and not incur unnecessary expenses.
- Rather than thinking about maximizing your FAR rate, it might be better to envision **minimizing the disallowances** between your actual overhead rate and your FAR overhead rate.

## ... Maximizing Your FAR Overhead Rate?

- Another important consideration is how your FAR overhead rate compares to others in the industry and in your geographic area.
- While many government contracts are awarded based solely on qualification, there are still times where a higher FAR overhead rate may actually price you out of the job.
- It can be very useful to compare your firm's FAR overhead rate to median rates within the industry.
- There is great industry data available, including FAR rates by geographic region, individual states, and firm size.

## Maximizing Your FAR Overhead Rate?

- Following is an excerpt from the 2024 PSMJ A/E Financial Performance Benchmark Survey:

Table 33  
**Overhead Rate (FAR Format)**

	<i>Overhead Rate, Government Format (FAR)</i>			
	25 <sup>th</sup> Percentile	Median	Mean	75 <sup>th</sup> Percentile
Overall	162.1%	187.2%	192.0%	218.0%
Staff Size 1 to 20	156.3	186.9	192.9	225.8
Staff Size 21 to 50	146.2	182.1	180.3	216.2
Staff Size 51 to 100	168.2	189.5	198.6	213.0
Staff Size 101 to 200	175.7	195.6	203.6	219.6
Staff Size 201 to 350	172.3	183.3	185.9	204.4
Staff Size 351 to 750	171.0	184.4	185.6	214.4
Staff Size over 750	155.1	185.4	187.9	210.2

## ... Internal Financial Statements are the First Step

- Determining an accurate FAR overhead rate starts with a properly formatted trial balance and internal financial statements.
- It is critical for an A/E firm to establish a chart of accounts that is effective for several important uses, including:
  - Billing and analysis of job profitability,
  - Preparation of effective internal financial statements, and
  - Comparisons to industry standards.
- The financial statements of the firm should be in the proper format for A/E firms.
  - Direct labor and other direct expenses are separated from indirect (overhead) expenses.
  - This quickly allows for a determination of the firm's overhead rate.
  - Compare and contrast the following sample income statements.
- Compare and contrast the following sample income statements.

# Sample Income Statement: General Format

## Sample Engineers, P.C. Traditional Income Statement For the Year Ended December 31, 2024

	<u>Amount</u>	<u>%</u>
<b>Revenue</b>	\$ 9,882,468	100.00%
<b>Cost of sales</b>	<u>1,728,362</u>	<u>17.49%</u>
<b>Gross profit(margin)</b>	<u>8,154,106</u>	<u>82.51%</u>
<b><u>Selling, general &amp; administrative expenses</u></b>		
Payroll expense	4,732,596	47.89%
Vacation, sick & holiday pay	526,847	5.33%
Payroll taxes	486,597	4.92%
Fringe benefits	426,580	4.32%
Office rent expense	333,000	3.37%
Depreciation	236,215	2.39%
Other Operating Expenses	<u>968,105</u>	<u>9.80%</u>
Total indirect expenses	<u>7,709,940</u>	<u>78.02%</u>
<b>Operating income</b>	444,166	4.49%
<b>Other income / (expense)</b>		
Interest income (expense)	(52,615)	-0.53%
Other income	<u>11,252</u>	<u>0.11%</u>
<b>Pre-tax net income</b>	402,803	4.08%
Income tax expense	<u>(120,000)</u>	<u>-1.21%</u>
<b>After-tax net income</b>	<u>\$ 282,803</u>	<u>2.86%</u>

