

**OVERSIGHT OF DESIGN AND ENGINEERING  
FIRMS' INDIRECT COSTS CLAIMED  
ON FEDERAL-AID GRANTS**

***FEDERAL HIGHWAY ADMINISTRATION***

***Report Number: ZA-2009-033***

***Date Issued: February 5, 2009***



# Memorandum

**U.S. Department of  
Transportation**

Office of the Secretary  
of Transportation  
Office of Inspector General

Subject: **ACTION:** Report on Oversight of Design and  
Engineering Firms' Indirect Costs Claimed on  
Federal-aid Grants  
Federal Highway Administration  
Report Number ZA-2009-033

Date: February 5, 2009

From: Mark H. Zabarsky *Mark H. Zabarsky*  
Assistant Inspector General for  
Acquisition and Procurement Audits

Reply to  
Attn. of: JA-60

To: Acting Federal Highway Administrator

This report provides the results of our audit of the implementation of Section 307 of the National Highway Systems Designation Act (NHSDA). These provisions are intended, in part, to ensure that design and engineering (D&E) firms' indirect cost rates do not contain unallowable costs.<sup>1</sup> We began this audit because of concerns expressed by state transportation officials regarding the allowability of executive compensation and other indirect costs at some D&E firms. Our audit objectives were to evaluate the implementation of NHSDA Section 307 audit requirements, and test the allowability of executive compensation and other high risk indirect cost elements billed by D&E firms on state departments of transportation (DOT) contracts. The Federal Highway Administration (FHWA) is responsible for providing direction for, and overseeing the implementation of, the audit provisions in Section 307.

During the 7-year period ending 2004, under the Transportation Equity Act for the 21st Century, FHWA awarded an average of \$30.6 billion, annually, in Federal-aid highway grants (Federal-aid) to state DOTs. Of that amount, state DOTs paid about \$4 billion to more than 3,500 D&E firms for the design of highways, bridges, and related infrastructure; and construction inspection and management. About \$1.4 billion, 35 percent, was paid for indirect costs, the balance for direct-charge engineering work.

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<sup>1</sup> Unallowable costs are those that under the provisions of any pertinent law, regulation, or contract cannot be included in price, cost reimbursement, or settlement under a Government contract.

In conjunction with the Defense Contract Audit Agency (DCAA), we examined 41 D&E firms for executive compensation out of the statistically sampled universe of 3,580 firms. We also examined other indirect costs at 9 of the 41 firms. Exhibit A details our audit scope and methodology. We performed this audit in accordance with generally accepted government auditing standards as prescribed by the Comptroller General of the United States.

## **BACKGROUND**

The provisions of Section 307 of NHSDA, passed by Congress in 1995: (1) require the use of the Federal Acquisition Regulation (FAR) as criteria to determine cost allowability when performing indirect cost rate audits of D&E firms; (2) eliminate duplicate audits of D&E firms by multiple audit entities; and (3) remove ceilings established by certain states for indirect rates, salaries, and bonuses. Regulatory requirements for implementing Section 307 are found in 23 Code of Federal Regulation (CFR) 172.

Indirect rates are comprised of costs such as executive compensation; employee fringe benefits and wages; facilities charges; and insurance, legal, consultant, and travel costs. State DOTs use indirect cost rates, in part, for reimbursing D&E firms for allowable costs incurred. Also, these rates are used when establishing final contract costs, and they provide the historical cost basis for estimating and negotiating new contracts.

Audits of D&E firms' indirect cost rates are critical to detect fraud and protect taxpayer funds as the firms' Federal-aid contracts are exempt from price competition. D&E firms must be selected on qualifications alone; price and other contract terms are negotiated only with the most highly qualified firm.<sup>2</sup> Similar audits on indirect cost rates of Federal contracts save, on average, more than four times their cost.

FHWA is responsible for establishing an oversight program to monitor the effective use of Federal-aid funds and, since the passage of the Intermodal Surface Transportation Equity Act in 1991, has increasingly delegated this responsibility to state DOTs. FHWA, regardless of the project responsibilities delegated to the states (or other Federal agencies), is ultimately responsible for all Federal highway programs and provides assurances that Federal-aid funds are expended in a manner consistent with applicable Federal laws and regulations.

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<sup>2</sup> The Brooks Act, 40 United States Code 1101 through 1104, requires that contracts for architectural and engineering services be negotiated on the basis of demonstrated competence and qualification at fair and reasonable prices.

## RESULTS IN BRIEF

We found that indirect cost rate claims from 21,<sup>3</sup> of our sample of 41, D&E firms included unallowable costs—some expressly unallowable<sup>4</sup>—totaling about \$15.7 million. Of that amount, state DOT contracts were charged about \$5.5 million, of which about \$4.4 million—the Federal share—was reimbursed with Federal-aid funds.<sup>5</sup> Examples of unallowable costs we found were:

- \$301,667 for 45 automobile leases—5 of which were luxury class including Mercedes, BMW, and Lexus—with no documented business purpose.
- \$280,609 in executive compensation in excess of the Federal statutory cap.<sup>6</sup>
- \$247,685 for items such as social dinners with clients; dining club memberships; outings to professional and college sporting events; theme and holiday parties; and trips to Atlantic City, a city zoo, and a county expo fair.

Lack of accountability at D&E firms and insufficient transaction testing by Certified Public Accountant (CPA) firms were the immediate causes of unallowable costs we found. Further, FHWA and state DOT oversight did not ensure effective monitoring of D&E firms' indirect cost rate claims or indirect cost rate audits performed by CPA firms. FHWA relies on state DOTs to implement Section 307 but has not collected sufficient information to properly evaluate the states' implementation efforts. For example, FHWA did not know how well states performed oversight or whether indirect cost rate audits met the intent of Section 307 requirements. FHWA must improve its monitoring of state DOTs to identify and resolve implementation problems.

### D&E Firms Included Significant Unallowable Costs in Indirect Cost Rate Claims

D&E firms are required to support that claimed costs for reimbursement on state DOT contracts comply with FAR cost principles, and remove unallowable costs

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<sup>3</sup> The 21 firms include 20 that had “unallowable executive compensation” costs, of which 7 also had “other unallowable costs.” One of the 21 firms just had “other unallowable costs.”

<sup>4</sup> An expressly unallowable cost is one that is specified by statute or regulation as being unallowable.

<sup>5</sup> The \$5.5 million represents the portion of D&E firms' unallowable costs allocated to all state DOT contracts, both federally and non-federally funded. Most Federal-aid projects are reimbursed 80 percent with states or other allowable sources being responsible for the balance. Federal participation on projects such as Federal Lands and Emergency Relief can go as high as 100 percent. To conservatively estimate the Federal share of the unallowable costs, we used 80 percent of the \$5.5 million, which is approximately \$4.4 million.

<sup>6</sup> Section 808 of Public Law 105–85, Fiscal Year (FY) 1998 Defense Authorization Act, directed that the Office of Federal Procurement Policy set an annual cap for executive compensation costs that will be allowable under Federal contracts. For D&E firms' FY 2003, the cap was set at \$405,273.

from their indirect cost rate claims. We found that D&E firms did not remove significant unallowable costs and claimed reimbursement for such costs in the millions of dollars.

