

# Direct and Indirect Labor



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# Risk Assessment- Research and Planning

The auditor was assigned to perform a floor check audit for a medium sized contractor during the end of the third quarter of the current year. The supervisor explained that the initial entrance conference for this assignment had already been held during the first quarter, and the contractor's Human Resources Manager had provided a listing of employees which identified their department, job title, building location, and whether they normally charge direct or indirect. The supervisor instructed the auditor to first review the permanent file and then they would discuss the best way to accomplish the objectives of a floor check audit. The auditor reviewed the permanent file and noted the following information relevant to the audit.

- The contractor had \$250 million in sales with \$100 million of that on Government contracts. Sixty percent of the Government sales were from cost reimbursable contracts with the remainder from fixed price contracts.

# Risk Assessment- Research and Planning (Continued)

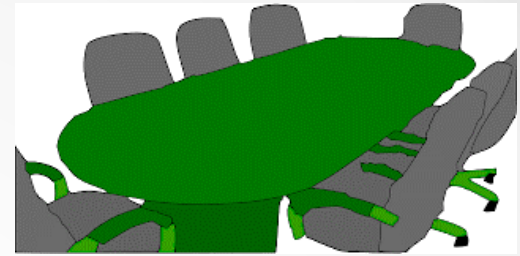
- The contractor had one large campus with 3 separate buildings in which all of its 500 employees were located. The listing of employees identified that 70 percent of the employees normally charge direct to contracts.
- The contractor develops and manufactures the communication modules used in several DoD and commercial aircraft. This includes the production manufacturing line and system development of software applications that run the module. Similar modules are also produced for use in commercial satellites.
- An audit of the accounting system is currently in process. The post-award accounting system audit from 2 years prior reported no system deficiencies.
- The prior year's floor check audit had no significant findings, and the prior year incurred cost audit did not question any labor-related costs.

# Risk Assessment-Research and Planning (Continued)

- An audit lead from a proposal audit during the previous year identified that the contractor had significantly underbid a cost-reimbursable contract by proposing a G&A rate of 2.5 percent when the actual rate was running about 12 percent. An addendum to the original audit lead stated that the Air Force awarded the contract (titled ACCESS) for \$500 million over 5 years. The addendum further explained that the awarded contract included a 5 percent G&A rate ceiling, and that the cost elements comprising the G&A pool were corporate department expenses and Bid and Proposal<sup>1</sup> (B&P) costs.
- The contractor had submitted 6 contractor disclosures over the past 8 months for employees charging hours on their timesheet which were then billed to the Government when the employees were not actually working.

<sup>1</sup> Federal Acquisition Regulation (FAR) 31.205.18 defines B&P as costs incurred in preparing, submitting, and supporting bid and proposals (whether or not solicited) on potential Government or non-Government contracts. B&P does not include the costs required in the performance of a contract or sponsored by a grant or cooperative agreement.

# Entrance Conference



The auditor reviewed the documentation for the floor check entrance conference held in the first quarter. In particular, the previous auditor had asked questions of the contractor's Compliance Director and documented the responses.

**Auditor Question: "What changes have been made to the labor charging system and its policies and procedures over the last year?"**

*Contractor Response: "We implemented an electronic timekeeping system five months ago that uses an internet interface. The rollout of the new practice included mandatory training for all employees. Otherwise, we have not made any changes to how labor costs are charged."*

# Entrance Conference (Continued)

**Auditor Question:** “What changes have occurred in the overall company and organizational structure over the last year?”

*Contractor Response: “Mainly we have really grown our Government contract base over the last 2 years, in particular with the Air Force. This includes both prime contracts and subcontracts.”*

# Entrance Conference (Continued)

**Auditor Question: “Please describe any internal floor checks or timekeeping monitoring activities that are done to ensure that employees comply with the timekeeping policies and procedures.”**

*Contractor Response: “Currently we don’t have any such monitoring programs since previous DCAA floor checks have not identified any real issues with timekeeping. However as our Government business and employee numbers have been steadily increasing, I, as the Compliance Director, think we should implement an internal floor check program so I will be discussing this compliance recommendation with management fairly soon.”*



# Entrance Conference (Continued)

**Auditor Question:** “Does management allow employees to work from home, and if so, is there an established work at home program with written policies and procedures?”