# Sample Income Statement: A/E Format

## Sample Engineers, P.C. Income Statement - A/E Format

	For the Year Ended December 31,			
	2024		2023	
	Amount	% Net	Amount	% Net
Gross revenue	\$ 9,882,468	118.59%	\$ 10,856,901	134.50%
Reimbursable expenses	1,549,410	18.59%	2,785,074	34.50%
Net revenue	8,333,058	100.00%	8,071,827	100.00%
Direct labor	2,685,624	32.23%	2,731,584	33.84%
Direct expenses	178,952	2.15%	182,684	2.26%
Gross profit(margin)	5,468,482	65.62%	5,157,559	63.90%
<u>Indirect expenses</u>				
Indirect labor	1,696,972	20.36%	1,772,843	21.27%
Vacation, sick & holiday pay	526,847	6.32%	452,480	5.43%
Payroll taxes	486,597	5.84%	490,506	5.89%
Fringe benefits	276,580	3.32%	256,843	3.08%
Office rent expense	333,000	4.00%	333,000	4.00%
Depreciation	236,215	2.83%	234,009	2.81%
Other Operating Expenses	968,105	11.62%	984,587	11.82%
Total indirect expenses	4,524,316	54.29%	4,524,268	54.29%
Operating income	944,166	11.33%	633,291	7.85%
Other income / (expense)				
Interest income (expense)	(52,615)	-0.63%	(59,158)	-0.73%
Other income	11,252	0.14%	7,591	0.09%
Net income before discretionary items	902,803	10.83%	581,724	7.21%
Discretionary bonuses	350,000	4.20%	-	0.00%
Profit-sharing contribution	150,000	1.80%	150,000	1.86%
Pre-tax net income (loss)	402,803	4.83%	431,724	5.35%
Income tax expense	(120,000)	-1.44%	(110,000)	-1.36%
After-tax net income	\$ 282,803	0.83%	\$ 321,724	0.83%



# Internal Financial Statements are the First Step

- The chart of accounts should also be formatted to allow for a quick and efficient determination of a firm's overhead rate in accordance with the FAR.
- This might include segregating disallowed expenses into separate general ledger accounts.
- A sample FAR overhead rate calculation is shown on the following slide.

# Sample Statement of Indirect Expenses, Direct Labor and Overhead Rates per Direct Labor Dollars Incurred

	Indirect Expenses in Annual Financial Statements	Note Reference	FAR Adjustments to Indirect Expenses	Eligible Indirect Expenses in Accordance with FAR
Indirect expenses:				
Salaries and wages	\$ 250,000		\$ -	\$ 250,000
Payroll taxes and benefits	84,000		-	84,000
Rent expense	20,000		-	20,000
Depreciation	60,000	(A)	(3,000)	57,000
Advertising expense	24,000	(B)	(24,000)	-
Telephone expense	15,000		-	15,000
Insurance expense	65,000	(C)	(12,000)	53,000
Profit sharing plan	15,000		-	15,000
Business relations	5,000	(D)	(5,000)	-
Office supplies	10,000		-	10,000
Professional fees	125,000	(E)	(20,000)	105,000
Contributions	4,000	(F)	(4,000)	-
Dues and subscriptions	3,000	(G)	(1,000)	2,000
Utilities	13,000			13,000
Vehicle expense	46,000	(H)	(20,000)	26,000
Other expenses	2,000	(I)	(1,000)	1,000
Repairs and maintenance	15,000		-	15,000
Permits and licenses	6,000		-	6,000
Bad debts	3,000	(J)	(3,000)	-
Travel expense	5,000		-	5,000
Professional development	8,000	(K)	(3,000)	5,000
Interest expense	8,000	(L)	(8,000)	-
Total indirect expenses	<u>\$ 786,000</u>		<u>\$ (104,000)</u>	<u>\$ 682,000</u>
Facilities capital cost of money	<u>\$ -</u>	(M)	<u>\$ 7,000</u>	<u>\$ 7,000</u>
Direct labor	<u><u>\$ 450,000</u></u>		<u><u>\$ -</u></u>	<u><u>\$ 450,000</u></u>
Overhead rate computation on direct labor:				
Indirect expenses	174.67%			151.56%
Facilities capital cost of money	0.00%			1.56%

## ... Determining Disallowances under FAR

- In preparing FAR overhead statements, it is important that Management and the CPA auditor understand the cost principles of FAR Subpart 31.2.
- This section of FAR lists expressly unallowable costs and establishes criteria for determining the allocability and reasonableness of cost items.
- Costs are allocable to a contract as either direct costs specifically incurred for the contract or indirect costs if they are incurred for the overall operation of a firm.