Contractors, such as D&E firms, receiving state contracts paid with Federal-aid funds are not required to certify that no known unallowable costs were charged to the Government; therefore, they have less incentive to remove these costs. In contrast, contractors awarded contracts by the Federal Government are required to provide such certification and can be assessed penalties if unallowable costs are knowingly claimed. We found that one firm was required to prepare both Federal and state DOT claims using the same cost principles in FAR, Part 31. Accordingly, the indirect costs claimed as “allowable” should have been identical. When the firm had to certify that the claim contained no known unallowable costs for the Federal Government, however, it identified and removed \$1.6 million in unallowable costs that should have been excluded from its state claim, but were not. Requiring certification from D&E firms receiving Federal-aid funds, and assessing penalties on those who knowingly claim unallowable costs, would encourage compliance with regulations and deter D&E firms from claiming unallowable costs.

### **CPA Firms Did Not Perform Sufficient Transaction Testing**

We found that CPA firms’ indirect cost rate audits were not sufficient in transaction testing when determining the allowability of costs included in D&E firms’ indirect cost rate submissions. As a result, the CPA firms missed significant unallowable costs that should have been detected. For example, our review at one D&E firm found more than \$950,000 of unallowable costs including a political contribution, alcohol, and spa resort charges. These costs were not questioned by the CPA firm because it limited its review only to costs the D&E firm identified and removed from the indirect cost rate claim as unallowable.

State auditors from nine states also raised concerns—via unsolicited comments during our audit—about the quality of work performed by CPA firms. To illustrate, an audit supervisor at one state audit office commented, “We believe that getting reliable audits from private CPA firms on a consistent basis is an unrealistic expectation.” The state auditor further added, “Because the consulting firm is engaging the CPA and paying the bill, most CPA firms will exploit the lack of well defined expectations to the benefit of the consulting firm rather than the government.” Our work, coupled with comments by state auditors, raises questions about the reliability of CPA firms’ audit work. We concluded the following contributed to problems identified in CPA firms’ audit work:

- D&E firms did not hire CPA firms qualified to perform indirect cost rate audits. Instead, they hired firms with whom they had existing

relationships—those that performed financial statement audits or prepared corporate tax returns.

- CPA firms did not have relevant training, related to cost principles in FAR, for effectively performing FAR indirect cost rate audits. For example, six of the nine CPA firms we reviewed did not have training related to FAR Part 31 cost principles. Professional auditing standards require audit organizations to ensure staff members collectively possess the necessary technical knowledge, skills, and experience before beginning work on an assignment.
- FHWA did not clearly define and communicate the specific roles, responsibilities, and requirements for state DOTs regarding the oversight and acceptance of the work of CPA firms hired by D&E firms.

We provided FHWA a draft of this report on October 29, 2008, and on January 14, 2009 we received FHWA's response. We recommend that FHWA: (1) require D&E firms to certify their claims and authorize state DOTs to assess penalties when D&E firms claim known unallowable costs; (2) assign responsibility to specific states for overseeing CPA audit work; (3) issue guidance on how to effectively procure audit services; and (4) establish an oversight program and process for monitoring state DOTs' implementation of Section 307 of NHSDA. If fully implemented, these recommendations could put approximately \$30.2 million in future Federal-aid funds to better use and reduce the risk of paying unallowable costs on state DOT D&E firm contracts.

FHWA generally concurred with our recommendations, stating that it is committed to improving the overall stewardship and oversight of the procurement, management, and administration of engineering consultant service contracts. FHWA stated that they are currently working closely with state DOTs' and industry's representatives to make the necessary program management changes to eliminate unallowable costs. A complete list of recommendations can be found starting on page 12 of this report. FHWA's response can be found in its entirety in the appendix.

## **FINDINGS**

### **D&E Firms Included Significant Unallowable Costs in Indirect Cost Rate Claims**

FAR cost principles require contractors to identify unallowable costs in their accounting records and exclude them from their annual indirect cost rate claims.

We found D&E firms typically did not remove significant costs as unallowable in their claims—in some cases, costs expressly forbidden by Federal statute and regulations, such as entertainment, donations, and alcohol. Indirect cost rate submissions are used, in part, to establish final rates for reimbursement under cost-type contracts. Inflated indirect cost rates could result in harm to the Government due to over billing on Government contracts.

To assess the risk that D&E firms may be over billing on state DOT contracts, we reviewed the allowability of executive compensation and other indirect costs claimed by D&E firms. We identified unallowable costs claimed by 21 of 41 D&E firms of about \$15.7 million (the Federal share charged to state DOT contracts is \$4.4 million). Of the \$15.7 million, about \$10.7 million (table 1) were unallowable executive compensation and about \$5 million (table 2) were other unallowable costs.

**Unallowable Executive Compensation Claimed in Indirect Cost Rates.** Our analysis of a statistical sample of 41 D&E firms identified 20 firms billing Federal-aid contracts for unallowable executive compensation of approximately \$10.7 million. The Federal share of the \$10.7 million charged to state DOT contracts is \$2.8 million. See table 1 for details. Four firms billed Federal-aid contracts so excessively that a portion of the amounts even exceeded the Federal statutory cap by \$280,609 (see footnote 6 for further details on the statutory cap). We also identified two firms that included unallowable items in their executive compensation charges with a total value of about \$1 million. These charges were associated with bonuses tied to the market value of company stocks, out-of-period deferred compensation, forgiving a loan to an officer, and one firm claiming costs attributable to another division—all explicitly prohibited by FAR.

**Table 1. Unallowable Executive Compensation**

<b>Types of Unallowable Costs</b>	<b>Number of Firms</b>	<b>Total Unallowable</b>	<b>State DOT Portion (Note 1)</b>
Unreasonable	20	\$9,421,299	\$3,282,096
Exceeds Federal Cap	4	280,609	69,626
Other	2	<u>961,594</u>	<u>172,626</u>
<b>Total</b>	(Note 2)	<b><u>\$10,663,502</u></b>	<b><u>\$3,524,348</u></b>
<b>Federal Share Charged to State DOT Contracts (Note 3)</b>			<b><u>\$2,819,478</u></b>
Note 1: The \$3,524,348 represents the portion of D&E firms' indirect costs allocated to state DOT contracts. The remaining \$7,139,154 (\$10,663,502 – \$3,524,348) represents the portion allocated to D&E firms' business, other than state DOTs.			
Note 2: We did not total the number of firms because some had multiple types of unallowable costs. Specifically, the four firms that had executive compensation exceeding the cap also had unreasonable costs. The two firms that had other unallowable costs also had unreasonable costs. One firm had all three types of unallowable costs.			
Note 3: The \$2,819,478 represents 80 percent of the \$3,524,348 state DOT portion of the unallowable costs. See footnote 5, page 3, for further explanation of the 80 percent.			