*Contractor Response: “Our type of business doesn’t really lend itself to working from home so we do not allow our employees to telework.”*

# Entrance Conference (Continued)

**Auditor Question: “What does management consider are the primary risks of fraud in the labor charging system?”**

*Contractor Response: “Well we had a lot of problems controlling our paper time cards, in particular when employees had to submit timesheet revisions. This was one reason we implemented the new electronic timekeeping system. It provides a better audit trail for processing and tracking labor revisions, including a mandatory field to explain the reason for the timesheet correction.”*

# Entrance Conference (Continued)

**Auditor Question: “What allegations of fraud or suspected fraud affecting labor charges is management aware of?”**

*Contractor Response: “You are probably aware of the 6 disclosures we have made over the last several months since your office is currently auditing them. We got a tip on our hotline about some employees who weren’t at their offices but were still charging labor to contracts. Our compliance department investigated the allegations and we found that a group of guys in our systems development department had colluded to charge time when they weren’t actually working. They were both non-supervisory and supervisory employees. We fired all the employees, counseled their individual supervisors and conducted specialized training for the remainder of the employees in the department.”*

# Entrance Conference (Continued)

**Auditor Question: “What additional allegations of fraud or suspected fraud affecting labor charging is management aware of? For instance, have employees, former employees, regulators, or other stakeholders submitted allegations to a hotline?”**

*Contractor Response: “I think I just answered that question. I am not aware of anything else other than the disclosures I just explained.”*

# Preliminary Analytical Procedures

The auditor discussed with the supervisor some of the risk factors identified in the risk assessment to date such as contract mix with product similarity between Government and commercial customers; labor mischarging in the contractor disclosures; audit lead for large contract with G&A rate ceiling, and lack of internal monitoring of employee timekeeping practices. The auditor expressed concern about potential mischarging risks between commercial and Government contracts as well as direct versus indirect labor mischarging risks. Because of the identified increased risk factors, the auditor suggested performing some additional procedures such as pre-interview analyses of the labor charges incurred over the last year. The supervisor agreed and the auditor performed various labor cost trend analyses that compared the current year's costs to the previous year's costs. The purpose of the trend analyses was to disclose any significant changes in the ratio of direct to indirect costs that require further evaluation.

# Preliminary Analytical Procedures (Continued)

ANALYSIS



The auditor noted the following results.

- Total indirect costs increased 55 percent.
- Total direct costs increased 30 percent.
- Direct labor costs on Government cost-type contracts increased by 20 percent.
- Direct labor costs on commercial contracts increased by about 12 percent.
- Indirect labor in the Engineering Development and Systems Development departments increased by 35 percent and 25 percent, respectively.

# Preliminary Analytical Procedures (Continued)

The auditor noted that many of these increases could not be readily explained. The auditor decided to analyze the same trends by quarter to determine if there were any patterns of labor cost shifting evident in the data. The auditor documented the results of these procedures.

- Charges to B&P projects were strong in the first quarter but then steadily dropped off to only negligible amounts in the current quarter.
- Indirect labor costs in the Engineering Development Department rose sharply in the middle of the second quarter and had continued increasing.
- Indirect labor costs in the Systems Development Department began increasing substantially during the beginning of the third quarter.
- Labor on commercial contracts remained consistent throughout the year but was still higher overall when compared with the previous year's costs.
- Charges to cost reimbursable contracts spiked in the second quarter and continued to increase through the current period. Sixty percent of all labor charges to cost reimbursable contracts were on the ACCESS contract.

# Audit Team Brainstorming for Fraud Risk Assessment

The audit team comprised of the lead auditor, floor check audit team, supervisor, and incurred cost technical specialist held a planning meeting to discuss the results of the risk assessment to date and identify potential noncompliances, due to error or fraud, that could materially affect direct or indirect labor charged or allocated to Government contracts. Based on these discussions, the audit team developed a plan for conducting the floor check.