## ... Determining Disallowances under FAR

- FAR 31.201-2 then provides that a cost is an allowable charge to a government contract only if the cost is:
  - Reasonable in amount;
  - Allocable to government contracts;
  - Compliant with Generally Accepted Accounting Principles and standards promulgated by the Cost Accounting Standards Board (when applicable);
  - Compliant with the terms of the contract; and
  - Not prohibited by any of FAR Subpart 31.2 cost principles.

## Common Disallowances Under FAR

- Advertising
- Bad debts
- Contributions
- Personal use of company vehicles
- Fines and penalties
- Lobbying and political activities
- Interest expense

## Common Disallowances Under FAR

- Many of these disallowances are straightforward and easy to apply. For example, some costs are not allowable and must be removed from overhead in determining the FAR overhead rate.
  - Interest expense
  - Bad debts
  - Donations
- However, there are nuances related to other disallowances that must be understood and carefully considered to avoid subtracting expenses from overhead that should be allowed under the FAR.

## Common Disallowances Under FAR

- For instance, determining the disallowance for marketing costs is open to more complex interpretation.
  - Many firms mistakenly disallow all marketing salaries as part of advertising and promotion under FAR 31.205-1.
  - However, direct sales type marketing, including bid and proposal costs, are generally allowable under FAR 31.205-18 and FAR 31.205-38.
- Maintaining proper mileage logs will also help to minimize the disallowance for personal use of company vehicles and maximize the amount of vehicle costs included in allowable overhead.
- Travel and entertainment expenses are another area where a lack of understanding and poor documentation often lead to more disallowances than might be necessary.

## Reasonable Compensation Analysis

- In addition to the above prohibited expenses, another common and sometimes significant disallowance is based on the reasonableness of compensation.
- An A/E firm is responsible for preparing an analysis to support the reasonableness of claimed compensation costs in accordance with FAR 31.205-6.
- Typically, this analysis focuses on executive positions because those positions comprise the highest compensation levels and are most likely to exceed reasonable levels.

## Reasonable Compensation Analysis

- FAR 31.205-6 indicates that compensation for personal services is allowable subject to general criteria and additional requirements, including:
  - Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages;
  - The total compensation for individual employees or job classes of employees must be reasonable for the work performed; however, specific restrictions on individual compensation elements apply when prescribed; and
  - The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

## Reasonable Compensation Analysis

- Total compensation generally includes allocable and allowable wages, salaries, bonuses, deferred compensation, and employer contributions to defined contribution pension plans.
- Individual elements of compensation must be reviewed for allowability in compliance with the FAR.
- FAR 31.205-6 distinguishes between allowability and reasonableness of compensation.
- For an element of compensation to be allowable, it must meet the FAR requirements specific to that element.

## Reasonable Compensation Analysis

- Chapter 7 of the AASHTO Guide provides a step by step approach for performing a compensation analysis.
- Factors to consider include compensation for similar executive positions and considering firms:
  - Of the same size;
  - In the same industry;
  - In the same geographic area; and
  - Engaged in similar non-government work under comparable circumstances.
- A compensation analysis should be performed using **multiple nationally published surveys**.
- Many transportation contractors have turned to the National Compensation Matrix (**NCM**) to evaluate the reasonableness of executive compensation, which was released in 2012 and is updated annually.

# Reasonable Compensation Analysis

A sample reasonable compensation analysis using the NCM is shown below.

