Expressly Unallowable Costs

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Risk Assessment-Research and Planning

The auditor was assigned to audit the indirect cost pools [engineering overhead, facilities, and general and administrative (G&A)] claimed in a contractor's annual incurred cost submission covering costs from 2 years prior. The contractor was a major segment of a top ten defense contractor. The auditor first verified that the submission had been determined adequate for audit. The auditor then reviewed the contractor's permanent file to gain an understanding of the contractor's operations and DCAA's audit experience with the contractor. The auditor documented the following relevant information from reviewing the permanent file.

- The accounting system and control environment audits were currently in process.
- The prior year incurred cost audit had no significant findings; however, the incurred cost audits for the 3 years before questioned significant computer expense costs charged to the G&A pool.

Risk Assessment- Research and Planning (Cont'd)

- An audit lead related to contractor's accounting systems conversion documented questioned costs from earlier incurred cost audits in which the contractor expensed costs which should have been capitalized. The audit lead also included a copy of an advanced agreement negotiated with the contractor by the Administrative Contracting Officer (ACO) that established how much of the conversion costs would be reimbursable under Government contracts. The advance agreement included the following information and stipulations.

Risk Assessment-
Research and Planning (Cont'd)

- It was signed a year after the conversion project started and covered allowable incurred costs to date and reimbursement of future costs for enhancements and upgrades.
- It listed the indirect project codes that the contractor had established to accumulate the costs related to the system conversion.
- It stated that the contractor would move agreed-to unallowable costs of $3.25 million to a designated capital expenditure account that was to be written off over 5 years to the unallowable computer expense account in the G&A pool. The ACO and contractor agreed that conversion costs in excess of the $7 million already incurred were unreasonable and, thus unallowable. The agreement identified that the unallowable costs were incurred in the indirect project code titled Training and Change Management.

Preliminary Analytical Procedures

The auditor performed the analytical mandatory annual audit requirement (MAARs) procedures in the standard audit program applicable to the engineering overhead, facilities, and G&A indirect pools in the submission. 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 identified relevant information from this review that required further audit analysis and/or explanation.

- The computer expenses account in the year under audit was one of the most significant accounts in all three indirect cost pools.

Preliminary Analytical Procedures (Cont'd)

- The auditor identified in the results of the comparative analyses for the three indirect pools that:
  - computer expense account in the G&A pool increased 55 percent when compared with the prior year's actual costs and the budget for the year under review;
  - computer expense account in the engineering overhead and facilities pools increased by 85 percent and 125 percent, respectively when compared with the prior's years actual costs; and
  - budget for the year under review did not include costs in the computer expense account in either the engineering overhead pool or the facilities pool.
- The comparative analysis by account for the G&A pool showed substantial increases for the depreciation expense account as listed below:
  - a 40 percent increase from the prior year's actual costs, and
  - a 60 percent increase from the budget for the year under audit.

Interim Audit Team Discussion

The supervisor and incurred cost technical specialist met with the auditor to discuss the audit risk assessment, progress to date and potential risk factors, including the risk of fraud. The team noted the following concerns and decided that the auditor should perform additional procedures prior to the entrance conference.

- The team was puzzled by the changes to the computer expense account in the comparative analyses.   In particular, why the claimed computer expense account costs in the incurred cost submission were so significant in the engineering overhead and facilities pool but had not been budgeted at all for that year. The incurred costs technical specialist suggested that the auditor should review the contractor's Cost Accounting Standards (CAS) Disclosure Statement to determine if computer expenses were a disclosed cost element for the engineering overhead and facilities pools.
- Due to the significant costs charged to the computer expense account in all the pools, the team agreed that the auditor should request the computer expense account transaction detail for all three pools and perform a nomenclature review to identify the sort of expenses charged to that account.

Interim Audit Team Discussion (Cont'd)

- The supervisor recalled hearing during an audit office management meeting that the contractor's corporate office had entered into an administrative agreement[1] with the Army Suspension and Debarment Office (SDO) regarding a fraud case. The team agreed the auditor should review the agreement and determine what impact the compliance agreement might have on the audit of the indirect expenses. The auditor could obtain the agreement by accessing the website www.fapiis.gov, the Federal Awardee Performance and Integrity Information System (FAPIIS)[2].