Based on the sample test results, we projected that, overall, D&E firms overcharged state DOT contracts for unallowable compensation of \$41.2 million<sup>7</sup> (the Federal share charged to state DOT contracts is \$32.9 million).<sup>8</sup> We used the projected sample mid-point to estimate the impact of excessive executive compensation for this report. Upper and lower confidence limits were calculated at a 95 percent confidence level—meaning that chances are 9.5 out of 10 that actual excessive executive compensation would fall within the lower (\$9.4 million) and upper (\$73 million) confidence limits if all 3,580 D&E firms were reviewed. The range between the upper and lower confidence limits is large because D&E firms' excessive executive compensation amounts varied greatly—from \$0 to almost \$1 million, with about half having no excessive executive compensation.

<sup>7</sup> \$41,170,410 is the midpoint of the projection of the audit findings for the 3,580 D&E firms that received payments from state DOTs. The projection based on a 95 percent confidence level resulted in a margin of error of \$31,783,261, which can also be expressed as  $\pm 77.2$  percent. See Exhibit A, page 16, for the calculation of the unallowable executive compensation used as the base amount for the projection to the universe.

<sup>8</sup> The Federal share of \$32.9 million was computed by multiplying the total projection of \$41,170,410 by the Federal share, 80 percent, explained in footnote 5. ( $\$41,170,410 \times .8 = \$32,936,328$ .)

By implementing the recommendations in this report, FHWA could put approximately \$30.2 million<sup>9</sup> in future Federal-aid funds to better use.

**Other Unallowable Costs Claimed in Indirect Cost Rates.** We judgmentally selected nine of the larger D&E firms in our sample, and reviewed the allowability of indirect costs more susceptible to unallowable charges, such as travel, employee welfare, consultants, and in-house meetings (see table 2). Eight firms had unallowable costs, some expressly unallowable, included in their indirect rate claims, representing a significant problem in the millions of dollars.

**Table 2. Other Unallowable Costs**

<i>Indirect Costs</i>	<i>Number of Firms</i>	<i>Total Unallowable</i>	<i>State DOT Portion</i>
Entertainment, Alcohol, and Employee Morale	6	\$355,958	\$217,162
Personal Income Taxes	1	355,767	234,806
Pensions	2	740,000	278,400
Travel-Auto/Lodging/Meals	3	435,566	294,440
Consultant/Professional Fees	3	254,196	58,507
Other Unallowable Charges	5	101,873	57,877
Unsupported Costs	5	449,624	346,706
Direct Charges	3	<u>714,082</u>	<u>236,930</u>
<b>Subtotal</b>		<b>\$3,407,066</b>	<b>\$1,724,828</b>
Costs Claimed Due to Lack of Certification	1	<u>1,639,814</u>	<u>208,256</u>
<b>Total</b>		<b><u>\$5,046,880</u></b>	<b><u>\$1,933,084</u></b>
<b>Federal Share Charged to State DOT Contracts</b>			<b><u>\$1,546,467</u></b>

Examples of unallowable costs identified in table 2:

- \$301,667 for 45 automobile leases—5 of which were luxury class including Mercedes, BMW, and Lexus—with no documented business purpose. See Exhibit B, number 4 for details.
- \$247,685 for items such as social dinners with clients; dining club memberships; outings to professional and college sporting events; theme

<sup>9</sup> We calculated the \$30.2 million by subtracting \$2.7 million from the \$32.9 million (discussed in footnote 8). The \$2.7 million represents the Federal share (80 percent) of the \$3,351,722 unreasonable executive compensation (\$3,282,096 in table 1) and executive compensation that exceeds the Federal cap (\$69,626 in table 1).

and holiday parties; and trips to Atlantic City, a city zoo, and a county expo fair. See Exhibit B, number 1 for details.

- \$60,000 paid to a consultant based on a verbal agreement. See Exhibit B, number 5 for details.
- \$19,956 in travel costs for a project managers' meeting held at a spa resort with no evidence to support costs. See Exhibit B, number 4 for details.
- \$5,153 for non-business-related air travel by a firm's president and his wife. See Exhibit B, number 4 for details.
- \$914 for a 2-night hotel stay not supported by a hotel receipt or business purpose. See Exhibit B, number 4 for details.

Exhibit B gives complete details of our findings of other unallowable costs included in table 2.

### *Lack of Accountability Contributed to Significant Unallowable Costs Being Claimed*

Federal Government contractors are required to certify<sup>10</sup> that no known unallowable costs have been charged to the Government, and can be assessed monetary penalties if they falsely certify or include known unallowable costs in an indirect cost rate claim. To the contrary, neither FHWA nor any states have such requirements on state DOT contracts. Consequently D&E firms have less incentive to ensure that these costs are removed from their state DOT indirect cost rate claims. Including similar sanctions in state DOT contracts would place the burden on D&E firms to remove unallowable costs, rather than state governments. This would hold D&E firms accountable and help ensure tax dollars are not wasted.

Given the billions of dollars in Federal-aid funds spent annually, it is essential that D&E firms are held accountable so as to mitigate the Government's risk. For example, when a D&E firm was required to prepare both Federal and state DOT claims using the same cost principles in FAR, Part 31, the indirect costs claimed as "allowable" should have been identical. The firm was required to certify that the Federal claim contained no known unallowable costs, and it identified and removed \$1.6 million in unallowable costs that also should have been excluded from its state DOT claim, but were not. Had the firm been required to certify the allowability of costs, and been subject to penalties on its state DOT contracts, the

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<sup>10</sup> FAR 42.703-2, titled "Certificate of Indirect Costs," implements 10 United States Code 2324(h) and 41 United States Code 256(h).

D&E firm may have more tightly scrutinized its state DOT indirect cost rate claim. FHWA must direct state DOTs to require D&E firms to certify that all indirect costs are allowable, and authorize states to assess penalties when contractors knowingly claim unallowable costs. In our opinion, implementing such requirements would reduce the risk of unallowable costs being billed to state DOT contracts.

### **CPA Audits Did Not Consistently Identify Unallowable Executive Compensation and Other Unallowable Costs**

NHSDA requires that cost principles contained in FAR be used when performing indirect cost rate audits of D&E firms. These principles provide criteria for determining the allowability of costs for reimbursement on Government contracts. Generally, states allow D&E firms to engage CPA firms to perform indirect cost rate audits. While CPA firms attest that they use the cost principles contained in FAR, state DOT auditors have raised concerns about the quality of such audits. Specifically, auditors from nine states provided unsolicited comments during our audit that they saw little value in the work these CPA firms performed. For example, one state audit office remarked that CPA firms not well versed in FAR cost principles may exclude from review accounts that have a high inherent risk—accounts subject to material unallowable costs. They went on to say that, in many cases, these accounts are not adequately tested by CPA firms and, ultimately, unallowable costs remain in indirect cost rate claims. Another state audit office believed that CPA audits are not reliable and, in most instances, CPAs relied too heavily on internal controls and severely limited their testing of questionable costs.