**Figure 1: NCM Compliance Schedule**

Company name			Firm X								
Date Prepared			7/31/2024								
For costs incurred during fiscal year ended			12/31/2023								
Gross revenue from engineering consulting services			\$5,000,000.00			(revenue applicable to general engineering, and related services)					
(Steps 1 & 2)			(Step 1)			(Step 3)			(Step 4)	(Step 5)	
Position (match to NCM Job Descriptions)	Salary	Bonus	Deferred Compensation	Other Compensation	Total Compensation	Adjustment for Unallowable Activities	Adjustment for Unallowable Forms of Compensation	Compensation Subject to Reasonableness Test	NCM Amount	Adjustment: Amount in excess of NCM	Total Required Adjustment
Chief Executive Officer	\$ 275,000	\$ 65,000	\$ 32,000	\$ 23,000	\$ 395,000	\$ (18,000)	\$ (500)	\$ 376,500	\$ 366,714	\$ (9,786)	\$ (28,286)
Chief Financial Officer	214,000	22,000	18,000	28,000	282,000	(17,000)	(500)	264,500	226,750	(37,750)	(55,250)
Senior Vice President	204,000	29,376	17,000	2,584	252,960	(10,000)	(500)	242,460	238,207	(4,253)	(14,753)
Vice President	146,250	35,100	12,000	1,650	195,000	(6,900)	(200)	187,900	214,083	-	(7,100)
Vice President	146,250	38,500	9,000	1,250	195,000	(6,900)	(200)	187,900	214,083	-	(7,100)
Human Resource Director	165,000	8,000	10,000	5,000	188,000	(8,400)	(100)	179,500	132,159	(47,341)	(55,841)
TOTALS	\$ 1,150,500	\$ 197,976	\$ 98,000	\$ 61,484	\$ 677,000	\$ (67,200)	\$ (2,000)	\$ 1,438,760	\$ 1,391,996	\$ (99,130)	\$ (168,330)

## Reasonable Compensation Analysis

- Special consideration must be given to the statutory compensation cap that was implemented through the Bipartisan Budget act of 2013.
  - This cap is applicable to contracts executed on or after June 24, 2014 and may have caused some firms to have two overhead rates, depending on the execution date of the contract.
  - The NCM instructions and Q&A's have been updated to reflect this change.
  - The cap is updated annually and the amount increased to \$671,000 for the year ended December 31, 2025.

## Facilities Capital Cost of Money

- Another factor to consider is the Facilities Capital Cost of Money (“FCCM”).
- While interest expense must be subtracted from overhead, firms are allowed to calculate and add an additional amount for the FCCM determined –
  - Based on the average amount of fixed assets used in the firm’s operations
  - multiplied by*
  - The prorated average Prompt Payment Act Interest Rate determined by the U.S. Secretary of the Treasury.
- Although the FCCM generally is computed as a rate based on direct labor cost, the FCCM should not be included as part of the overhead rate, but must be separately stated on the overhead schedule.

## Facilities Capital Cost of Money

- The FCCM can be part of the overhead charged to the customer if it is appropriately included in the terms of the contract.
- Following is a sample of the FCCM calculation from the AASHTO Guide:

### 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	<u>700,000</u>
Average Net Book Value	\$ 650,000
Multiplied by: Average Treasury Rate	<u>3.19%<sup>45</sup></u>
Equals: Facilities Capital Cost of Money	\$ 20,735
Divided by: Direct Labor Cost	<u>3,250,250</u>
Equals: Facilities Capital Cost of Money Rate	<u><u>0.63%</u></u>

*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.*

## Recording Direct and Indirect Labor

- While the focus of FAR audits is often on overhead expenses and disallowances, an A/E firm is also required to have **project-costing** and **labor-charging** systems that properly account for direct and indirect labor costs.
- This is critical and will be tested in a FAR audit as direct labor is the basis for a firm's overhead rate.
- To determine an accurate overhead rate, payroll costs must be **correctly** and **consistently** allocated between **direct** and **indirect labor**.
- A critical component is establishing and maintaining effective procedures for time sheet preparation, review, and approval.

