

Adjusting Journal Entries-Labor Transfers

The Scenario

Risk Assessment-Research and Planning:

The auditor was assigned to audit the overhead pools (indirect costs) for the incurred cost audit of a non-major contractor with auditable sales of \$125 million. The auditor first confirmed that the incurred cost submission had been determined adequate for audit. Then the auditor reviewed general information about the contractor from the permanent file, internal control summaries, prior years' incurred cost audits, accounting system audit, and the internal control questionnaire (ICQ) for the year under audit. Based on this review, the auditor noted information potentially relevant to the allowability and allocability of the costs in the overhead pools.

- The prior two incurred cost audits questioned only minimal costs charged to accounts in the overhead pools.
- The labor floor check¹ for this incurred cost year did not identify any labor charging issues.
- The accounting system audit report stated that the contractor was noncompliant with the Defense Federal Acquisition Regulation Supplement (DFARS) 252.242-7006 accounting system criteria. The deficiencies included:
 - classification of direct versus indirect labor costs not done as described in the contractor's Cost Accounting Standards (CAS) disclosed practices;
 - adjusting journal entries not always approved by management or documented as required by the contractor's policies and procedures; and
 - inadequate policies and procedures for management monitoring and review of the accounting system.

Preliminary Analytical Procedures:

The auditor studied the incurred cost overhead pool schedules included as part of the submission and performed the standard audit program preliminary steps related to the overhead pools. The steps included verifying the overhead rate computations, tracing the claimed pool and base amounts to the accounting records, and comparing the claimed indirect expenses by individual account to the prior year's actual costs and its budget for the year under review. The auditor noted the following regarding the engineering overhead pool.

- The overhead rate increased over 60-percent from the prior year's actual and budgeted rates. The increase was largely due to increased pool costs.
- For the year under audit, the direct labor costs contract base to which the engineering overhead pool costs were allocated was composed of 75 percent cost reimbursable, 10 percent time and materials, and 15 percent fixed price and/or commercial. These percentages

¹ Labor floor checks are periodic physical observations of work areas and interviews of employees to determine whether: (1) contractor employees are actually at work, (2) contractor employees are performing in their assigned job classification, and (3) contractor employee time is charged to the appropriate job or indirect account.

were comparable to the prior year's except the fixed-price/commercial percentage was only 8 percent of the contract base for that year.

- The accounts with the most significant increases were the travel, indirect labor, and awaiting assignment accounts. In particular, the awaiting assignment² account increased more than 350 percent from the prior year.

Entrance Conference:

The auditor met with the contractor's representative to discuss the audit objectives and to have the contractor's representative explain the information in the overhead rate schedules, including how the costs on the schedules tie or reconcile with the costs charged in the accounting records (walk-through of submission). During the entrance conference, the auditor asked the contractor's representative the following series of questions relative to the information gathered to date and potential fraud risks.

Auditor Question: "What changes were made in how costs were charged direct versus indirect during this incurred cost year?"

Contractor Response: "There were no changes in that area."

Auditor Question: "What gets charged to the awaiting assignment account in the engineering overhead pool?"

Contractor Response: "That is an indirect labor account that we use mainly for direct employees that are waiting to have their security clearance status confirmed prior to starting work on a project. This usually does not take more than a week or two."

Auditor Question: "We noted in our comparative analysis that this account increased significantly from the prior year. Do you know why?"

Contractor Response: "I will need to check into this and get back to you. Perhaps there were many more employees that needed confirmation of their clearance status than in past years or the process might have taken more time for some employees. I am aware that we had more classified contracts during this incurred cost year than the previous year."

Auditor Follow-up: "Okay but we will need you to provide a written explanation for the increase and also a listing of the employees who underwent the security clearance confirmation process during this incurred cost year."

Contractor Response: "I can get that to you in a week or so."

Auditor Question: "What does management consider the greatest risk for fraud for costs charged to the overhead accounts?"

Contractor Response: "We are a very decentralized company and have a lot of employees so probably employee fraud such as submitting false expense or travel vouchers, charging time when not working, and purchases for personal use. We have geared our internal controls, training, and system monitoring to these areas."

² Contractors may title this account with a different name such as "idle time."

Also we just recently started doing some computer trend analyses of our overhead costs to try to identify charging patterns that might indicate a potential problem needing further evaluation."

Auditor Question: "What knowledge does management have regarding any fraud or suspected fraud affecting the overhead costs?"

Contractor Response: "None."

Auditor Question: "What allegations of fraud or suspected fraud affecting overhead costs is management aware of? For instance, have employees, former employees, regulators, or other stakeholders submitted allegations to the contractor's hotline?"