We also assessed the adequacy of work performed by nine CPA firms and found similar problems with their audits. For example, one firm's transaction tests were limited to those transactions that the D&E firm voluntarily removed as unallowable costs from its indirect rate. The CPA firm did this limited testing to determine if the Government could have been billed for more. They did not assess other costs for their allowability to determine if the Government had been over billed. Without sufficient transaction testing, there is no assurance that excessive contractor indirect costs are not priced into, or reimbursed on, Government contracts. In this case, we identified more than \$950,000 in unallowable costs missed by the CPA firm. These costs included a political contribution, alcohol, and spa resort charges.

CPA firms are responsible for testing the work that the D&E firms have performed. Improving the quality of these audits also would reduce the risk of errors going undetected. For instance, at one D&E firm in our sample, two CPA firms conducted annual indirect cost rate audits and neither detected double billing of corporate office costs throughout a 6-year period, totaling \$33 million (\$24.8

million of which was included in indirect rates). Reconciling the firm's indirect rate claims to the underlying accounting records—a basic and mandatory audit step performed by DCAA—could have found this double billing.

### *Factors Contributing to CPA Firms Not Identifying Unallowable Costs in Indirect Rate Claims*

The following factors contributed to the weaknesses we identified in the audit work performed by CPA firms:

**Audit services are not being effectively acquired.** Since D&E firms are not required to certify the accuracy of their indirect rate claims, they have less incentive to hire CPA firms who are adequately trained and experienced to perform indirect cost audits. Rather than hire firms qualified to perform such audits, D&E firms tended to hire CPA firms with whom they had existing relationships—performing financial statement audits or preparing corporate tax returns. Additionally, a D&E firm representative stated that it hired CPAs based on low price. Although cost is a legitimate factor, D&E firms should hire qualified CPAs with training and expertise relevant to the audit subject area.

While D&E firm representatives said they were unaware of any guidance on how to select CPA firms, resources are available. One example is the May 1988 handbook “How to Avoid a Substandard Audit: Suggestions for Procuring an Audit” developed by the National Intergovernmental Audit Forum.<sup>11</sup>

**CPA firms did not have relevant training to perform effective audits.** CPA audits were affected by their staffs' lack of relevant training. Our review of nine CPA audit teams found that six did not have training related to FAR, Part 31, cost principles. CPA staffs, similar to Federal auditors, are required to have adequate technical knowledge to perform the engagements they accept. Professional auditing standards require that audit organizations ensure staff members collectively possess the necessary technical knowledge, skills, and experience before beginning work on an assignment. The lack of training in FAR cost principles contributed significantly to the CPA firms' inability to adequately perform such audits.

**Oversight of CPA audits was not effective.** Neither FHWA nor state DOTs consistently oversaw the work of CPA firms hired by D&E firms to ensure it was performed properly. FHWA representatives said they delegated oversight responsibility to the states; however, FHWA did not clearly communicate such

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<sup>11</sup> The handbook is available on GAO's website: [www.gao.gov/govaud/niaf.pdf](http://www.gao.gov/govaud/niaf.pdf).

expectations so that states knew what was expected and which D&E firms they were responsible for overseeing. Discussions with state DOT representatives indicated that the level of oversight they provided depended on the significance of Federal-aid funding awarded to a D&E firm within their state. To align oversight responsibility with state DOTs' financial interests, FHWA should adopt the Federal Government's best practice of assigning oversight responsibility to the agency that has the largest financial interest with a contractor.

Furthermore, according to the Policy on the Stewardship and Oversight of the Federal Highways Program, dated June 22, 2001, FHWA has oversight responsibilities for all of its programs. FHWA did not establish a tracking system or collect sufficient information to evaluate the implementation of Section 307 requirements. For example, FHWA was unable to say which D&E firms were awarded contracts with Federal-aid funds, how many D&E firm audits were performed, which states had responsibility for overseeing the audit work performed by D&E firms, and which D&E firms required an audit. The combination of poorly audited indirect cost rates and inadequate oversight has enabled D&E firms to claim millions in unallowable costs on Federal-aid highway grants. This is evidenced by the \$15.7 million (the Federal share charged to state DOT contracts is \$4.4 million) in unallowable costs identified in our audit work. FHWA needs to improve its oversight of Section 307 implementation and assign responsibility to specific states for ensuring that D&E firms' indirect cost rates do not contain FAR unallowable costs.

## **RECOMMENDATIONS**

We recommend that FHWA:

1. Revise the CFR to:
  - a. Require D&E firms to certify that all indirect costs claimed on Federal-aid contracts are allowable.
  - b. Provide state DOTs authority to assess penalties when contractors knowingly claim expressly unallowable costs.
  - c. Assign specific responsibility and accountability for overseeing audit work performed by CPA firms hired by D&E firms.
2. Issue guidance that can be used to effectively procure audit services for indirect cost rate audits. The guidance should include recommendations to:
  - a. Use competition when soliciting for qualified CPA firms.

- b. Evaluate competitors using specific technical factors such as the CPA firm's past experience, technical approach, and staff qualifications.
  - c. Require continuing education specific to FAR cost principles for auditors performing indirect cost rate audits.
3. Recover the unallowable executive compensation costs and other unallowable expenses identified in this audit—\$2.8 million in unallowable executive compensation and \$1.6 million in other unallowable indirect charges.
  4. Establish a process for monitoring and ensuring that state DOTs implement Section 307.

## **AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL RESPONSE**

A draft of this report was provided to FHWA for comment on October 29, 2008. We received their response on January 14, 2009, and they clarified certain comments in a January 16, 2009, electronic mail. FHWA's January 14, 2009, response can be found in its entirety in the appendix. FHWA fully concurred with three of our four recommendations, and partially concurred with the remaining one. Agency comments to our recommendations are summarized below:

**Recommendation 1:** FHWA partially concurred and stated it would take or has initiated the following actions:

- Initiate the process to develop revisions to the consultant services provisions contained in 23 CFR 172 by August 31, 2009, to require that firms certify the allowability of costs used to establish indirect cost rates claimed on Federal-aid supported contracts. FHWA expects to issue the notice of proposed rulemaking by April 30, 2010. (1.a)
- Pursue the issue of assessing penalties as part of the reauthorization of its highway program. FHWA stated that it could not provide a target completion date due to uncertainties concerning the new Administration's reauthorization process for the next surface transportation bill, including when this process would be initiated. FHWA also stated it does not currently have the regulatory authority to require States to assess penalties for the billing of unallowable costs. Until FHWA can pursue the issue, it will continue to follow suspension and debarment regulations to deal with firms who are in violation of the FAR. We request that FHWA provide a target completion date for this recommendation. (1.b).

- Work with AASHTO, the American Council of Engineering Companies (ACEC), and others to revise the *AASHTO Uniform Audit & Accounting Guide*. This effort will also focus on increasing the clarity in the roles and responsibilities associated with cognizance in establishing indirect cost rates. FHWA plans to use this collaborative effort to identify any additional changes that may be needed to 23 CFR 172, and expects the revised guide to be published by May 30, 2010.<sup>12</sup> (1.c)

**Recommendation 2:** FHWA concurred and stated that it will modify its technical guidance and provide best practices to incorporate the recommendation for acquiring CPA services, and post the revisions on its website by April 30, 2009.