## Accounting for Overtime

- **Uncompensated overtime** for salaried employees must be accounted for by either:
  - The effective rate method, or
  - The salary variance method.
- Specific guidance also applies to **overtime premium**.
  - Consultants must maintain records that segregate overtime premium amounts and classify them as direct or indirect costs.
  - Consultants must establish overtime policies that are applied consistently and result in equitable cost allocations.
  - Consultants must treat overtime premium costs consistently for all contracts, regardless of the customer (government versus commercial) or type of contract involved.

## Office and Field Overhead Rates

- A/E firms might be required to calculate separate Office and Field overhead rates:
  - If they meet some size threshold, often for net revenue
  - When it is specified in contract terms
- Types of field offices include:
  - Construction contract administration/Construction inspection,
  - Project office,
  - “On Call” Engineers, and
  - Contract Employees
- Field overhead rates will be lower as field offices do not require all of the same costs necessary as at the home office

# Sample FAR Overhead Calculation with Field Rate

	Expenses in Annual Financial Statements	Note Reference	FAR Adjustments to Indirect Expenses	Indirect Expenses in Accordance with FAR	Allocations		Percent to Field Office
					Home Office	Field Office	
Indirect expenses:							
Salaries and wages	\$ 1,080,000		\$ -	\$ 1,080,000	\$ 917,522	\$ 162,478	15.04%
Payroll taxes and benefits	568,000		-	568,000	482,549	85,451	15.04%
Rent expense	380,000		-	380,000	361,000	19,000	5.00%
Depreciation	140,000	(A)	(8,000)	132,000	117,000	15,000	Specific
Advertising expense	65,000	(B)	(65,000)	-	-	-	15.04%
Telephone and computer expense	82,000		-	82,000	77,900	4,100	5.00%
Insurance expense	132,000	(C)	(12,000)	120,000	114,000	6,000	5.00%
Profit sharing plan	120,000		-	120,000	110,000	10,000	Specific
Marketing and business relations	46,000	(D)	(28,000)	18,000	17,100	900	5.00%
Office supplies	126,000		-	126,000	126,000	-	0.00%
Professional fees	68,000	(E)	(12,000)	56,000	47,575	8,425	15.04%
Contributions	34,000	(F)	(34,000)	-	-	-	N/A
Dues and subscriptions	26,000	(G)	(3,000)	23,000	23,000	-	0.00%
Utilities	76,000			76,000	72,200	3,800	5.00%
Vehicle expense	66,000	(H)	(20,000)	46,000	32,200	13,800	30.00%
Other expenses	28,000	(I)	(1,000)	27,000	22,938	4,062	15.04%
Repairs and maintenance	32,000		-	32,000	27,186	4,814	15.04%
Permits and licenses	6,000		-	6,000	5,097	903	15.04%
Field supplies	17,000		-	17,000	-	17,000	100.00%
Bad debts	24,000	(J)	(24,000)	-	-	-	N/A
Travel expense	19,000		-	19,000	19,000	-	0.00%
Professional development	42,000	(K)	(6,000)	36,000	36,000	-	0.00%
Interest expense	<u>31,000</u>	(L)	<u>(31,000)</u>	<u>-</u>	<u>-</u>	<u>-</u>	N/A
Total indirect expenses	<u>\$ 3,208,000</u>		<u>\$ (244,000)</u>	<u>\$ 2,964,000</u>	<u>\$2,608,267</u>	<u>\$ 355,733</u>	
Facilities capital cost of money	<u>\$ -</u>	(M)	<u>\$ 14,000</u>	<u>\$ 14,000</u>	<u>\$ 10,000</u>	<u>\$ 2,000</u>	Specific
Direct labor	<u>\$ 2,260,000</u>		<u>\$ -</u>	<u>\$ 2,260,000</u>	<u>\$1,920,000</u>	<u>\$ 340,000</u>	15.04%
Overhead rate computation on direct labor:							
Indirect expenses	<u>141.95%</u>			<u>131.15%</u>	<u>135.85%</u>	<u>104.63%</u>	
Facilities capital cost of money	<u>0.00%</u>			<u>0.62%</u>	<u>0.52%</u>	<u>0.59%</u>	