[1]This is a written agreement between a contractor and the Government to resolve a suspension or debarment proceeding. It states the facts and circumstances supporting the proposed suspension or debarment action and identifies the actions the contractor has taken or will take to address the issues and prevent future occurrences. It can also be referred to as a compliance agreement.

[2]FAPIIS is a congressionally mandated system that contains specific information on the integrity and performance of DoD and certain other Federal agency contractors and grantees. It consolidates information from Contractor Performance Assessment Reporting System (CPARS), proceedings information from the Entity Management section of System for Award Management (SAM) database, and suspension/debarment information from the Performance Information section incorporating the Excluded Parties List System (EPLS) of SAM. Users can perform searches using entity names, Data Universal Numbering Systems (DUNS) numbers or Contractor and Government Entity (CAGE) codes.

Results of Additional Analytical Preliminary Audit Procedures

The auditor completed the steps discussed and noted the following additional information.

- The CAS Disclosure Statement did not list computer expense as a major function, activity or element of cost for either the engineering overhead or facilities pools.
- The computer expense account detail indicated that, depending on the pool, between 45 and 68 percent of the account total was comprised of various journal entry transactions. These transactions were associated with the indirect project codes listed in the advance agreement for the accounting system conversion expenses.

Results of Additional Analytical Preliminary Audit Procedures (Cont'd)

- The Army Suspension and Debarment Office's administrative agreement (dated six months ago) with the contractor's parent corporation was in lieu of debarment pursuant to criminal violations of the Anti-Kickback Act[3] at four business segments that involved executive management knowledge of and complicity in the fraudulent behavior. The contractor business segment being audited was one of those involved in the criminal acts. The corporate office made restitution to the Government; fired all individuals responsible for the violations, and agreed to employ an outside compliance firm to verify compliance with the agreement and to recommend improvements and/or enhancements to existing ethics programs and controls at all business segments.

[3]The Anti-Kickback Act of 1986 (41 U.S.C. 51 to 58) prohibits providing, attempting to provide, or offering to provide any kickback; soliciting, accepting, or attempting to accept any kickback; or including, directly or indirectly, any kickback in the contract price charged by a subcontractor to a prime contractor or a higher-tier subcontractor or in the contract price charged by a prime contractor to the Government. Kickback is defined as any money, fee, commission, credit, gift, gratuity, thing of value, or compensation of any kind which is provided, directly or indirectly, to any prime contractor, prime contractor employee, subcontractor, or subcontractor employee for the purpose of improperly obtaining or rewarding favorable treatment in connection with a prime contract or in connection with a subcontract relating to a prime contract.

Entrance Conference

The auditor, supervisor, and incurred cost technical specialist met with the contractor's audit liaison and controller to discuss the audit objectives and to have the contractor representatives explain the information in the overhead rate schedules, including how costs on the schedules tie or reconcile with the costs recorded in the accounting records (walk-through of the indirect pools in the submission). During the entrance conference, the auditors asked the contractor representatives the following series of questions related to the audit procedures performed to date and potential fraud risks.

Auditor Question: "What significant changes to the accounting system did the company make that impacted the indirect costs charged for this incurred cost year?"

Contractor Response: "That year we did some minor upgrades to our timekeeping system component and made some repairs to the enterprise resource planning (ERP) software to correct some identified processing glitches. But I would not necessarily categorize these as "significant." We segregated the costs for these efforts into indirect project codes in accordance with our advanced agreement for the system conversion."

Entrance Conference (Cont'd)

Auditor Question: "What costs are charged to the computer expense accounts?"

Contractor Response: "Well charges for the system enhancements and corrections I just mentioned would normally be charged to that account if they are not capitalized. Other non-capitalized computer-related expenses would also be charged to this account."

Auditor Question: "Under what circumstances would these type expenses be capitalized?"

Contractor Response: "We would capitalize the costs of major system upgrades that were expected to provide significant additional system functionality. That was not the case with the system enhancements and repairs this year. Also these were the first real changes we have made to the system since the conversion was completed which is probably why the charges to the computer expense account are larger than in years past."

Entrance Conference (Cont'd)

Auditor Question: "The account detail for the computer expenses accounts charged to all the indirect pools shows that a significant portion of the charges were from various journal entry transactions. Please explain these transactions."