**Recommendation 3:** FHWA concurred and stated that it would initiate action by March 31, 2009, to recover \$4.4 million in unallowable costs identified in this audit and expects to complete this action by March 31, 2010.

**Recommendation 4:** FHWA concurred and stated it would take or has initiated the following actions:

- Work with the American Association of State Highway Transportation Officials (AASHTO), state DOTs, and industry to address cognizance via an update to the *AASHTO Uniform Audit & Accounting Guide*. Additionally, FHWA will clarify the roles and responsibilities with cognizance in their rulemaking process. FHWA expects the revised guide to be published by May 30, 2010.<sup>12</sup>
- Initiate oversight measures to monitor, evaluate, and report on the use of consultant services through a revision to the FY 2009 Single Audit Compliance Supplement (Office of Management Budget Circular (OMB) A-133). FHWA anticipates these provisions to be posted to the OMB website by April 2009.

## ACTIONS REQUIRED

FHWA's planned actions satisfy the intent of our recommendations, subject to follow-up provisions in DOT Order 8000.1C. For recommendation 1b, please provide us with a target completion date as to when FHWA will submit a draft of proposed legislative language to Congress as part of reauthorization within 60 days from the date of this report in accordance with DOT Order 8000.1C. We appreciate the courtesies and cooperation of FHWA representatives during this

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<sup>12</sup> In a January 16, 2009, electronic mail from FHWA's Associate Administrator for Infrastructure.

audit. If you have any questions concerning this report, please call me at (202) 366-5225 or Ken Prather, Program Director, at (202) 366-2985.

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cc: Acting Chief Financial Officer, FHWA  
Director, Office of Program Administration, FHWA  
Associate Administrator for Infrastructure, FHWA  
Martin Gertel, M-1  
Cynthia Thornton, HAIM-13

## **EXHIBIT A. SCOPE AND METHODOLOGY**

We conducted this audit between November 2004 and October 2008 in accordance with generally accepted government auditing standards. (The audit completion was delayed due to competing priorities.) Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We reviewed FY 2003 costs—the most current data available at the start of the audit. To assess the risk of state DOTs overpaying indirect costs on state contracts, we reviewed the allowability of executive compensation and other indirect costs such as consulting, membership and professional organizations, and employee benefits. We used the cost principles specified in FAR, Part 31, as criteria to test the allowability of indirect costs claimed by D&E firms. To assess the allowability of executive compensation, we also used market surveys and the Federal statutory cap as criteria. We reviewed pertinent laws and regulations, and guidance from AASHTO. In addressing our objectives, we performed the following steps:

- Contacted all state DOTs to obtain information regarding the audit provisions under Section 307 of NHSDA for contracting with D&E firms and their methods for implementing those provisions.
- Used contract payment data received from state DOTs to develop a universe of 3,580 D&E firms that had active contracts with state DOTs.
- Selected a stratified random sample of 49 of the 3,580 firm universe for detailed testing of executive compensation. The universe was divided into 13 groups (stratum) based on amounts paid to each D&E firm by state DOTs. A random sample was then taken from each stratum and combined to develop the total sample of 49 firms. Determined that 8 of the 49 D&E firms either were a division of another sampled firm (4), or were not a D&E firm (4). We did not test executive compensation at these 8 firms and assigned \$0 unallowable executive compensation costs to them for purposes of projecting unallowable executive compensation to the universe. Accordingly, we refer to the remaining 41 firms reviewed throughout the report.

Projected the results of the sample across the universe of 3,580 firms. Twelve of the 13 strata had unallowable executive compensation; 1 strata had no unallowable executive compensation. To project the results, we: (1) calculated the total unallowable executive compensation amount for each firm; (2) calculated the average for each stratum by summing the total for each firm and

dividing by the number of firms in the stratum; (3) weighted each stratum average by its proportion of payments in the universe; (4) added the weighted averages of all 13 strata; and (5) calculated the mid-point estimate of unallowable executive compensation for the universe by multiplying the weighted average by the number of firms in the universe (3,580). These calculations were done using William G. Cochran's widely accepted formulas published in *Sampling Techniques*, 3rd edition, pp. 90, 91, and 95, John Wiley & Sons, 1977.

The base for projection of the \$41.2 million includes \$3,282,096 of unreasonable executive compensation found at the 20 firms and \$69,626 of executive compensation that exceeds the Federal cap identified in table 1. We then added \$7,526 of unreasonable executive compensation that we identified at three D&E firms and deemed as immaterial for cost-recovery purposes to arrive at a total of \$3,359,248 in unreasonable executive compensation at 23 firms. To account for ceilings imposed by state DOTs, we judgmentally applied a 10 percent reduction (\$335,925) to the total unallowable executive compensation of \$3,359,248. The result is a base for projecting unallowable executive compensation of \$3,023,323.

To summarize, the stratified random sample of 49 out of 3,580 D&E firms included 23 D&E firms that charged state DOT contracts \$3,023,323 in excessive executive compensation. Projecting these audit findings, we estimate that the 3,580 D&E firms charged \$41,170,410. We are 95 percent confident that the actual excessive executive compensation charged by D&E firms is between \$9,387,149 and \$72,953,670. In other words, the chances are 9.5 out of 10 that if we reviewed all 3,580 firms' indirect cost rate claims, the excessive executive compensation charged to state DOT contracts would be between \$9,387,149 and \$72,953,670. These projections are applicable solely to the period of our review.

We did not project the "other" unallowable executive compensation costs of \$172,626 (see table 1) because we believe the circumstances of the unallowable costs were unique to those firms.

- Judgmentally selected 9 firms from our 41-firm sample and made field visits to analyze their books and records to determine if judgmentally selected indirect account transactions were allowable and/or reasonable per FAR, Part 31. We also met with their outside auditors to discuss and review their audit work. The "other unallowable costs" (see table 2) were not projected because the sample firms were judgmentally selected.
- Contacted all sampled firms for various accounting data.
- Obtained DCAA's services to perform audits of executive compensation for 21 firms in our sample. OIG staff audited the remaining 20.

## **Exhibit A. Scope and Methodology**

- Summarized and provided each of the 41 firms with preliminary results of the executive compensation and unallowable cost testing performed by DCAA and the OIG. Received responses from 18 firms. Analyzed those responses and developed, in conjunction with DCAA, our final position on the allowability of indirect costs and executive compensation. We then offered the D&E firms an opportunity to comment on our final position and considered additional information provided. During this process, we held meetings, had telephone discussions, and/or sent electronic mail to the D&E firms. Issues unresolved between auditors and the firms will be resolved by FHWA and state DOT officials during the cost-recovery process, see recommendation number 3.
- Held meetings and discussions with the following throughout the audit regarding problems cited in this report:
  - ACEC
  - American Road & Transportation Builders Association
  - Design Professionals Coalition
  - AASHTO
  - FHWA Administrator and other FHWA representatives
  - State DOT auditors
  - D&E firm representatives

## **EXHIBIT B. DETAILS OF UNALLOWABLE COSTS**

In our review of the nine firms' indirect claims, using FAR, Part 31 as criteria, we identified \$5,046,880 of unallowable and/or unreasonable costs detailed as follows:

### 1. Entertainment, Alcohol, and Employee Morale (\$355,958)

According to FAR 31.205-14, costs incurred in connection with social activities, amusements, and any directly associated costs, for example, meals or tickets to shows or sporting events, are unallowable. Six firms had unallowable charges totaling \$247,685 for items such as social dinners with clients, company-sponsored employee social events, and dining club memberships. The social events included outings to professional and college sporting events; company picnics; theme and holiday parties; and trips to Atlantic City, a city zoo, and a county expo fair. Two firms claimed costs for meals and social events that included alcohol charges, which are expressly unallowable under FAR 31.205-51.