## ... Management Responsibilities for FAR Overhead Statements

- The AASHTO Guide clearly indicates that management must not rely on the CPAs end-of-year audit testing as the sole method for detecting unallowable costs.
- Management bears the responsibility for identifying, segregating, and removing unallowable costs from all billings to government contracts.
- This requirement applies to direct costs, indirect costs and any cost proposals that are submitted for government contracts.

## ... Management Responsibilities for FAR Overhead Statements

- In establishing a sufficient internal control system, an A/E firm must train accounting staff, including payables clerks and staff members responsible for preparing project billings, in the FAR Subpart 31.2 cost principles so that, as transactions occur, unallowable cost items can be:
  - Identified;
  - Segregated; and
  - Disallowed.
- This is critical as too often we see that firms do not know if their FAR overhead rate has increased or decreased from the prior year and, therefore, whether the amounts used in contracts are understated or overstated.

## ... Management Responsibilities for FAR Overhead Statements

- Even if a firm cannot always segregate its disallowances during the year, Management should be able to estimate its FAR overhead rate by understanding the relationship to the overall firm overhead rate.
- If a firm historically has an overhead rate of 160% and disallowances under the FAR average 12%, this information can be used to estimate the FAR overhead rate if, for example, the overall overhead rate increases to 170% or decreases to 150%.
- This will help to reduce surprises when preparing for the annual FAR audit and allow a firm to better negotiate contracts as unexpected changes in the FAR overhead rate can often cost a firm real dollars.

## ... Choosing a CPA Audit Firm

- An A/E firm should exercise a proper level of due diligence in selecting a CPA to perform its FAR audit.
- FAR overhead statements are unique, and FAR audits should be performed by a CPA that is:
  - Experienced in working with A/E firms, **and**
  - Experienced in performing FAR audits.
- FAR audits must be performed in accordance with Generally Accepted Government Audit Standards (“GAGAS”), which are different than Generally Accepted Auditing Standards (“GAAS”) and require specialized training.

## ... Choosing a CPA Audit Firm

- The AASHTO Guide believes this matter to be so important that it has a section providing specific criteria to consider in selecting a CPA.
- Among other factors, the Guide indicates that the CPA should:
  - Meet all GAGAS requirements, including requirements for adequate continuing professional education (CPE) credits in governmental auditing;
  - Have received favorable peer review reports;
  - Be well versed in GAGAS, the provisions of FAR Part 31, Cost Accounting Standards, related laws and regulations, and the guidelines and recommendations set forth in the Guide.

## ... Choosing a CPA Audit Firm

- Have a working knowledge of the A/E industry, including common operating practices, trends, and risk factors;
- Be well versed in job-cost accounting practices and systems used by A/E firms;
- Assign direct supervisory staff to the engagement who have prior experience performing overhead audits in compliance with FAR Part 31;
- Have experience performing FAR audits and have knowledge of government procurement with regard to various types of contracts and contract payment terms affecting the development and/or application of an allowable overhead rate; and
- Design and execute an audit program that meets the AICPA's professional standards, as well as the specific testing recommendations described in the Guide.

# Sample Peer Review Report

## Report on the Firm's System of Quality Control

March 27, 2021

To the Partners of Dannible & McKee, LLP and  
the National Peer Review Committee

We have reviewed the system of quality control for the accounting and auditing practice of Dannible & McKee, LLP (the firm) applicable to engagements not subject to PCAOB permanent inspection in effect for the year ended September 30, 2020. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants (Standards).

