

Uncompensated Overtime



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Risk Assessment- Research and Planning



The auditor was assigned to audit the direct cost (labor, materials and other direct costs) portion of a contractor's incurred cost submission from the previous year. The supervisor stated that the incurred cost technical specialist had determined the submission adequate for audit. The supervisor also explained that the audit should focus more on direct labor testing, in part, because a labor floor check¹ was not performed last fiscal year due to a large volume of higher priority proposal audits.

¹Labor 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.



Risk Assessment- Research and Planning



The auditor began the audit by reviewing general information about the contractor from the electronic permanent file (ECPF²), prior year incurred cost audit, incurred cost submission under audit, business system audits, internal control questionnaire (ICQ) for the year under audit, and documentation of the incurred cost technical specialist's discussion with the Administrative Contracting Officer (ACO). The auditor documented the materiality and sensitivity of the information relevant to the audit.

²ECPF is DCAA audit tool that provides a standard electronic structure for maintenance of contractor permanent files. There are several folders in the Audit Planning folder, which potentially affect risk assessment considerations for fraud. Annotations of contractor disclosures, submitted fraud referrals and fraud risk indicator information should be maintained in their designated electronic perm file subfolders. Auditors should review these subfolders when performing the audit risk assessment.



Risk Assessment- Research and Planning



- Contractor develops software applications for use in Government operations.
- Contractor had sales of \$140 million in the year under audit of which 90 percent were on Government contracts. The contract mix was 50 percent cost reimbursable, 25 percent time and material (T&M), and 25 percent fixed price and commercial contracts.
- Direct labor was the most significant direct cost element accounting for 85 percent of the claimed direct cost in the incurred cost submission under audit.



Risk Assessment- Research and Planning



- Contractor's contracts required compliance with all Cost Accounting Standards (CAS), referred to as full CAS coverage. The contractor was also required to maintain a CAS Disclosure Statement to identify the cost accounting practices used on Government contracts. DCAA did not report any CAS non-compliances for the year under audit.
- Prior incurred cost audit questioned unallowable consulting expenses, bonus payments, and executive compensation in the general and administrative (G&A) and overhead indirect pools. Hours charged on a T&M contract also were questioned because the contractor had exceeded the contract ceiling hours.



Risk Assessment – Research and Planning



- The electronic permanent file included an audit lead submitted by the auditor who performed the prior incurred cost audit. The audit lead sheet noted that the prior audit identified unallowable compensation costs. It also noted that bonus payments for management were given based on performance against predetermined financial targets and goals which could pose an increased risk for potential mischarging of labor costs.
- Floor check audits performed for the two years prior to the year under audit did not have any findings.



Risk Assessment – Research and Planning



- The post-award accounting system audit performed during the incurred cost year under audit determined that the accounting system and accounting practices were acceptable for accumulating and billing costs on Government contracts. However, the audit office issued a memorandum to the ACO for a billing process system deficiency that was not considered significant. The review of one public voucher on a T&M contract noted:
 - Some billed hours did not reconcile to accounting records and the associated timesheets;
 - This was an isolated instance attributed to an inadvertent biller error; and
 - The contract was for help desk services and system enhancements on a DoD program management and scheduling software application.



Risk Assessment - Research and Planning



- The electronic permanent file did not contain any contractor disclosures or fraud referrals.
- The ACO was unaware of any cost or performance issues with any of the contracts listed in the submission or any of the associated direct costs claimed for those contracts.



Risk Assessment – Labor System



Since a labor floor check had not been performed during the year under audit, the incurred cost technical specialist told the auditor to review available labor system information to obtain an understanding of the contractor's labor and timekeeping policies and procedures and related internal controls. This step would ordinarily have been done as part of the standard audit program for the floor check. The auditor reviewed available labor information for the year under audit including organization and operations data, listing of employees by location, and timekeeping policies and procedures. The auditor documented relevant information about the labor system necessary to gain the required understanding and plan the direct labor transaction testing for cost reimbursable and T&M contracts.



Risk Assessment – Labor System (Cont'd)



- All of the 400 direct and indirect employees worked in one large facility. The operations applications department had the largest number of employees.
- Contractor had a web-based electronic timekeeping system in which employees input and certify their time and attendance and supervisors approve the electronic timesheets.