Three firms incurred \$108,273 for unallowable employee morale items that included:

- \$8,273 for employee Christmas gifts and gift certificates. FAR 31.205-13(b) states that the cost of gifts is unallowable.
- \$100,000 for beverages provided to employees, daily, at no charge; these costs are unallowable because the firm did not attempt to recover costs. FAR 31.205-13(d) states that losses from operating food services are allowable only if the firm's objective is to operate such services on a break-even basis.

### 2. Personal Income Taxes (\$355,767)

One firm charged its partners' personal income taxes in the amount of \$355,767. The U.S. Court of Appeals for the Federal Circuit ruled that taxes that are not an expense of the business are unallowable on Government contracts. The Court cited FAR 31.205-41(a)(1) as the basis for its decision.

### 3. Pensions (\$740,000)

According to FAR 31.205-6(j)(4)(i), allowable pension costs are limited to the net contribution *required* to be made for a cost accounting period. One firm claimed a \$600,000 discretionary profit-sharing contribution made to a pension fund. Because the \$600,000 contribution was discretionary (voluntary), it was not required and is therefore unallowable.

FAR 31.205-6(a)(6)(iii) states that compensation for owners of closely held companies in excess of costs that are deductible under the Internal Revenue Code and regulations are unallowable. One firm charged \$140,000 of pension expenses that were not deductible under the Internal Revenue Code.

4. Travel-Auto/Lodging/Meals (\$435,566)

FAR 31.205-46 allows only travel costs incurred for company business and sets additional limits on certain types of costs. We identified three firms that included the following unallowable travel expenses:

- Automobile lease payments of \$301,667 for 45 vehicles (several of which were luxury class, i.e., Mercedes, BMW, Audi, and Lexus) without documented business purposes. FAR 31.205-46(d) allows for reasonable automobile-use costs for company business. It also states the cost of automobiles that relates to personal use by employees (including transportation to and from work) is compensation for personal services and is unallowable. Without proper documentation, cost allowability cannot be verified. FAR 31.201-2(d) states that firms are responsible for maintaining records that adequately demonstrate that the subject costs comply with applicable FAR cost principles.
- Lodging costs at one firm of \$65,629 that were not sufficiently documented to determine whether they were incurred for company business. FAR 31.205-46(a)(1) states costs incurred by contractor personnel on official company business are allowable. Furthermore, FAR 31.205-46(a)(7) states travel costs are allowable only if the following information is documented: (1) date and place of the expenses, (2) purpose of the trip, and (3) name of the person on the trip and their title or relationship to the firm. Examples of these expenses included:
  - \$5,250, total, for quarterly condominium charges and apartment rentals. One employee's apartment charge was supported only by a check request, another only by an invoice. No support was provided for four employees' condominium charges, including a charge from the Chief Executive Officer of the firm.
  - \$19,956 charged for the Laguna Cliff Marriott Resort & Spa for what the firm described as a project managers' meeting. There was no evidence to support these costs, such as receipts, list of attendees, agenda for the meeting, dates, time, etc.

**Exhibit B. Details of Unallowable Costs**

- \$6,999 charged for a 3-day technology operations managers’ meeting at a resort, supported by the firm’s spreadsheet containing a list of employees to be invited. There were no receipts for lodging or lunch, and no meeting agenda to determine if the meeting took place, or if it was for official company business.
  - \$2,646 for two trips to London for which no purpose was provided.
  - \$914 for two night’s hotel expenses (\$399 per night) in Washington, DC, claimed by the Chief Executive Officer. The maximum allowable lodging rate was \$150 per night. The expense report did not list a business purpose, nor did the receipt submitted include the name or address of the hotel.
- Lodging, meals, and incidental costs totaling \$55,737, exceeding maximum Federal per diem limits. Under FAR 31.205-46(a)(2), per diem costs are allowable only to the extent that they do not exceed, on a daily basis, the maximum per diem rates allowed by the various Federal travel regulations.
  - Unallowable airfare expenses, including first-class fares, totaling \$12,533. Of that amount, \$5,153 was for non-business-related air travel by a firm’s president and his wife. According to FAR 31.205-46(b), airfare costs in excess of the lowest customary standard, coach, or equivalent airfare offered during normal business hours are unallowable.

#### 5. Consultant/Professional Fees (\$254,196)

FAR 31.205-33(f) allows fees for consultant services only when supported by evidence of the nature and scope of the service furnished. Such evidence includes details of service agreements, i.e., cost, services performed, etc., and consultants’ work products. We found \$234,196 of costs claimed not to be adequately supported. The majority of these expenses were not supported by evidence of services performed, i.e., work products. For example, one firm paid a consultant \$5,000 a month (\$60,000) with no written agreement. When asked for a copy of the consultant’s agreement, the firm said the agreement was verbal. In another example, a firm had a written agreement, but the services to be performed were not clearly described. We also identified \$20,000 in professional fees related to a company acquisition, which are expressly unallowable under FAR 31.205-27.

6. Other Unallowable Charges (\$101,873)

At five firms, we identified unallowable charges totaling \$101,873, such as a political dinner, flowers, fruit, and other miscellaneous expenses. Items found of particular interest were:

- \$35,352 charged by two firms for image-enhancing items such as golf shirts with the company logo imprinted on them and photos of projects for the company website. FAR 31.205-1(f)(1) disallows public relations and advertising costs whose primary purpose is company image enhancement. In addition, three firms claimed sponsorship costs of \$40,150 at various conferences. One firm stated its sponsorships were for conferences “more social in nature and did not involve the dissemination of technical information.” FAR 31.205-1(f)(3) disallows sponsorships for meetings, conventions, symposia, seminars, and other special events when the primary purpose of the event is other than dissemination of technical information or stimulation of production.
- Charges by one firm of \$8,532 for six bronze statues presented as achievement awards. The supporting documentation showed that the statues were \$1,422 each, and each recipient also received a \$10,000 cash award. According to FAR 31.201-3, 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. FAR also states that the burden of proof is on the contractor to show that a cost is reasonable.
- Donation of furniture valued at \$3,500. FAR 31.205-8 disallows contributions or donations, including cash, property, and services, regardless of recipient.