A summary of the nature, objectives, scope, limitations of, and the procedures performed in a System Review as described in the Standards may be found at [www.aicpa.org/orsummary](http://www.aicpa.org/orsummary). The summary also includes an explanation of how engagements identified as not performed or reported in conformity with applicable professional standards, if any, are evaluated by a peer reviewer to determine a peer review rating.

### Firm's Responsibility

The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. The firm is also responsible for evaluating actions to promptly remediate engagements deemed as not performed or reported in conformity with professional standards, when appropriate, and for remediating weaknesses in its system of quality control, if any.

### Peer Reviewer's Responsibility

Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review.

### Required Selections and Considerations

Engagements selected for review included engagements performed under *Government Auditing Standards*, including a compliance audit under the Single Audit Act, audits of employee benefit plans, an audit of a broker dealer, and an examination of a service organization (SOC 1).

As a part of our peer review, we considered reviews by regulatory entities as communicated by the firm, if applicable, in determining the nature and extent of our procedures.

### Opinion

In our opinion, the system of quality control for the accounting and auditing practice of Dannible & McKee, LLP applicable to engagements not subject to PCAOB permanent inspection in effect for the year ended September 30, 2020, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of pass, pass with deficiency(ies), or fail. Dannible & McKee, LLP has received a peer review rating of pass.

*Goff Backa Alfera & Company, LLC*  
GOFF BACKA ALFERA & COMPANY, LLC

## ... Performing a FAR Audit

- FAR audits include many of the same requirements as financial statement audits under Generally Accepting Auditing Standards (“GAAS”), regardless of the size of the A/E firm.
- The CPA must:
  - Follow AICPA professional standards; and
  - Obtain sufficient, appropriate audit evidence to support the opinion that the overhead schedule was prepared in compliance with FAR Subpart 31.2 cost principles.
- The FAR audit must be performed in accordance with GAGAS.

## ... Timing of a FAR Audit

- A FAR audit is a very thorough process that will likely take 100-150 hours for small to mid-sized A/E firms.
- Audits of larger or more complex entities will require additional time.
- Also, more hours might be needed for firms that are not well organized!

## Specific Requirements of a FAR Audit

- Execute an engagement letter that clearly specifies the type of engagement to be performed and the roles of each party.
- Understand the environment and the operations of the consultant.
- Understand and test internal controls.
  - The AASHTO Audit Guide provides a standard internal control questionnaire used by State departments of transportation.
- Assess risk, including potential fraud risks.

## Specific Requirements of a FAR Audit

- Perform substantive tests regarding the overhead report.
  - Test overhead costs and potential disallowances.
  - Test payroll processing and posting between direct and indirect wages.
  - Test compensation for reasonableness.
- Supervision and review of documentation.
- Summarize the audit findings.
- Develop the report and communication of compliance issues and internal control matters.

# Sample FAR Overhead Audit Report

## Independent Auditor's Report

Month XX, 2024

To the Board of Directors  
of Sample Company,

### Opinion

We have audited the accompanying Statement of Indirect Expenses, Direct Labor and Overhead Rates Per Direct Labor Dollars Incurred (the "Statement") of Sample Company (the "Firm"), for the year ended Month XX, 2023, and the related notes to the Statement.

In our opinion, the accompanying Statement referred to above presents fairly, in all material respects, the indirect expenses, direct labor and overhead rates per direct labor dollars incurred of the Firm for the year ended December 31, 2023, in accordance with accounting practices prescribed by Part 31 of the Federal Acquisition Regulation ("FAR") described in Note 1.