Risk Assessment – Labor System (Cont'd)



- The auditor identified other system information from the timekeeping system policies and procedures as follows:
 - Supervisors provide employees with a listing of all project or account numbers they are authorized to charge at the beginning of every month. The listing includes a description for each of the project or account numbers.
 - A separate payroll company is responsible for preparing the payroll for automatic deposit in employee bank accounts.



Risk Assessment – Labor System (Cont'd)



- There are specific indirect labor accounts that direct labor employees charge when they perform indirect functions, such as training, idle time and special projects.
- All employees are required to record all hours worked on their timesheets.
- The contractor does not have a work at home program.



Entrance Conference



The auditor contacted the contractor's audit liaison to schedule an entrance conference and to discuss the initial data needed for the audit including electronic file downloads of the detailed accounting records for the direct costs in the submission. These accounting records included the job cost ledger, direct cost account subsidiary ledgers and labor distribution report. The auditor followed up with a written request for the information.



Entrance Conference (Cont'd)



The auditor, supervisor and incurred cost technical specialist met with the contractor's audit liaison to discuss the audit of the direct costs as part of the overall audit of the incurred cost submission. The audit liaison explained the direct cost schedules in the submission including how the costs tie or reconcile to costs charged in the job cost ledger.



Entrance Conference (Cont'd)



With respect to the direct labor costs in the submission, the audit liaison explained that the labor distribution report identified by employee the labor dollars and hours the employees charged to direct and indirect projects or accounts for the year under audit.



Entrance Conference (Cont'd)



The audit liaison also discussed the internal control policies and procedures related to direct costs charged to Government contracts. During the meeting the auditor asked the contractor representative the following series of questions related to the information obtained to date and potential fraud risks.



Entrance Conference (Cont'd)

Auditor Question: “What major events impacted the company during the year we are auditing?”

Contractor Response: “Well, you might have read in the news, but just before the start of that year, we were selected by the Office of Secretary of Defense (OSD) to execute a full-service program management and scheduling software program. It was a hard fought competition but we demonstrated that we could hold our own against the much larger defense contractors. The win has helped us maintain a foothold in the Government software development market. In fact during that year we began rolling out a prototype initial system for beta testing at several client sites ahead of schedule.”



Entrance Conference (Cont'd)

Auditor Question: “Which contract was that in the incurred cost schedule in the submission?”

Contractor Response: “It was actually two contracts under the operations applications department. It was notated in the submission as the DPMS program which refers to the Defense Program Management and Scheduling Program. There was a cost plus fixed fee (CPFF) contract for system design, development and testing. The T&M contract was for implementation and post implementation activities like training, troubleshooting and system enhancements.”



Entrance Conference (Cont'd)

Auditor Question: “What changes did management make to the company’s organizational structure that could affect the way direct costs are charged or allocated to contracts?”

Contractor Response: “We didn’t make any organizational changes at all that year.”

Auditor Question: “Did management make any accounting changes in how costs were charged direct versus indirect during this incurred cost year?”

Contractor Response: “No.”



Entrance Conference (Cont'd)

Auditor Question: “What changes did management make to the timekeeping policies and procedures that year?”

Contractor Response: “Our policies didn’t change per se but we did increase our monitoring of the system by having our timekeeping department do more internal floor checks and conduct more timekeeping training.”

Auditor Follow-up: “Could you please provide us reports for the internal floor checks conducted during the year under audit?”

Contractor Follow-up Response: “I will get those records from the timekeeping department, but we would request that you review them in my office.”



Entrance Conference (Cont'd)

Auditor Question: “Were any of the company’s contracts in an overrun position that year?”

Contractor Response: “Not to my knowledge but I will check with our finance department to be sure.”

Auditor Follow-up: “Please check and then provide a written response listing all contracts that were in an overrun position at any time during the year under audit.”



Entrance Conference (Cont'd)

Auditor Question: "What does management consider are the most significant fraud risks for charging direct costs to Government contracts?"

Contractor Response: "Our labor force is our most valuable asset. A high quality work force directly contributes to the success of our business. Labor is our most significant incurred cost element. So we have focused a lot of our internal controls on the management and monitoring of labor costs. In particular, that year we provided comprehensive training on our timekeeping policies and procedures to all managers who approve time charges. This included sessions on indicators of mischarging, misallocation, and other potential labor fraud or errors in labor recording. Prior to the training, we also did an in-depth review of the timekeeping and other labor-related policies and procedures. As a result, we clarified and reinforced some provisions.