Contractor Response: "I am not aware of any allegations, but I will check with our attorneys."

Additional Preliminary Procedures:

Concerned with some of the responses, the auditor used the contractor-provided online access to its accounting system to extract a detailed listing of transactions for the awaiting assignment account in the engineering overhead pool. The listing queried from the system included the information data fields listed below:

- date,
- amount,
- employee name/number,
- cost center,
- type of transaction, and
- comments.

The auditor noted that 68 percent of the costs for the account were from adjusting journal entry transactions, which was somewhat unexpected. Based on the contractor representative's explanation of the account, the basis for most of the charges should have been regular labor time sheet charges. The auditor then performed the same query for the prior year's costs for this account and noted that the transactions were primarily from employee labor charges from timesheets.

Audit Team Brainstorming for Fraud Risk Assessment:

The audit team composed of the auditor, supervisor, lead auditor for the overall incurred cost audit, and the Cost Accounting Standards (CAS) technical specialist discussed the results of the preliminary audit work and brainstormed about the risks of potential fraud related to the overhead pools. In particular, the team concluded that the unusual adjusting journal entry transactions in the awaiting assignment account, the increase to the account, and the reported accounting system deficiency related to adjusting journal entries were all fraud indicators. The team also discussed the contractor's statements about potential employee fraud in relation to the increased travel costs in the engineering overhead pool. The audit team decided to perform additional procedures to address the identified fraud indicators.

- A 100-percent audit of the adjusting journal entry transactions in the awaiting assignment account. This step would evaluate whether the adjustments were appropriate, adequately documented, and properly approved.

- A comparison of the employees needing security clearance status confirmation to the employees that charged their labor to the awaiting assignment account. The contractor's representative was to provide this listing. This step would confirm the contractor's explanation regarding the increase in costs charged to this account.
- A statistical sample of the individual travel transactions comprising the travel account in the engineering overhead pool with a large enough sample size to cover an increased risk of unallowable or unauthorized costs in the account.

Results from Audit Procedures:

The auditor performed the planned testing and obtained the following results.

- The testing of the adjusting journal entry transactions in the awaiting assignment account indicated the following:
 - All the adjusting entries transferred costs from a commercial project number to the awaiting assignment account with the same explanation that "employees charged wrong task order."
 - The only documentation supporting the adjusting journal entries was a list of employees whose labor was being transferred. Using an employee list obtained from the permanent file, the auditor identified that these employees were all computer technicians.
 - The adjusting entries, totaling \$725,000, were all made at the end of a given month, and were for work performed several months earlier.
 - The employee who approved the adjustments also processed the journal entry transactions in the accounting system.
- The list that the contractor representative provided of employees that needed their security clearance status confirmed that year generally matched the employees who charged their labor costs on timesheets to the awaiting assignment account. None of these employees were on any of the employee listings that supported the adjusting journal entry transactions.
- The testing of the travel account transactions identified some nominal questioned costs. A few sample items had employees claiming first-class airfare without justification and/or claiming more than the allowable daily per diem amounts for the travel location.

Expanded Audit Procedures and Results:

The auditor and supervisor discussed the results and decided that they needed to meet with contractor management to obtain further explanations about the adjusting journal entry transactions. At the meeting with the contractor representative and its controller, the auditor presented the results of reviewing the adjusting journal entries from the awaiting assignment overhead account and asked the following series of questions.

Auditor Question: "What is the scope of work of the commercial project from which the costs were transferred?"

Contractor Response: "This is a project to provide computer hardware products to a commercial customer. As you know, the contract is part of the engineering overhead base."

Auditor Question: "The documentation supporting the adjusting entries states that the employees charged the wrong task order. Why is this?"

Contractor Response: "The employees in question provided computer hardware and software technical support to our customers. They erroneously charged the contract when they were "waiting" for technical troubleshooting calls."

Auditor Question: "Do these employees provide technical support to any of your Government contracts or are they basically "assigned" to this contract?"

Contractor Response: "This was a new project that year and these employees were initially hired to support that effort, but the technical support required was more extensive than originally thought. These employees are and were available to provide technical support on all our contracts whether commercial or Government. That is why their "awaiting" labor was charged to the overhead pool."

Auditor Question: "According to the CAS (Cost Accounting Standards) Disclosure Statement, this type of technical labor is only to be charged direct. However, because of the adjusting journal entries, these employees' labor ended up being charged indirect. Why are these costs being charged differently than how the disclosed practices allow?"

Contractor Response: "We understand your concern and will concur to you questioning these costs. The program manager responsible for these transfers is new and unfamiliar with Government regulations. We will provide additional training on our cost charging practices."

