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## Incurred Cost Audit - Related Party Transaction

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### The Scenario

A DoD auditor is performing an incurred cost audit of One Defense Consulting's (ODC) 2011 incurred costs. ODC is a medium-sized defense contractor with primarily cost-type Government contracts. The contractor's 2011 incurred cost submission was determined adequate for audit. During the risk assessment phase, the auditor selected several indirect cost accounts for transaction testing.

In selecting the indirect cost accounts, the auditor compared the 2011 account balances to the prior year's account balances. The auditor noticed a significant increase in Rent Expense. The auditor selected Rent Expense as well as Indirect Salaries, Consulting Fees, and Legal Fees for transaction testing.

As part of the transaction testing, the auditor requested invoices, proof of payment, and any applicable source documents (lease agreements, consulting agreements, etc.). The costs in the selected accounts were tested to ensure the costs were in accordance with Federal Acquisition Regulation (FAR) 31.201-2 (Allowability), 31.201-3 (Reasonableness), and 31.201-4 (Allocability).

During review of the source documents for the Rent Expense account, the auditor noted the lessor on the lease agreement as Defense Dynamics, formerly known as One Defense Holdings, which is the holding company of ODC. The auditor reviewed the invoices and proof of payment. The typical accounts payable process for this contractor is as follows:

Accounts Payable Clerk → Staff Accountant → Controller

The auditor noticed that for the lease payments selected, the typical process had not been followed. The staff accountant had not been involved in the process. The controller mentioned during the risk assessment phase that the staff accountant had been in and out of the office over the last several months due to an ongoing medical issue.

### Internal Control Weaknesses with Potential Fraud Indicators

- Contractor's lessor is a related party, which creates a potential for fraud.
- Significant increase in the contractor's rent expense raises a red flag, especially considering it is a related-party transaction.
- Contractor did not follow established accounts payable procedures for processing lease payments.
- Intermittent absence of the staff accountant weakens accounts payable internal controls, creating opportunity for fraud.

**General Comments/Lessons Learned.** The auditor should determine the reasonableness of the lease terms in accordance with FAR 31.205-36. Determining reasonableness may be accomplished by comparing the terms of the lease with the contractor's other comparable

leases as well as actual advertised prices for the facilities in question or other similar facilities. Along with reasonableness, the auditor should validate the costs through third-party confirmation. During an incurred cost audit, auditors should review the notes to the financial statement for possible audit leads. Auditors should obtain confirmation from the contractor that the financial statements include disclosure of all related party transactions. A lack of internal controls over the accounts payable process can lead to opportunity for fraud. Strong internal controls can detect and deter fraud. It is important for auditors to perform audit procedures to determine adequacy and effectiveness of internal controls at the contractor's location.