Entrance Conference (Cont'd)

Auditor Question: "What allegations of fraud or suspected fraud are management aware of that potentially affect costs charged to the contracts in this submission? In addition to employees, this could include former employees, regulators, government officials, or other stakeholders."

Contractor Response: "We have a very robust ethics and compliance program that includes an internal hotline. Our legal and compliance departments are responsible for receiving and investigating any allegations that are received from the hotline as well as others received from any source. We would then submit a formal disclosure to the Government of situations deemed reportable under the Federal Acquisition Regulations (FAR)³. Fortunately we haven't had any instances of this yet."

³FAR 52.203-13, Contractor Code of Business Ethics and Conduct, requires contractors to timely disclose in writing to the Government credible evidence of a violation of federal criminal law involving fraud, conflict of interest, bribery, or gratuity violations found in 18 USC or a violation of the civil False Claims Act.



Entrance Conference (Cont'd)

Auditor Follow-up Question: “Does that mean you haven’t received or investigated any allegations of potential fraud?”

Contractor Response: “I didn’t say that. We just haven’t determined that we need to formally submit any disclosures.”

Auditor Question: “What knowledge does management have regarding any other fraud or suspected fraud affecting the costs charged to contracts in this submission?”

Contractor Response: “We have no such knowledge.”



Preliminary Analytical Procedures



The auditor and incurred cost technical specialist discussed the analytical procedures that needed to be performed for the claimed direct costs. The auditor confirmed that all the direct costs in the submission had been verified to the job cost ledger without exception. The incurred cost technical specialist also verified that the auditor evaluating the claimed indirect costs had performed comparative analytical procedures on the direct versus indirect costs charged during the previous two years.



Preliminary Analytical Procedures (Cont'd)



The results of those procedures did not identify any major inconsistencies in the direct vs. indirect cost charging practices. The auditor suggested that the analytical procedures for the direct costs in this audit should focus on labor since it represented such a significant percentage of the claimed direct costs. The auditor performed the procedures in the following order in consultation with the incurred cost technical specialist.



Preliminary Analytical Procedures (Cont'd)



Analytical Procedure: Determine from the direct cost schedule in the submission to which cost reimbursable and T&M contracts the contractor charged the most significant direct costs.

Result: The CPFF and T&M Defense Program Management and Scheduling (DPMS) contracts represented 72% of the auditable direct costs⁴.

⁴Auditable costs are those incurred on contracts that include the clause FAR 52.215-2, Audit and Records-Negotiation. These are typically cost-reimbursement, incentive, time-and-materials, labor-hour, or price redeterminable contracts. Incurred costs on firm-fixed price contracts and contracts for commercial items are not auditable. Contractors will be paid the contractual firm fixed price irrespective of the costs they actually incur on the contract. In addition, per FAR 15-209(b), contracting officers do not include the above audit clause in solicitations for commercial items that are exempt from the requirement to provide certified cost or pricing data.



Preliminary Analytical Procedures (Cont'd)



Analytical Procedure: Analyze the contractor-provided list of contracts in an overrun position for the year under audit.

Result: Two FFP contracts in the security applications department were listed as minimally overrun during the third and fourth quarters of the year.

Analytical Procedure: Compare total contract billed amounts with total actual costs incurred or charged (profit margin test) for each of the five T&M contracts in the incurred cost submission. The incurred cost submission schedules contained the needed information.

Result: For the DPMS T&M contract, the auditor calculated a 1 percent profit, significantly less than originally negotiated and included in the fixed T&M labor rates⁵. Profit margins appeared reasonable on the other four T&M contracts.

⁵In a T&M or labor hour contract, the contractor bills the hours incurred at fixed labor rate. These rates are usually broken out by labor category and are specified in the contract. They are comprised of a base labor rate as well as all costs associated with the labor, including indirect costs and profit. They are often referred to as “loaded” labor rates.



Preliminary Analytical Procedures (Cont'd)



Analytical Procedure: Perform a trend analysis of the labor costs charged on the two DPMS contracts during the year under audit to identify any unusual changes in the labor charging pattern that might indicate potential mischarging. The auditor used information from the contractor's labor distribution report to perform this analysis.