Auditor Question: "Why did the employee who initiated and processed the adjusting journal entries also approve them?"

Contractor Response: "The system should not have let the program manager both process and approve the transaction. We will need to look into why that happened and get back to you."

Auditor Follow-up: "Please provide the amended timesheets supporting these labor transfers."

Contractor Response: "We do not routinely complete amended timesheets for labor adjustments processed on adjusting journal entries."

Auditor Question: "Without amended timesheets, how does the employee document that they concurred to the corrections of their originally charged labor?"

Contractor Response: "These transactions were management decisions initiated by the program manager that should have been reviewed by a higher level of management. We will be looking into why that apparently did not happen."

Auditor Follow-up: "Also since there are no amended timesheets, we would like to talk with some of these employees."

Contractor Response: "We do not understand why you need to talk to any of our employees. We already agreed to concur to the questioned cost and we will be looking further into what happened with these adjusting entry transactions."

Further Actions:

After the meeting with contractor management, the audit team (composed of the same individuals on the brainstorming team) decided on the following course of actions and expanded audit steps.

- Submit a written request to interview the employees related to the adjusting journal entries in the awaiting assignment account.
- Question (remove) the costs from the adjusting journal entries charged to the engineering overhead pool and include them in the engineering overhead pool base.
- Expand the transaction testing for adjusting journal entries in the overall incurred cost audit. This will be performed as a separate audit under the incurred cost assignment covering the mandatory annual audit requirement to review adjusting journal entries. In particular, the auditor will query the system to identify journal entry transactions when the same employee processed and approved the adjustment. Then the auditor will perform a 100-percent review of the identified adjusting journal entries.
- Issue a report that the contractor is noncompliant with its disclosed direct versus indirect labor charging practices (Cost Accounting Standard [CAS] 402, “Consistency in Allocating Costs Incurred for the Same Purpose”), based on the findings from the engineering overhead pool audit.
- Issue a business system deficiency report for the identified accounting system deficiencies regarding lack of segregation of duties in processing and approving of adjusting journal entries; management override of established controls; and labor adjustments not supported by amended timesheets signed by the employee.
- Perform monthly monitoring of indirect rates to identify any unusual overhead cost charging patterns originating from adjusting journal entries until the system deficiencies are adequately corrected.
- Increase testing of interim public vouchers and review charges identified as originating from adjusting journal entries until the system deficiencies are adequately corrected.
- Discuss with the Administrative Contracting Officer (ACO) the results of the review, the forthcoming CAS noncompliance and business deficiency reports, and the current status of the previously reported accounting system deficiencies. The supervisor will recommend that the ACO withhold a percentage of contract payments until all the accounting system deficiencies have been adequately corrected.
- Draft a written fraud referral, DCAA Form 2000, for the potentially irregular adjusting journal entry activities.

General Comments/Lessons Learned:

Cost transfers³ always represent a potential fraud risk, and the auditor should exercise a higher level of professional skepticism when auditing these transactions. The auditor should always obtain a sufficient explanation for transfers and expand the scope of audit as necessary. This includes evaluating the circumstances and appropriateness of the adjustment transactions as well as the contractor's rationale for making the transfers. In most cases, the auditor cannot accept the contractor's explanation without some additional audit work. If necessary, this should generally include interviewing additional contractor personnel such as contractor employees whose time charges were affected by the adjustments. In auditing adjusting journal entries, the auditor should be particularly alert to indicators of management overrides of internal controls and/or lack of adequate internal control procedures.

The auditor must also be skeptical when costs are transferred between contract line items or delivery/task orders on the same contract. Some contracts include cost ceilings or different sources of funding on the line items or delivery/task orders. The auditor should always determine the type of the work orders/charge numbers involved in the transfers and brainstorm what potential motives or rationalizations the contractor could have for the making the cost transfers besides the explanation(s) provided by the contractor. In general, cost transfers are an easy way to move costs and thus highly vulnerable to manipulation. Close scrutiny is required before accepting any cost transfer.

FRAUD INDICATORS

- **Transfers from fixed-price Government or commercial contracts.**
- **Transfers from or to cost-type Government contracts.**
- **Transfers from or to indirect accounts.**
- **Transfers from contracts to Bid and Proposal (B&P) and Independent Research and Development (IR&D) accounts.**
- **Transfers to any type of holding or suspense account.**
- **Transfers from one contract line item or work order to another line item or work order on the same contract but with different appropriations.**

³ Contractors could transfer costs from one line item to another line item on the same contract, from one contract to another, or from one account to another account. Transfers of costs require the auditor to exercise professional skepticism when determining whether the contractor's explanation for the transfer makes sense and is acceptable.