Contractor Response: "These are probably charges for computer help desk services. The help desk center is part of a different business segment and the allocable charges are transferred to our segment via interdivisional electronic invoices. The charges are then recorded by journal entry in the indirect pool to which the help desk services are related. For example, help desk services for direct employees would be charged to computer expenses for the engineering overhead pool. This is per the disclosed accounting practices in our CAS Disclosure Statement."

Auditor Question: "Why does the Disclosure Statement not list computer expense as a major function, activity or element of cost for either the engineering overhead or facilities pools?"

Contractor Response: "These expenses are probably listed as service center or help desk costs. This is not a new accounting practice; we have been receiving transferred in help desk allocations for several years."

Entrance Conference (Cont'd)

Auditor Question: "What knowledge does company management have regarding any fraud or suspected fraud impacting the claimed indirect costs we are auditing?"

Contractor Response: "We are not aware of any such allegations affecting the claimed indirect rates. We just went through an extensive criminal investigation where numerous employees were discovered to be involved in a major kickback and bribery scheme. The parent company fired all involved or with knowledge of the activities including our company president."

Auditor Question: "What additional allegations of fraud or suspected fraud affecting the indirect costs charged to the three pools is management aware of? For instance, have employees, former employees, regulators, or other stakeholders submitted allegations to a hotline?"

Contractor Response: "Management is not aware of any such allegations impacting costs charged to the indirect pools. We are currently in process to stand up an internal hotline system which will provide procedures to receive and review any allegations of fraud, illegal acts, or abuse that are submitted."

Entrance Conference (Cont'd)

Auditor Question: "What actions has company management taken to address the business ethics and internal control requirements in the administrative agreement with the Army Suspension and Disbarment Office?"

Contractor Response: "Well, first an outside compliance firm hired by our corporate office came in and reviewed our current business ethics program and related internal controls. Based on that original assessment, they have been working with our management to enhance our business ethics including a significantly more robust ethics training program and the new internal hotline for employees to submit suspected instances of fraud, illegal acts and abuse, particularly those impacting our Government operations. We also have to provide monthly reports to our corporate office's compliance department on our progress towards implementing the compliance firm's recommendations and solutions."

Auditor Question: "What does management consider the primary risks for fraud or misstatement in the indirect accounts and rates to be?"

Contractor Response: "As a company, we have not really considered this question. The compliance firm we are working with is helping us design and implement a comprehensive risk assessment process to address the risk of fraud, waste and abuse in our business operations. Since our Government business is so significant, this process should encompass our indirect rate costs and structure."

Audit Team Brainstorming for Fraud Risk Assessment

The audit team met again to discuss the results of the preliminary audit procedures to date; information learned from the entrance conference and submission walk-through; and to brainstorm about risk of fraud and/or material misstatement in the indirect pools. During the discussion, the auditor made the following observations.

- From the analyses performed to date on the computer expenses accounts, the contractor could have misclassified the costs for system enhancements and/or repairs. The contractor should have capitalized rather than expensed the costs. Additionally, the contractor could have claimed conversion-related expenses from prior years in this incurred cost year. That issue had come up in previous incurred cost audits and could happen again given the complexity of the overall computer system conversion.

Audit Team Brainstorming for Fraud Risk Assessment (Cont'd)

- The auditor commented that the contractor's explanation that the computer expense journal entry transactions were for transferred-in help desk service center charges did not seem entirely credible. Based on review of the expense detail report, the majority of transactions were associated with the system conversion indirect project codes. However, the supervisor explained that that the journal entry transactions could have just been charged to the wrong account and the contractor representatives at the entrance conference were not aware of them.
- Implementation of the contractor's control environment was deficient during this incurred cost period as evidenced by executive company management willingly engaging in illegal activities and overriding or circumventing internal controls. The contractor had only just recently begun to assess the adequacy of its internal controls related to the business ethics program and fraud prevention and detection.

Results from Audit Team Brainstorming

As a result of the brainstorming exercise, the audit team identified specific procedures to perform during the audit to address the risk of fraud and material misstatement in the computer expense and depreciation accounts.

- Review 100 percent of the journal entry transactions in the computer expense accounts, in all the indirect pools. The testing would verify the origin, validity, and approval of the charge, including whether costs related to the system conversion or enhancements were properly classified and charged in accordance with related Government requirements and Generally Accepted Accounting Principles (GAAP)[4].

