NEW DEVELOPMENTS

DCAA Issues Guidance on Executive Compensation Cap

The Defense Contract Audit Agency issued guidance to its auditors on implementing the new $374,228 executive compensation cap set by the Office of Federal Procurement Policy. The cap does not limit the amount a federal contractor may pay its senior executives but rather the amount that may be charged against federal contracts. The cap applies to all defense and civilian agencies and stems from a provision in the 1998 defense authorization act authorizing OFPP to revise the cap periodically based on the medium executive compensation for all senior executives of benchmarked corporations. The new cap was set by OFPP May 3, intended to apply to contractor fiscal year 2001 and beyond until revised.

The audit guidance states (1) the cap applies to costs incurred after January 1, 2001 and to all agency contracts covered by the FAR cost principles including those awarded prior to January 1 (2) auditors are to allow no more than $374,228 in the pricing of each senior executive for calendar fiscal year 2001 and all subsequent years and (3) no escalation of the cap beyond 2001 is warranted because the amount applies to all subsequent years until revised.

DOD Ends Contractor Cost Sharing for Some R&D Efforts

In his first official act, the Undersecretary of Defense for Acquisition, Technology and Logistics Edward Aldridge issued a policy memorandum on May 16 to acquisition personnel that DOD will no longer force its contractors to share the cost of research and development programs. The memo states DOD needs to be concerned about the financial health of the defense industry in order to be able to acquire innovative technologically excellent weapons and equipment at affordable prices. The policy provides that none of the following forms of contractor investment in defense programs are acceptable:

- use of contractor independent research and development funds to subsidize defense R&D
- cost ceilings that, in effect, convert cost-type contracts into fixed price contracts
- unreasonable capping of annual funding increments on R&D contracts
- award of development contracts at prices known to be less than the contractor's probable costs of performance.

The policy states an exemption would apply if there is a reasonable probability of a potential commercial application related to the R&D effort.

DOD IG Reports Failure to Ask for Cost and Pricing Data Results in Higher Prices

(Editor's Note. In spite of general prescriptions to use commercial pricing, the following adds pressure to increase, not decrease, use of cost builds for pricing contracts.)

In a report issued May 30, the Department of Defense (DOD) Inspector General (IG) stated DOD may frequently pay more than it should for goods and services when prices are established without submission of contractor certified cost or pricing data. The report asserted contracting officers often lacked valid exemptions from requirements to obtain certified cost or pricing data. The report found COs failed to challenge prices of commercial items and frequently accepted prices from contractor catalogs without analysis. Price analysis documentation frequently did not adequately support determinations of price reasonableness in the majority of cases reviewed and COs often relied on unverified prices from previous contracts. Factors contributing to poor price analysis and inflated prices were attributed to lack of planning, staff shortages, little manager oversight and general lack of emphasis on obtaining cost or pricing data.

The IG recommended staffing shortage and excess workload be addressed, initiate price trend analysis when only one offer is received and emphasize the proper process for dealing with contractors who refuse to provide data when asked. Other recommendations include (1) obtain cost or pricing data when asked (2) use DCAA for pricing assistance (3) establish better
controls on the use of exceptions for obtaining cost or pricing data and (4) establish better corrective actions in the future.

**NASA Wants to Increase its Fee Pools**

(Editor's Note. Though NASA has been quite innovative in using new contracting techniques, we often hear from clients that NASA contracts are frequently unprofitable due to low fees and restrictions on cost recovery (e.g., limiting overhead to 10 percent on modifications). The following actions, though not going very far, reflect NASA's awareness of this situation.)

The National Aeronautics and Space Administration is developing a pilot program to test new approaches for determining fees on certain NASA contracts. NASA is attempting to reverse two problems: (1) due to increased competition, there are lower profit pools which for multiyear contracts do not provide “much of a carrot” to solve new problems, particularly those requiring lots of time or expertise and (2) many companies appear to be uninterested in bidding on NASA work because low fees do not provide a decent return on investment.

To reduce the tendency for offerors to propose excessively low fees to win contracts, contractors will not be asked to bid fees in their proposals but rather NASA will look at three alternative approaches: (1) establishing a fee based on estimated cost of the contract at time of award (2) setting a dollar amount as the maximum fee available or (3) establishing a narrow range in which offerors can bid fees. Under the third option, if a proposed fee is “too low” evaluation points could be deducted because the contractor does not intend to use its best resources.

**OMB Proposes Public-Private Competition for All Inter-Service Support Agreements**

The Office of Management and Budget July 2 proposed changes to the OMB Circular A-76 Revised Supplemental Handbook making all inter-service support agreements (ISSAs) subject to public-private competitions. The proposal would eliminate the current exemption of ISSAs from competition and subject them to competition with private firms on a recurring three to five year review cycle. In addition, all new or expanded work by a customer agency will have to be competed. The proposed recurring competition requirement will not apply to reimbursable support agreements within a single agency for the time being.