### Basis of Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America ("U.S. GAAS") and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. Our responsibilities under those standards are further described in the Auditors' Responsibilities for the Audit of the Statement section of our report. We are required to be independent of the Firm and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### Emphasis of Matter - Basis of Accounting

We draw attention to Note 1 of the Statement, which describes the basis of accounting. As described in Note 1, the Statement prepares its financial statements using accounting practices prescribed or permitted by Part 31 of the FAR to demonstrate compliance with Part 31 of the FAR's regulatory basis of accounting and budget laws, which practices differ from accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

## Responsibilities of Management for the Statement

Management is responsible for the preparation and fair presentation of the Statement in accordance with accounting practices prescribed by Part 31 of the FAR, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of the Statement that is free from material misstatement, whether due to fraud or error.

## Auditors' Responsibilities for the Audit of the Statement

Our objectives are to obtain reasonable assurance about whether the Statement as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and, therefore, is not a guarantee that an audit conducted in accordance with U.S. GAAS and *Government Auditing Standards* will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the Statement.

In performing an audit in accordance with U.S. GAAS and *Government Auditing Standards*, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the Statement, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the Statement.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Firm's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the Statement.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

## Restriction on Use

This report is intended solely for the information and use of the Board of Directors, Stockholders and management of the Firm and government agencies, or other customers related to contracts employing the FAR cost principles and is not intended and should not be used by anyone other than these specified parties.

## Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated Month XX, 2024, on our consideration of the Firm's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts, including provisions of the applicable sections of Part 31 of the FAR. The purpose of that report is solely to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Firm's internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Firm's internal control over financial reporting and compliance.

## Internal Control and Compliance Report

- In addition to the FAR overhead statement, the CPA firm is required to prepare a separate report on internal controls and compliance.
- This is a requirement in accordance with GAGAS.
- The internal controls will focus on control deficiencies related to payroll, cash disbursements, and other transactions impacting the FAR overhead statement.
- The compliance report will address the A/E firm's compliance with government regulations, including FAR Part 31 and related laws.

# Sample Internal Control and Compliance Report

## Independent Auditor's Report on Internal Controls Over Financial Reporting and Compliance

Month XX, 2024

To the Board of Directors of  
Sample Company,

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, the Statement of Indirect Expenses, Direct Labor, and Overhead Rates Per Direct Labor Dollars Incurred (the "Statement") of Sample Company (the "Firm") as of December 31, 2023 and the related notes to the Statement and have issued our report thereon dated Month XX, 2024.

### **Report on Internal Control Over Financial Reporting**

In planning and performing our audit of the Statement, we considered the Firm's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the Statement, but not for the purpose of expressing an opinion on the effectiveness of the Firm's internal control. Accordingly, we do not express an opinion on the effectiveness of the Firm's internal control.

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 and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's Statement will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

### **Report on Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Firm's Statement is free from material misstatement, we performed tests of the Firm's compliance with certain provisions of laws, regulations and contracts, including provisions of the applicable sections of 48 Code of Federal Regulations ("CFR") by Part 31 of the Federal Acquisition Regulation ("FAR"), noncompliance with which could have a direct and material effect on the determination of the amounts reported on the Statement. 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*.

### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Firm's internal control and compliance. This report is intended solely for the use and information of the Firm and government agencies, or other customers related to contracts, employing the cost principles of the FAR and should not be used by anyone other than these specified parties.

## Conclusion

- Performing services for government clients can be a profitable opportunity for A/E firms that understand the complexities of working with Federal, state and other government entities.
- One such complexity is the requirement that Management determine an overhead rate in accordance with the FAR.
- An A/E firm may also need to contract with a CPA firm to provide an audit of the firm's FAR overhead rate.
- Management must make certain that it has a thorough understanding of the FAR and the AASHTO Guide.

## Conclusion

- An A/E firm may also consider aligning itself with a consulting firm with expertise in the FAR to provide training and assistance where necessary.
- If a FAR audit is required, it is critical that an A/E firm hire a properly qualified CPA based on the criteria specified in the AASHTO Guide.



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# Questions



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