7. Unsupported Costs (\$449,624)

We identified \$449,624 of unsupported costs charged by five firms. Per FAR 31.201-2(d), firms are responsible for maintaining records, including supporting documentation, that adequately demonstrate that the subject costs comply with applicable FAR cost principles. We questioned one firm’s entire “Inter-Office Business Meetings” account totaling \$396,199 because it contained numerous costs that were inadequately supported. The costs included charges for personal lunches, dining club meals, cigarettes, alcohol, first class airfare, and spa resort charges. The supporting documentation provided for this account included vague expense reports, summary receipts (no line-item detail), and little or no meeting notes, agendas, or lists of attendees. The \$53,425 questioned at other firms was for undocumented

business meetings and/or meals and other unsupported miscellaneous expenses.

8. Direct Charges (\$714,082)

Three firms charged \$714,082 of legal, labor, and copy center costs incurred for direct contracts to indirect pools. FAR 31.202(a) requires that direct costs be charged only to that contract.

9. Costs Not Claimed Due to Certification (\$1,639,814)

When required to certify its Federal Government indirect rate claim, one firm removed \$1.6 million more in unallowable costs, detailed below, than they removed from the same FY claim submitted to state DOTs, using the same FAR regulations:

<i>Indirect Costs</i>	<i>Amount</i>
Entertainment	\$274,863
Travel-Airfare, Lodging, Per Diem, Meals	955,127
Professional Fees	216,823
Dues, Memberships, Other	<u>193,001</u>
Total	<u>\$1,639,814</u>

**EXHIBIT C. MAJOR CONTRIBUTORS TO THIS REPORT**

<b><u>Name</u></b>	<b><u>Title</u></b>
Kenneth Prather	Program Director
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Jelilat Ojodu	Auditor
Jill Cottonaro	Management Analyst
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Jean Diaz	Writer/Editor

## APPENDIX. AGENCY COMMENTS



# Memorandum

Subject: **INFORMATION:** Federal Highway Administration (FHWA)  
Response to Office of Inspector General (OIG) Draft Report,  
“FHWA Must Improve Oversight of Design and Engineering  
Firms’ Indirect Costs Claimed on Federal-aid Grants”

Date: January 14, 2009

From: Thomas J. Madison, Jr.   
Administrator

Reply to  
Attn. of: HIF/HAIM

To: Calvin L. Scovel III  
Inspector General (JA-40)

Thank you for the opportunity to review and comment on the OIG Draft Report, “FHWA Must Improve Oversight of Design and Engineering Firms’ Indirect Costs Claimed on Federal-aid Grants.” In general, we concur with the recommendations contained in the document, except as specifically noted below. The FHWA is committed to improving the overall stewardship and oversight of the procurement, management, and administration of engineering consultant service contracts.

The report projects an annual potential for cost savings ranging from \$9.3 million to \$72.9 million. The FHWA agrees with the underlying need to make the necessary program management changes to eliminate unallowable costs. Our strategy for making these improvements, including implementation of your recommendations, is to collaborate with the American Association of State Highway and Transportation Officials (AASHTO), the American Council of Engineering Companies (ACEC), the American Road and Transportation Builders Association (ARTBA), the Certified Public Accountant (CPA) community, and others, as appropriate, to achieve compliance with applicable Federal requirements. Following are our comments and planned actions on the specific audit report recommendations.



**Recommendation #1:** Revise the Code of Federal Regulations (CFR) {23 CFR 172} to:

- a. Require Design and Engineering (D&E) firms to certify that all indirect costs claimed on Federal-aid contracts are allowable.
- b. Provide State departments of transportation (DOT) authority to assess penalties when contractors knowingly claim expressly unallowable costs.
- c. Assign specific responsibility and accountability for overseeing audit work performed by CPA firms hired by D&E firms.

**Response:** We concur in part. The FHWA recognizes the need for strengthening our existing regulations as well as increasing oversight and training relating to the procurement of engineering consultant service contracts that use Federal-aid funds.

We will initiate the process to develop the revisions to the consultant services provisions contained in 23 CFR 172 by August 31, 2009, to integrate and address these issues, including that firms certify the allowability of costs used to establish indirect cost rates claimed on Federal-aid supported contracts. The notice of proposed rulemaking is expected to be issued by April 30, 2010, at which time we will pursue final rulemaking upon completion of the public comment period and the resolution of comments received. This process will also reflect the applicable changes to 23 United States Code (U.S.C.) 112(b)(2) made by Section 174 of the Transportation, Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, and Independent Agencies Appropriations Act, 2006 (119 Statute 2396; Public Law 109-115), which occurred following other changes to the statute made by Section 307 of the National Highway System (NHS) Designation Act of 1995 and the Transportation Equity Act for the 21<sup>st</sup> Century.

The FHWA lacks the authority to effectively require through regulation that the States assess civil penalties for a consultant's known billing of unallowable costs. The assessment of civil penalties associated with State-awarded contracts is subject to State law.

We believe that the requirement of a State to assess civil penalties associated with unallowable costs is better pursued through statute as part of reauthorization of the highway program. In the interim, FHWA will continue to rely on the suspension and debarment regulations (49 CFR 29) to address consulting firms that willfully violate the Federal Acquisition Regulations (FAR) cost principles as a matter of contractor responsibility.

The FHWA is working closely with AASHTO, ACEC, ARTBA, the CPA community, and others to revise the *AASHTO Uniform Audit & Accounting Guide*.

A key component of this effort includes the development of a robust CPA Work Paper Review Program, designed to give State DOTs a tool to ensure increased consistency in the quality of CPA-performed audits of consultant indirect cost rates. In addition, the audit guide revision effort is focusing on increased clarity in the roles and responsibilities associated with cognizance in establishing indirect cost rates. The work paper review program, coupled with increased guidance on cognizance, will serve to improve the quality and consistency in results from CPA audits of indirect cost rates. We plan to use this collaborative effort to identify any additional changes that may be needed to 23 CFR 172. As discussed in more detail below, the audit guide revision process is well under way, with adoption and publication expected by the spring of 2010.

**Recommendation #2:** Issue guidance that can be used to effectively procure audit services for indirect cost rate audits. The guidance should include recommendations to:

- a. Use competition when soliciting for qualified CPA firms.
- b. Evaluate competitors using specific technical factors such as the CPA firm's past experience, technical approach, and staff qualifications.
- c. Require continuing education specific to FAR cost principles for auditors performing indirect cost rate audits.

**Response:** We concur. We recognize the need for improved CPA audit quality, and agree that CPA experience, training, and other qualifications are key to achievement of this objective. As the FHWA does not have a vehicle, short of Federal legislation, for mandating a CPA firm procurement regime for either States or engineering firms, our focus is on effecting improved guidance through revisions to the *AASHTO Uniform Audit & Accounting Guide*. However, FHWA will modify our technical guidance and provide best practices on the administration of engineering and design-related services contracts to incorporate the OIG recommendations for acquiring CPA services. These revisions will be completed and posted on FHWA's website by April 30, 2009.

