
LABOR MISCHARGING

The Scenario

A small contractor is performing on a \$55 million cost-type research and development (R&D) contract for the Department of the Navy. The contractor primarily provides engineering, testing, and training services for the development and integration of new flight systems. Included in the contractor's original proposal to the Department of the Navy were the following engineering categories, along with the respective education/experience requirements and direct labor rates:

	Staff Engineer I	Staff Engineer II	Senior Staff Engineer	Principal Staff Engineer
Education	B.S. from accredited university	B.S. from accredited university	B.S. from accredited university	M.S. from accredited university
Experience	None required	> 5 years	> 15 years	> 15 years
Direct Labor Rate	\$26.00	\$35.00	\$52.00	\$68.00

During the risk assessment, the auditor assigned to the contractor's first year Incurred Cost Audit performed a comparative analysis of the contractor's claimed direct labor account to the budgetary estimate. The auditor noted a significant difference between the claimed amount and the budgeted amount, so the auditor selected the direct labor account for further examination and testing of details. The auditor first compared the claimed direct labor hours to the budgeted direct labor hours. The auditor did not find any significant differences in the total direct labor hours, but the auditor did note significant differences between the budgeted direct labor hours by engineering labor category and the claimed direct labor hours by engineering labor category.

When the auditor requested an explanation for the variances, the Controller, who performed various accounting, payroll, and billing duties, indicated that constantly-evolving Department of Navy demands caused them to incur more direct labor hours in the Staff Engineer II, Senior Staff Engineer, and Principal Staff Engineer labor categories, which caused the increase in the total direct labor cost. To corroborate the Controller's assertion, the auditor contacted the Contracting Officer at the Department of Navy. The Contracting Officer informed the auditor that she had, in fact, approved a change in the original scope of work. The auditor obtained and reviewed the supporting documentation from the Contracting Officer and noted that the justification/approval package did not include a revised statement of work.

To ensure the engineers met the minimum qualification requirements, the auditor pulled personnel records for a sample of employees. Based on the auditor's review of the personnel files, the auditor determined that several of the engineers performing under the Staff Engineer II, Senior Staff Engineer, and Principal Staff Engineer labor categories did not meet the minimum education and/or experience requirements as outlined in the Request for Proposal and the contractor's original proposal.

Additionally, the auditor found that some personnel files were incomplete – the annual appraisals had not been included nor had the resumes, transcripts, or job descriptions. For the personnel files that were incomplete or inadequate, there also appeared to be a significant gap in the employee identification numbers. For example, the auditor noted that an employee with a complete personnel file had an employee identification number that was four digits. Those employees with incomplete or inadequate personnel files had employee identification numbers that were seven digits.

Internal Control Weaknesses with Potential Fraud Indicators:

- Significant variances between budgeted direct labor and actual/claimed/billed direct labor amounts
- Material differences between budgeted hours and actual/claimed/billed hours
- Lack of segregation of duties in the accounting, payroll, and billing functions
- Inadequate documentation of justifications/approvals for changes in the scope of work
- Minimum employment qualifications not being met by personnel
- Incomplete and/or inadequate personnel records
- Significant gaps or breaks in employee identification numbers

General Comments/Lessons Learned: In accordance with Generally Accepted Government Auditing Standards (GAGAS), auditors should design the engagement to detect instances of fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements that may have a material effect on the subject matter. In audits of claimed or proposed direct labor, auditors should evaluate the strength of the internal controls in the payroll and labor distribution process. The auditor should be alert to the risk of labor mischarging, including ghost employees or employees who are friends/family of management. Since small businesses sometime lack the resources required to achieve adequate segregation of duties, the need to perform additional substantive testing (e.g., reviewing personnel records or interviewing employees to verify existence) is particularly important.