Result: Identified the following changes to the labor charging patterns during the year under audit:

- Hours charged to the T&M contract began increasing after the first 2 months of the year and steadily continued that trend throughout the year;
- Hours charged to the CPFF minimally decreased 6 months into the year; and
- At the same time, 6 months into the year, employees charging the CPFF contract began to occasionally charge a small amount of hours to an indirect account for selling costs.



Preliminary Analytical Procedures (Cont'd)



The auditor also noted a change in how many hours certain employees charged during the pay periods. Salaried employees charging the CPF contract started mostly recording only 8 hours per day on their timesheets at the 6 month point. Prior to that time, they frequently charged more than 8 hours per day/40 hours per week. On the other hand, salaried employees charging the T&M contract consistently recorded more than 8 hours per day/40 hours per week throughout most of the year.

Analytical Procedure: Scan the labor distribution reports for any pattern of unusual labor transfers made via adjusting journal entries.

Result: Identified no unusual labor transfer patterns. Most labor adjustments were made within a week of when the original labor was charged and no significant transfers between contracts were identified.



Audit Team Brainstorming for Fraud Risk Assessment



The auditor, supervisor and incurred cost technical specialist met to discuss the results of the risk assessment to date and to brainstorm about potential non-compliances, due to error or fraud, that could materially affect the direct costs charged to Government contracts. The auditor questioned why the profit percentage on the T&M DPMS contract was low at year end. This could indicate that the contractor may have underbid the fixed labor rates and was working more hours or charging hours into higher labor categories to compensate.



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

The incurred cost technical specialist also thought it was peculiar that the employees charging the CFFF DPMS contract began, after 6 months, to only record 8 hours per day on their timesheets when previously they had frequently recorded more than 8 hours. The contractor's policy was to record all hours worked whether paid or not. So either they stopped working uncompensated overtime or they were not recording it.



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

The auditor responded that the charging pattern change might have occurred for other reasons. For instance, the contractor may have worked extra hours in the first half of the year to get back on schedule. Once caught up, working extra hours would not be needed. The supervisor reminded the group that contractor management bonuses were based on achieving or exceeding pre-defined financial targets which could provide motivation for mischarging.



Audit Procedures and Results



The group decided to perform the following audit procedures with respect to direct labor considering the risk factors identified and the lack of a floor check for the year under audit.

Audit Test: To test the reliability of the labor accounting records, use statistical sampling to verify labor hours charged in the labor distribution report to the related timesheet source document. The sample size of the labor transactions should be sufficient to address the highest risk of misstatement that the auditor was unwilling to accept. The sample should exclude any labor adjustment transactions since those would be reviewed separately.

Result: Labor transactions were verified to timesheets for all sample items except two.



Audit Procedures and Results (Cont'd)



Audit Test: Identify from the labor distribution report employees that charged to multiple contracts or indirect activities (like selling cost) and verify that their travel during the year matched the labor charged during the travel period.

Result: Comparison of travel records to labor charges did not identify any labor exceptions. However, the auditor noted that many employees working on the CPF F DPMS contract had traveled for business presentations to the Veterans Administration (VA) and the Department of Commerce. The related labor and travel charges were charged to the indirect selling cost account.



Audit Procedures and Results (Cont'd)



Audit Test: Identify from the labor records salaried employees who stopped recording more than 8 hours per day.

Interview these individuals to determine whether:

- the labor charges in the labor accounting records correspond to actual work performed; and
- the employees were working uncompensated overtime but not recording it on their timesheets.

To do so, ask the selected employees to:

- explain what projects/contracts they worked on during the year under audit and what job/s they performed on those contracts/projects.



Audit Procedures and Results (Cont'd)



- describe instances where they were working more than 8 hours per day and why that was necessary;
- state whether they always recorded all the hours they worked on their timesheet; and
- explain why they stopped recording more than 8 hours per day on their timesheets during the last half of the year.

During the interviews, ask relevant follow-up questions of any employee whose responses need further explanation.



Audit Procedures and Results (Cont'd)



Result: The auditor conducted the planned interviews and noted the following regarding employees who had been working on the CPF F DPMS.