As stated in response to Recommendation #1, this collaborative effort to revise the audit guide involves AASHTO and industry. A center piece of this effort is the development of a robust CPA Work Paper Review Program aimed at giving States and engineering firms a tool to evaluate the quality of CPA audits, as well as the underlying qualifications and training of CPA audit staff, including their knowledge of the FAR cost principles. The revised audit guide will also include clarification on cognizance, specific requirements concerning governmental audit standards applicable to Federal-aid funded engineering contract related engagements, discussions on common interpretations of the FAR cost principles, detailed guidance on risk and materiality, and other relevant aspects of this

program area, all of which will serve to improve the quality of all audits of indirect costs, including those performed by CPA firms.

The FHWA will incorporate, to the extent applicable, all relevant components of this guide into its proposed rulemaking process to ensure achievement of intended results. This collective effort will include any necessary guidance, training, and related activities to ensure Federal, State and local governments, as well as industry, understand and correctly apply resultant regulations and guidance. This process has been under way since September 2007, with the draft guide expected to be submitted in the summer of 2009 to AASHTO, with adoption and publication expected by the spring of 2010.

**Recommendation #3:** Recover the unallowable executive compensation costs and other unallowable expenses identified in this audit—\$2.8 million in unallowable executive compensation and \$1.6 million in other unallowable indirect charges.

**Response:** We concur. However, as the amounts cited in the report for unallowable executive compensation and other unallowable indirect charges are estimates, FHWA will have to first validate the questioned costs by firm and by State. This comprehensive effort will require a determination of amounts paid for with State funds versus those reimbursed with Federal funds.

Additionally, the various Federal program codes used must be identified, along with the relative pro rata shares involved in making payment with FHWA funds. The FHWA will initiate cost recovery efforts, through State DOTs and industry by March 31, 2009, with completion expected by March 31, 2010.

**Recommendation #4:** Establish a process for monitoring and ensuring that State DOTs implement Section 307.

**Response:** We concur. We note that Section 307 amended 23 U.S.C. 112(b)(2), which has subsequently been amended twice since the enactment of Section 307 of the NHS Designation Act of 1995 (Public Law 104-59). As noted above, FHWA, working with AASHTO, State DOTs and industry, will continue efforts to address cognizance via the existing *AASHTO Uniform Audit & Accounting Guide* update process. We will also clarify the roles and responsibilities with cognizance in our rulemaking process.

Additionally, FHWA recognizes the need to monitor, evaluate, and report on the use of consultant services. The FHWA has initiated oversight measures through a revision to the Fiscal Year (FY) 2009 Single Audit Compliance Supplement (Office of Management and Budget (OMB) Circular A-133) by identifying the

existing key compliance requirements associated with the consultant procurement and administration processes. We envision future revisions to the compliance supplement to incorporate newly revised regulations, as they occur. The FY 2009 OMB Circular adopting these provisions is anticipated to be posted to the OMB website by April 2009.

In closing, we would like to emphasize that FHWA's role in this program is to provide general program stewardship and oversight of State DOTs and local authorities' consultant services activities. We do not review or approve individual consultant service procurements, contracts, or indirect cost rate audit actions. Rather, through stewardship and oversight, we seek improvements to State DOTs and local authorities' consultant services procurements, policies, procedures, and practices. This is consistent with the direction of FHWA Federal-aid highway program oversight responsibilities established by Congress in 23 U.S.C. 106.

We look forward to working with our partners and stakeholders to address these findings. Collectively, we will develop and implement strategies and activities to improve the performance and quality of consultant services, with the following key goals:

- increased CPA audit quality;
- clarity on roles and responsibilities over cognizance;
- consistency in FAR cost principle interpretations;
- compliance with the FAR cost principles; and
- improvement in the procurement, management, and administration of consultant services.

This audit will effect improvements to the overall procurement, project management, and financial administration of State DOTs and local authorities' consultant services programs and practices nationally. If you have any questions or comments regarding this response, please contact Mr. Jon Obenberger at (202) 366-2221 or Mr. David Bruce at (802) 828-4567

The following pages contain textual versions of the tables found within this document. These pages were not in the original document but have been added here to accommodate assistive technology.

## **Oversight of Design and Engineering Firms’ Indirect Costs Claimed on Federal-aid Grants**

### **Section 508**

#### **Table 1. Unallowable Executive Compensation**

The types of unallowable costs that were unreasonable at 20 firms had total unallowable costs of \$9,421,299 and the state DOT portion was \$3,282,096.

The types of unallowable costs that exceeded the Federal cap at 4 firms had total unallowable costs of \$280,609 and the state DOT portion was \$69,626.

“Other” types of unallowable costs at 2 firms had total unallowable costs of \$961,594 and the state DOT portion was \$172,626.

The total unallowable costs were \$10,663,502 and the state DOT portion was \$3,524,348.

Note 1 explains the state DOT portion: The \$3,524,348 represents the portion of D&E firms’ indirect costs allocated to state DOT contracts. The remaining \$7,139,154 (\$10,663,502 – \$3,524,348) represents the portion allocated to D&E firms’ business, other than state DOTs.

Note 2 explains that we did not total the number of firms because some had multiple types of unallowable costs. Specifically, the four firms that had executive compensation exceeding the cap also had unreasonable costs. The two firms that had other unallowable costs also had unreasonable costs. One firm had all three types of unallowable costs.

Note 3 explains the Federal share charged to state DOT contracts: The \$2,819,478 represents 80 percent of the \$3,524,348 state DOT portion of the unallowable costs. See footnote 5, page 3, for further explanation of the 80 percent.

#### **Table 2. Other Unallowable Costs**

For indirect costs for entertainment, alcohol, and employee morale at 6 firms, the total unallowable costs were \$355,958, and the state DOT portion was \$217,162.

For indirect costs for personal income taxes at 1 firm, the total unallowable costs were \$355,767, and the state DOT portion was \$234,806.

For indirect costs for pensions at 2 firms, the total unallowable costs were \$740,000 and the state DOT portion was \$278,400.

For indirect costs for travel-auto/lodging/meals at 3 firms, the total unallowable costs were \$435,566 and the state DOT portion was \$294,440.

For indirect costs for consultant/professional fees at 3 firms, the total unallowable costs were \$254,196 and the state DOT portion was \$58,507.

For indirect costs for other unallowable charges at 5 firms, the total unallowable costs were \$101,873 and the state DOT portion was \$57,877.

For indirect costs for unsupported costs at 5 firms, the total unallowable costs were \$449,624 and the state DOT portion was \$346,706.

For indirect costs for direct charges at 3 firms, the total unallowable costs were \$714,082 and the state DOT portion was \$236,930.

The subtotal for total unallowable costs was \$3,407,066 and the state DOT portion was \$1,724,828.

The costs claimed due to lack of certification at 1 firm were \$1,639,814 and the state DOT portion was \$208,256.

The total unallowable was \$5,046,880 and the state DOT portion was \$1,933,084.

The Federal share charged to state DOT contracts was \$1,546,467.

### **Exhibit B. Details of Unallowable Costs**

Indirect costs for entertainment totaled \$274,863.

Indirect costs for travel-airfare, lodging, per diem, and meals totaled \$955,127.

Indirect costs for professional fees totaled \$216,823.

Indirect costs for dues, memberships, and other totaled \$193,001.

Total indirect costs were \$1,639,814.