# Audit Team Brainstorming for Fraud Risk Assessment (Continued)

- Auditors will review labor distribution reports to identify the population of employees associated with the following labor charging risk areas, meaning the employees charged time to one or more of the following:
  - cost reimbursable contracts;
  - B&P costs;
  - Engineering Development indirect labor; and
  - Systems Development indirect labor;
- Auditors will then analyze individual employee labor charging patterns in the risk groups to identify those that had changed their labor charging patterns during the current year.
- For the employees found to have changed their labor charging patterns, auditors will review available employee travel records and determine whether these correlate with the related labor charges.

# Audit Team Brainstorming for Fraud Risk Assessment (Continued)

- The lead auditor will use the information from these analyses to select a non-statistical sample of employees to interview for the floor check. For example, an employee who generally charges their time direct to a project such as a commercial contract, but then started charging indirect should be selected for further review/analysis. Likewise an employee whose travel records do not support the labor charged should be considered for interview. The sample size should be sufficient to confirm or refute the mischarging risk.
- Auditors will develop appropriate factual questions for each employee selected to be interviewed and their supervisor. The questions should be designed to confirm or dismiss a potential mischarging risk or more fully explore the risk area. The questions will also specifically address the identified changes to labor charging patterns and related work authorizations.
- Auditors will verify labor charges on the timesheets obtained on the floor check date to the labor distribution report for that period and the actual work the employee stated they were performing.

# Results from Audit Procedures

- The audit team conducted the unannounced floor check interviewing from the identified risk area groups a total of 120 (out of 500) individuals, 80 employees and 40 direct supervisors. This represented 25 percent of the work force. Two person teams interviewed the selectees. The audit teams documented the results of the employee and supervisor interviews and other labor testing.
- Most of the employees interviewed could not explain what contracts, projects, or work was associated with the labor charge codes on their timesheet. They stated that they were just given the charge codes via email by their supervisor and that each week their timesheets were pre-populated with the charge codes they were authorized to charge which matched the emails they received. The supervisors confirmed that they provided charge numbers to their employees via email.

# Results from Audit Procedures (Continued)

- Employees in the Engineering Development indirect labor sample were all classified as direct charging employees. They described in the interview that they had been working for several months on solving some production problems on the communication modules that were overdue for delivery on several commercial satellite contracts. The supervisor for these employees explained that the problems they were solving were generic to all communication modules and so it was appropriate for them to stop charging the commercial contracts and charge indirect to Engineering Development indirect labor.

# Results from Audit Procedures (Continued)

- A budget analyst and his staff were currently charging the cost reimbursable ACCESS contract when they had previously charged B&P in the first quarter. They stated they had been assigned to work on ACCESS during the second quarter and described their current work as obtaining and analyzing financial information on a group of Air Force contracts, including ACCESS, and forwarding the results to various managers. They stated that they had performed several similar analyses throughout the year. The supervisor confirmed they had been assigned to ACCESS and were working on some cost reporting taskings, but could not identify the related contract requirements or deliverables. Several employees' travel records indicated a recent trip to an Air Force command not associated with ACCESS with "BAFO<sup>2</sup> Discussions" as the travel description or justification.

<sup>2</sup> The term BAFO usually means best and final offer and is one of the last phases in the bid solicitation process.

# Results from Audit Procedures (Continued)

- Several employees classified as direct charging in the Systems Development indirect labor sample were not present at their offices on the day of the floor check interviews. The audit team was able to conduct follow-up telephone interviews to confirm the employees' existence. They all explained that they were waiting to start work on a new NASA contract and were performing various administrative-type assignments such as training that would be needed before system development could begin on the new contract. They stated that their supervisors gave them their work schedules. Many expressed frustration that it had taken them over a month and a half to start work as the contract start date had been delayed several times. The supervisors stated during their interviews that the employees were unavailable because they were in training at an offsite location.