- Several employees complained that they had received additional tasking to help with selling presentations to the VA and Commerce for a program management system based on what they were designing for the DoD. This required them to work extra uncompensated overtime hours some days and on weekends.
- One employee who had been working uncompensated overtime showed the auditor an email that the program manager sent to multiple employees instructing them not to record all the extra hours on their timesheet, but to maintain an offline log of those hours. In addition, the program manager's email stated that the "surge" effort would be short-term but was necessary to keep the DPMS program on track. The message stated that employees willing to put in the extra hours would be rewarded.



Audit Procedures and Results (Cont'd)



- Several employees who had worked on the selling presentations stated that they charged all the hours worked to the CPFF development contract when they might have started working on the presentations 2 or 3 hours before the regular 8 hour day ended.



Audit Procedures and Results (Cont'd)



Audit Test: Determine whether labor adjustment transactions in the labor distribution report were appropriate, properly supported and authorized by selecting a random sample of transactions using statistical sampling techniques. The sample size should be sufficient to address the highest risk of misstatement that the auditor is unwilling to accept and should include both direct and indirect labor transactions.

Result: There were no exceptions identified with the labor adjustments reviewed.



Audit Procedures and Results (Cont'd)



Audit Test: For the five T&M contracts determine whether:

- the claimed/billed hours in the submission reconcile to those recorded in the accounting records; and
- the claimed labor hours, rates, and employee qualifications comply with contract provisions, including funding or contract ceiling limitations.

Result: The T&M testing identified that the contractor had billed hours worth \$135,000 in excess of contract funding on the DPMS contract.



Audit Procedures and Results (Cont'd)



Audit Test: Review proposal documentation for the T&M DPMS contract to determine whether the contractor:

- Identified uncompensated overtime hours in the proposal.
- Proposed labor rates that included expected uncompensated overtime hours in accordance with Federal Acquisition Regulation (FAR) 52.237-10, Identification of Uncompensated Overtime⁶.

⁶FAR 52.237-10 requires the contractor to identify in its proposal the hours in excess of an average of 40 hours per week, by labor category at the same level of detail as compensated hours, and the uncompensated overtime rate, whether at the prime or subcontract level. This includes uncompensated overtime hours that are indirect cost pools for personnel whose regular hours are normally charged direct. In addition, the contractor's accounting practices used to estimate uncompensated overtime must be consistent with its cost accounting practices used to accumulate and report uncompensated overtime hours



Audit Procedures and Results (Cont'd)



Result: The contractor did not identify the need for any uncompensated overtime hours or propose labor rates that included uncompensated overtime hours in the proposal for the T&M DPMS contract.



Expanded Audit Procedures and Results



At the direction of the supervisor and incurred cost technical specialist, the auditor requested the audit liaison to provide the offline employee logs they were directed to maintain by the program manager. The auditor used the available employee offline logs to calculate the amount of the uncompensated overtime the employees had worked during the incurred cost year. The auditor determined that the uncompensated overtime resulted in an impact of \$760,000 for the misallocation of costs and the exclusion of the excess hours from the overhead labor base.



Further Actions



The auditor, supervisor, and incurred cost technical specialist discussed the results of the audit of the direct labor costs and decided to take the following actions:

- Question the cost for labor exceptions identified during the audit.
- Issue separate business system deficiency reports for the identified accounting and billing system deficiencies including:
 - failure to properly record uncompensated overtime in accordance with timekeeping policies and procedures
 - labor charges not in accordance with actual work performed
 - billing hours in excess of contract funding



Further Actions (Cont'd)



- Issue a CAS noncompliance report explaining that the contractor is noncompliant with CAS 418, Allocation of Direct and Indirect Cost and its disclosed practices, for failure to properly account for uncompensated overtime resulting in a material cost misallocation.
- Draft a written fraud referral, DCAA Form 2000, for the apparent management-directed labor mischarging and improper accounting for uncompensated overtime that resulted in a material misallocation of costs to Government contracts. The fraud referral would be submitted even though the incurred cost audit was still in process.
- Draft an audit lead for future proposal and estimating system audits to verify on T&M contracts that the contractor properly adjusted proposed rates for estimated or historical use of uncompensated overtime.



Further Actions (Cont'd)



- Ask the PCO whether the contractor made any representations regarding uncompensated overtime during the T&M DPMS proposal review and negotiation processes. Discuss with the PCO:
 - that the proposal did not state that the contractor expected to work any uncompensated hours; however
 - the audit of the T&M DPMS contract identified employees working significant uncompensated overtime.



