
Employee Existence and Verification of Labor Charging Practices Audit

The Scenario

A Department of Defense Auditor performed an audit of employees' existence and verification of labor charging practices. The auditor performed the audit at a small government contractor with firm-fixed-price and cost-type contracts. The contractor manufactured aircraft parts for the Air Force and has one location at which all 73 of their employees are located.

During the risk assessment phase, the auditor reviewed prior audit results and did not find anything. The contractor provided a listing of their 73 employees that included job title, job description, and whether the employee charged direct or indirect to their contracts. The auditor performed a statistical sample on the employee universe that resulted in a sample size of 24 employees.

On the day of the site visit, the auditor requested the contractor's timekeeping policies and procedures. The contractor stated that there were no written policies or procedures. The auditor informed the contractor that once the interviews were conducted that he would be requesting final timesheets, job cost ledgers, and payroll and labor distribution reports. The contractor stated he would do his best to fulfill all requests in a timely manner; however his accounting/payroll staff consisted of two employees. They had been especially busy lately with the conversion from a manual timekeeping system to an electronic timekeeping system.

The auditor performed interviews on the selected employees. During the interviews, two of the 24 employees could not be located. The timekeeping system reported the employees as being "on the clock." When asked about the employees' whereabouts, the manager then went into his office and attempted to contact the employees. The manager returned and stated that he had just remembered the employees were in an off-site training class all week.

Internal Control Weaknesses with Potential Fraud Indicators:

- The contractor did not have written timekeeping policies and procedures.
- The accounting/payroll staff was small in size which was not conducive to proper segregation of duties.
- Cost-type contracts are susceptible to labor mischarging.
- Costs are reimbursed to the contractor.

General Comments / Lessons Learned. The auditor should perform steps to verify the absent employees' existence, such as a follow-up interview (if practical), review of personnel or security files, review of prior timesheets and observation of the employees' work area. The auditor should also reconcile current timesheets and statements of work obtained during interviews to final timesheets, as well as payroll and labor distribution reports. Cost-type contracts are susceptible to mischarging because costs are reimbursed to the contractor as

opposed to fixed-price contracts, which are negotiated on the front end at a set cost. Labor mischarging can occur in different forms such as ghost employee schemes, labor substitution, as well as cost shifting between contracts. Lack of internal controls over timekeeping and payroll processes can lead to opportunities for fraud. Strong internal controls can detect and deter fraud. Payroll staff should undergo proper training in order to detect and prevent instances of fraud. It is important for auditors to perform audit procedures to verify existence of employees as well as verification of labor charging practices.