[4]CAS 404, Capitalization of Tangible Assets, states the requirements for capitalization of tangible assets and CAS 409, Depreciation of Tangible Assets, relates to the depreciation of tangible capital assets. Federal Acquisition Regulations (FAR) 31.205-11 defines the allowability of depreciation charged for contractor's tangible capital assets. However in the absence of regulations specific to capitalization versus expensing of costs for computer systems conversions, DCAA guidance directs auditors to use GAAP to verify proper classification and charging of these costs. The Financial Accounting Standards Board (FASB) issued Accounting Standards Codification (ASC) 350-40 that incorporates Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed for or Obtained for Internal Use. This pronouncement provides the capitalization and expensing requirements for a wide range of software related activities including software acquisition, configuration, modification, data conversion, maintenance, etc. ASC 720-45 addresses the costing requirements regarding the business process reengineering activities that often accompany a major computer systems conversion project.

Results from Audit Team Brainstorming (Cont'd)

- Use statistical sampling to audit the other non-journal entry transactions in the computer expense account in each indirect pool. The sample sizes should be sufficient to address a high risk of misstatements (high expected error rate), which the auditor is unwilling to accept (low tolerable misstatement). The auditor should review all available supporting documentation for the selected transactions. In particular, if the costs were related to conversion or enhancement of the ERP system, the auditor should obtain sufficient evidence to determine whether the charge is allowable in accordance with regulations and the advanced agreement.
- Review 100 percent of the transactions in the unallowable computer expense account in the G&A pool to verify that the contractor had written off the mutually agreed to unallowable computer conversion costs as stated in the advanced agreement.
- Use statistical sampling to audit the depreciation expense accounts in all the indirect pools. The sample sizes should be sufficient to address a high risk of material misstatement in the account. The review would verify that claimed depreciation expenses were supported by a valid depreciable asset and properly computed in accordance with FAR and CAS.

Results from Audit Procedures

The auditor performed the planned transaction testing for the computer expense and depreciation accounts and documented the results.

- The audit of the journal entry transactions for the computer expense accounts found that 75 percent of the transactions across all three indirect pools were for prior year system conversion costs. The costs originated from the designated capital expenditure account to which the contractor agreed to charge the mutually agreed to unallowable costs in the advanced agreement. The total of these charges in all the pools was $650,000 supported by numerous journal entries of varying amounts. However the audit also identified some other allowable journal entry transactions for transferred-in help desk service allocations. These costs represented only a small part of the expenses reviewed.

Results from Audit Procedures (Cont'd)

- The documentation provided for the statistical sample of the non-journal entry transactions supported ongoing small computer system upgrade and repair projects that the auditor agreed should be expensed and were determined allowable and allocable.
- The only transactions in the unallowable computer expense account in the G&A pool were for computer support costs for several unallowable public events. The auditor also noted that there were no costs charged to the unallowable computer expense accounts for either the engineering overhead or facilities pools.
- Twenty-five percent of the sampled transactions in the G&A depreciation expense account were from journal entries similar to those in the computer expense account. The expenses originated from the designated capital expenditure account which the contractor agreed to charge the unallowable costs in the advanced agreement.

Additional Audit Procedures and Results

After consultation with the supervisor, the auditor discussed with the contractor audit liaison the results of audit of the indirect pools computer expense and depreciation expense accounts. The contractor representatives could not explain why the prior year system conversion costs that were agreed to as unallowable in the advanced agreement had been claimed in the incurred cost submission under audit.

Further Actions

The audit team, audit office manager and regional audit manager met to discuss the results of the review to date and the potential irregular journal entry charges identified. The group concluded that sufficient audit evidence existed to support an audit opinion questioning the claimed costs and for submitting a written fraud referral (Form 2000). The team also decided to take other actions.

Further Actions (Cont'd)

- Schedule a meeting to discuss the audit results and forthcoming fraud referral with the ACO, local DCMA Fraud Counsel who supports the ACO, a representative of the Army Procurement Fraud Branch, and military criminal investigators. During this meeting, DCAA would inform the group that the audit report would recommend assessing level two penalties under FAR 42.709-1[5] since the contractor claimed mutually agreed to unallowable costs. These costs were agreed to be unallowable prior to submission of the certified incurred cost submission. The Form 2000 would also identify all incurred cost years involved with the computer conversion and state that the incurred costs for these years could also include other irregular transactions not previously reviewed or identified in past incurred cost audits.