OMB said the proposal, in the form of a memorandum to the heads of executive departments and agencies, was needed to expand the amount of commercial work being performed under reimbursable review agreements without the benefit of competition. The support activities subject to the proposed competition is considered “wide ranging” including procurement and contracting services, legal services and other services related to personnel, health and safety, security, financial management, information technology, communications, publications, research and analysis, supplies, facilities, grounds maintenance and many more. (Editor's Note. Currently, support activities are financed by agencies either through direct appropriations or a revolving fund on a reimbursable basis where the prices charged are usually not based on the full cost of goods and services (e.g., cross subsidies, other pricing strategies are used to expand volume). We expect private-public competitions for these services will require significant changes in how government costs these services to provide a “level playing field” for competition.)

**Initiatives to Lessen Contracting-Out are Proposed**

The issue of accelerating or retarding outsourcing is becoming a political hot potato. Representatives of federal employees and sections of the country with high civilian federal employment have created proposals to lessen the scale of competition. The House has introduced a bill Truthfulness, Responsibility and Accountability in Contracting (TRAC) Act while the Senate’s version would suspend new federal outsourcing until the government develops a system for tracking costs and savings from contracting out. Both bills would:

- Temporarily suspend new service contracts until oversight efforts are established and enforced
- Require agencies to establish a system to monitor costs, efficiencies and savings of contracting out
- Allow federal agencies to hire additional federal employees when they can do the work more economically than private contractors
- Emphasize “contracting-in” by subjecting current contracting out services to private-public competition
- Require the Office of Procurement Management and the Labor Department to compare wages and benefits of federal employees and their contractor counterparts.

**FASB Issues Final Rules on Business Combinations**

141 and 142. Under FASB No. 141, Business Combinations, combinations are required to be accounted for using the purchase method. FASB no longer permits the pooling of interests method after June 30, 2001. FASB No. 142, Goodwill and Other Intangible Assets, requires that goodwill will no longer be written down or amortized. Instead, goodwill and other intangible assets will be tested for impairment and written down if their fair market value declines below book value.

**Senate Panel Approves Extension of Technology Transfer Program**

The Senate Small Business and Entrepreneurship Committee July 19 unanimously approved legislation to reauthorize for nine years the Small Business Technology Transfer (STTR) program. In addition to the extension the legislation made two key changes: (1) raise Phase II grant award amount from $500,000 to $750,000 and (2) raise in small increments the percentage participating departments must set aside for STTR – increase from .1 percent to .3 percent of an agency’s R&D budget in 2004 and .5 percent by 2007.

The STTR program funds cooperative research and development projects between small companies and research institutions such as universities and federally funded R&D labs. The STTR complements the SBIR program which funds R&D projects at small companies. The STTR program fosters development and commercialization of ideas that either originate or require significant involvement of a research institution. It has three phases: Phase I provides a participant a one year grant of $100,000 to determine the scientific and commercial merits of an idea; Phase II provides a two year (now) $750,000 grant to further develop the idea and; Phase III is for further commercialization of the idea which is funded by the private sector and other federal funds but not STTR funds. Five agencies participate – DOD, NASA, DOE, NIH and NSF.

**Army Rescinds Requirement to Collect Contractor Labor Data**

The Acting Assistant Secretary of the Army for Acquisition, Logistics and Technology Kenneth Oscar stopped the Army from collecting contractor labor data requirements. The data collection efforts of reporting $9 billion by more than 1,200 contractors was considered onerous by both the Army and industry. The rescission of the requirement will take effect by suspending the clause requiring the reporting on new contracts and COs will be required to notify contractors with existing contracts they need no longer submit reports.

**FAR Rule on Preference for Performance-Based Contracting of Services**

An interim FAR rule was passed explicitly establishing a preference for performance-based contracting when acquiring services. Proponents of performance-based contracting say it occurs when all aspects of the acquisition are structured around the purposes of the work where the requirements are set forth in clear, specific, and objective terms with measurable outcomes rather than how the work is performed or in broad, imprecise statements of work. The new policy requires COs to use performance based contract methods to the maximum extent possible when acquiring services. Exceptions to the policy are for architecture-engineering, construction and utility services or when the services are incidental purchases under a supply contract. The order of preference is (1) firm fixed price performance based contracts (2) a performance-based contract or task order that is not firm-fixed price and (3) a contract or task order not performance based.

**Correction…** In the March-April issue we reported that the Department of Defense is seeking ways to reduce restrictive intellectual property rights to encourage greater participation of commercial firms and cited a website to read the guidelines issued by DOD. That website has been changed to www.contracts.ogc.doc.gov and once at the site go to “Contracts Law Division” and then “News and Items of interest” where you will find “Intellectual Property: Navigating Through Commercial Waters.”