# Additional Audit Procedures and Results

The floor check audit teams decided to request additional data and explanations from the contractor representative to follow up on some of the interview responses. The contractor representative provided:

- a requested listing of current contracts in an overrun position. Several commercial contracts were listed and the explanatory field stated “production issues delaying delivery;”
- a requested listing of B&P projects for the year that identified their current status. The listing included multiple proposals for the Air Force that were in various stages of the procurement process such as initial proposal, discussions, BAFO and negotiation;

# Additional Audit Procedures and Results (Continued)

- requested documentation supporting that the current G&A rate was running about 11 percent;
- requested badge in and badge out records for Building 3 (location of Systems Development department) which validated that the employees who had been unavailable on the day of the floor check had routinely left the building early or come in later when their timesheet indicated they worked all day; and
- confirmation in an email that the company had recently been awarded its first NASA contract and that it was firm-fixed-price.



# Further Actions

The lead auditor, floor check audit team, supervisor and audit office manager all met to discuss the results of the floor check audit and decided to take the following actions:

- Calculate the questioned labor costs by determining the current year labor hours and dollars associated with the following identified mischarging patterns:
  - Direct charging employees charging direct costs for commercial contracts to Engineering Development indirect labor.
  - Direct charging employees charging Systems Development indirect labor while waiting for new contract to start and completing training and other tasking needed to begin work on the contract.
  - Employees charging direct to ACCESS contract when working on B&P projects for potential Air Force contract awards which reduce the impact of G&A rate ceiling.

# Further Actions (Continued)

- Issue a business deficiency report for the labor internal control deficiencies.
- Issue a report for non-compliance with CAS 402, Consistency in Allocating Costs Incurred for the Same Purpose.
- Draft a Form 1, Notice of Costs Suspended and/or Disapproved, to suspend reimbursement of the questioned costs if the contractor does not concur to the questioned cost.
- Discuss with the Administrative Contracting Officer (ACO) the results of the review and forthcoming deficiency and CAS non-compliance reports.
- Contact the local criminal investigator to discuss the results of the floor check and forthcoming Form 2000.
- Draft a written fraud referral, DCAA Form 2000, on the patterns of mischarging identified in the audit.

# General Comments and Lessons Learned

Improper charging of costs is one of the most common fraud indicators that auditors find and refer for investigation. However, improper charging of costs can occur for numerous reasons, such as wrong charge numbers and misunderstandings. Auditors should always request a complete explanation for discrepancies between what employees say they are working on, what they are charging, and practices contrary to the contractor's established timekeeping policies and procedures. The auditor should then fully evaluate the contractor's rationale and determine its validity before accepting or rejecting the costs.

The auditor must remain alert to risk situations that provide motivation for contractors to improperly charge costs to obtain the maximum reimbursement of those costs. These might include contracts with performance, production, or delivery issues that impact funding; or contract cost or rate ceilings that limit reimbursement of costs.

# Fraud Indicators

- **Distinctive potential mischarging patterns:**
  - Sudden, significant shifts in charging.
  - Decrease in charges to projects/contracts in overrun position or near ceilings.
  - A disproportionate percentage of employees charging indirect when compared to the contractor's normal or historical charging practices.
- **Large number of employees reclassified from direct to indirect or vice versa.**
- **Same employees constantly reclassified from direct to indirect or vice versa.**

# Fraud Indicators (Continued)

- **Weak internal controls over labor charging:**
  - Employee time cards completed in advance.
  - Employee time cards completed by the supervisor.
  - Adjustments to time cards without adequate explanation and/or authorization by employee.
  - Inadequate processes for work authorization and assignment of charge codes.
- **Actual hours and dollars consistently at or near budgeted amounts.**
- **Use of adjusting journal entries to shift costs between contracts, Independent Research and Development (IR&D), Bid and Proposal (B&P), commercial work, particularly when made a considerable time after when the costs were originally incurred.**

# Fraud Indicators (Continued)

- Significant increases or decreases in charging to sensitive accounts.
- Differences between what employees are actually working on or observed to be working on and recorded timesheet charges.
- Differences between employee timesheet charges and labor accounting records.
- Employee's time charged differently than associated travel costs.
- Employee's time charged differently than statements in contract status report deliverables submitted to the Government.