[5]FAR 42.709 implements 10 USC 2324(a) through (d) and 41 USC 256 (a) through (d) regarding assessment of penalties when contractors include expressly unallowable costs in 1) final indirect cost rate proposals; and 2) final statement of costs incurred or estimated to be incurred under a fixed price incentive contract. Level two penalties, which are twice the amount of the disallowed costs, are assessed when the costs were determined unallowable before the proposal was submitted.

Further Actions (Cont'd)

- Issue a report citing the contractor for non-compliance with CAS 405, Accounting for Unallowable Costs.
- Forward the results of the audit to date to the audit team currently working on the accounting system and control environment audits so that related internal control system deficiencies can be properly assessed and reported.
- Perform monthly monitoring of the indirect cost pools to identify any computer expense account or other indirect cost transactions that might require further analysis of allowability.

General Comments/ Lessons Learned

Auditors should be alert when a contractor claims expressly unallowable cost, including costs previously agreed to be unallowable. In accordance with the clause found at FAR 52.252-4, when submitting an incurred cost submission, contractor management certifies, in writing, that all the costs included in a proposal to establish final indirect cost rates are allowable in accordance with FAR cost principles and its supplements and applicable to the contracts to which the final indirect cost rates will apply. The contractor must submit the written certification before the Government will accept the proposal and an individual at a level no lower than a vice president or chief financial officer of the business segment that is submitting the incurred costs must sign it.

General Comments/ Lessons Learned (Cont'd)

When a contractor's certified incurred cost submission includes expressly unallowable costs, including those agreed to be unallowable, auditors should recommend all appropriate penalties per FAR 42.709. FAR 31.001 defines an expressly unallowable cost as a particular item of type or cost which, under the express provisions of an applicable law, regulation, or contract is specifically named and stated to be unallowable. For the purposes of assessing penalties, the applicable regulation is FAR 31.205, or the applicable government agency's supplement such as Defense Federal Acquisition Regulation (DFAR) 231.205), which defines the allowability of specified selected costs. Costs that are unallowable because they are unreasonable, unallocable, or violate another regulation or contract term are not considered expressly unallowable for assessment of the penalty. Any directly associated cost that is generated solely as a result of incurring the expressly unallowable cost and would not have otherwise been incurred are also expressly unallowable.

General Comments/ Lessons Learned (Cont'd)

Penalties are also assessed when costs are claimed in a certified incurred submission that were determined to be unallowable before proposal submission or were mutually agreed to be unallowable. Both require the determination or agreement to be in writing. Examples of these documents include:

- A DCAA Form 1, "Notice of Contract Costs Suspended and/or Disapproved," which was not appealed by the contractor or withdrawn by the DCAA.
- An unappealed contracting officer determination or final opinion.
- A prior Armed Services Board of Contract Appeals or court decision involving the contractor, which upheld the cost disallowance.
- An advanced agreement that describes the mutually agreed to be unallowable costs in sufficient detail to conclusively identify the costs in future proposals or claims.

Auditors should carefully consider, in cases where penalties are assessed, whether the facts and circumstances of the issues warrant submitting a fraud referral. Allowable Costs Under Defense Contracts, 10 U.S. Code § 2324, states that contractors are subject to the provisions of the Criminal False Claims Act (18 U.S. Code § 287) and/or the Civil False Claims Act (31 U.S Code § 3729) for knowingly including expressly unallowable costs in a proposal for settlement of costs for any period after such costs have been accrued.

Fraud Indicators

- Claiming expressly unallowable costs.
- Claiming costs determined to be unallowable/non-reimbursable prior to the certification of the incurred cost submission.
- Claiming mutually agreed to unallowable costs, including directly associated costs, in a certified incurred cost submission.
- Claiming costs that were verbally agreed to or conceded to as unallowable in a certified incurred cost submission when:
  - the agreement occurred prior to the submission in question;
  - the process involved bidding rates, billing rates or a prior year's final indirect rates; and
  - the contractor changed the account that the costs were charged to in an apparent attempt to hide or conceal the costs.
- Repeated failure to correct reported accounting system deficiencies involving charging or claiming of unallowable costs.
- Billing expressly unallowable costs, costs determined unallowable, or mutually agreed to be unallowable.