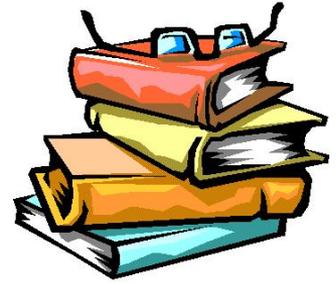
Further Actions (Cont'd)



- Discuss with the audit office manager whether a defective pricing audit should be performed on the T&M DPMS contract.
- Discuss with the ACO:
 - The results of the audit to date
 - The forthcoming CAS non-compliance and business system deficiency reports.
 - The potential significant estimating system deficiency of contractor personnel working significant uncompensated overtime but not identifying it in the proposal or appropriately adjusting the labor rates.



General Comments / Lessons Learned

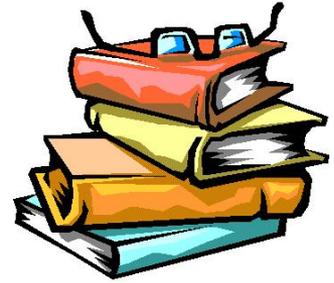


Uncompensated overtime is hours worked in excess of 8 hours a day or 40 hours per week by salaried/exempt employees. Salaried/exempt employees are employees who are paid a fixed amount per week, month or year regardless of the number of hours worked. Therefore, "uncompensated overtime" or "unpaid overtime" is a misnomer. The Fair Labor Standards Act (FLSA⁷) considers the salaries of exempt employees as compensation for all hours worked.

⁷The FLSA establishes minimum wage, overtime pay, recordkeeping, and youth employment standards affecting employees in the private sector and in Federal, State, and local governments.



General Comments / Lessons Learned (Cont'd)



FAR 37.115, Uncompensated Overtime, states that the use of uncompensated overtime is not encouraged⁸. An inequity in the costing of Government contracts may occur if more than a minimal amount of uncompensated overtime is worked, but not accounted for properly. When a salaried/exempt employee works on or charges more than one contract or project, the lack of accounting for all hours worked can allow for the manipulation of labor costs.

⁸The general policy in FAR 37.115-2 states that contracting officers must ensure that the use of uncompensated overtime in contracts to acquire services on the basis of the number of hours provided will not degrade the level of technical expertise required to fulfill the Government's requirements.



General Comments / Lessons Learned (Cont'd)



When applicable, the auditor should expand or perform other audit procedures to determine whether the failure to record all time worked would result in a material difference in the charging of costs. Uncompensated overtime can increase contractor profits, especially on a fixed-price contract bid using only a 40-hour week to calculate labor hour rates. The impact of non-recording of uncompensated overtime occurs whether the contractor requires employees to work unpaid hours or the employees voluntarily do so. Contractor profits increase because for every additional unpaid hour per week an employee works, a lower effective hourly rate is paid by the contractor.



General Comments / Lessons Learned (Cont'd)



This is especially the case when contracts have fixed labor rates. Overstated costs can occur when the contractor uses labor cost history that includes unpaid overtime to bid follow-on contracts. Overstated costs can also occur when contractors use unpaid overtime to compensate for bidding unrealistic labor rates or other costs. This could result in substantial quality or service shortfalls. These fraud indicators may also be found while performing a compliance review with CAS 418, Allocation of Direct and Indirect Cost, and proposal and post award audits.



Fraud Indicators



- **Professional salaried/exempt staff required to work a significant amount of unpaid overtime on a variety of projects, both direct and indirect.**
- **Salaried/exempt employees only charging the first 8 hours worked during any day for an extended period.**
- **A pattern of management-directed unpaid overtime being worked with employee bonuses based on the extra hours worked.**
- **Cost-type Government contracts worked during the first 8 hours and fixed price or commercial contract work performed only during the unpaid hours.**



Fraud Indicators(Cont'd)



- **Overrun contracts/projects worked on only during unpaid hours.**
- **Encouraging employees to work significant unpaid overtime but to not record the hours in direct conflict with company policy.**
- **Contractors consistently working significant uncompensated overtime when no uncompensated overtime was identified in the proposal and proposed labor rates were not adjusted for any uncompensated overtime.**