**Developments in Travel and Relocation Rules**

(Editor’s Note. Allowability of travel and relocation costs is one of the most frequent questions our clients and subscribers ask so we want to report on recent developments and decisions affecting these expenses. Though government contractor employees as opposed to government employees are not covered by each requirement of the Federal Travel Regulations, most contractors (not to mention auditors) use them as guidelines of allowability.)

If a meal is provided by, for example, an airline or is included in registration for an event you must adjust (e.g. lower) your per diem reimbursement. Section 301.11.18 of the FTR provided a new breakdown of meals and incidental expenses (M&IE) and the relevant meal cost must be deducted from the appropriate per diem rate below:
Termination costs are OK if the Government saves money. The DOD employee was authorized for 60 days of temporary quarters and she rented a month-to-month apartment for two months that required a 30 day notice termination. When her belongings arrived unexpectedly early, she moved into her permanent home after one month and the Board found she was entitled to the termination cost of her lease. Though Joint Travel Regulations state temporary quarter occupancy ends when the employee moves into their new home, the Board said lease termination costs are allowed if reasonable, prudent and the government saves money (GSBCA 15039-RECO).

Travelers are entitled to cost of a forfeited hotel room if they are able to secure lodging more convenient to their destination. Two employees were unsuccessful in finding lodging in the same city as their duty station so they booked a hotel farther away guaranteeing the rooms with their credit cards. They unexpectedly were able to book rooms closer to their station due to a cancellation and when they arrived at the hotel late in the afternoon they requested the desk clerk to cancel their reservations at the more distant hotel. Due to the lateness of the cancellation they were charged one night. Their agency refused to reimburse them since they had not cancelled “in a timely manner” while the Board sided with the employees stating it was required to make the back wage payments “prior to seeking reimbursement.” The Appeals court disagreed ruling the contractor was not liable for the back wages until it receives reimbursement from the agency (Richlin Security Service Co. v. Immigration and Naturalization Service, Fed. Cir., No. 00-1134).

You cannot be reimbursed real estate taxes for the sale of a home you did not commute from on a daily basis. A federal employee at Kelly Air Force Base stayed at a hotel near the base where he commuted each day and returned home on weekends. When transferred he asked for reimbursement for certain relocation expenses including real estate taxes on his home. DOD denied his request for reimbursement and the Board agreed with DOD stating that an employee who commutes to work from living quarters close to work on a daily basis and returns only on weekends is not entitled to real estate taxes (GSBCA 15521-RELO).

### CASES/DECISIONS

**Contractor Need Not Repay Wages Owed Until Reimbursed by Government**

The contractor received two contracts for guard services where the Department of Labor determined that the wage levels were lower than they should have been. To increase the compensation the contract had to be revised but the contracting officer and appeals Board refused to sign off on the contract because the contractor had not made payment to the employees stating it was required to make the back wage payments “prior to seeking reimbursement.” The Appeals court disagreed ruling the contractor was not liable for the back wages until it receives reimbursement from the agency (Richlin Security Service Co. v. Immigration and Naturalization Service, Fed. Cir., No. 00-1134).

**Subcontractor Without Cost Records is Out of Luck**

(Editor’s Note. The following decision should illustrate the need to (1) obtain some assurance subcontractors’ accounting systems can provide necessary data for invoicing (2) invoices should be examined and reflect in sufficient detail how totals are computed and (3) adhere to the record retention provisions of FAR Part 4. Subcontractor invoices for cost type, T&M and fixed unit prices are frequently audited during incurred cost audits and we have seen significant disallowances because records were not available, the invoiced costs were not properly documented, no evidence of accepted work product existed, no personnel were available to answer auditor questions, etc.)

AAC received a $4.6 million cost plus fixed fee contract from DOD and subcontracted some of the work to MGA. The contract was subject to FAR including Subpart 4.7 that requires the contractor to retain books, records and other supporting documentation to satisfy contract administration and audit purposes. AAC billed the government for $220,000 representing costs purportedly incurred by MGA and the government paid the invoices. MGA subsequently went out of business. When DCAA audited certain vouchers during its incurred cost audits it selected a voucher containing the subcontracted amount and when AAC was unable to provide details about its subcontractor’s accounting system, invoicing procedures, hours alleged to have

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been worked and acceptance of work, the auditors disapproved the costs. The contractor asserted the $220,000 of subcontractor costs were allowable and allocable because the subcontract costs were not questioned when billed while the CO disagreed saying MGA costs were not properly supported or documented.

The appeals board sided with the government ruling AAC owed the entire $220,000 to the government. The Board found that the MGA invoices merely summarized totals for cost categories without illuminating how the total were derived. It asserted AAC did not audit the invoices and there were no indication that MGA's accounting system was accurate, concluding there was no records supporting AAC's payments. The Board concluded that to side with AAC on such "limited evidence" would "nullify the duty of AAC to adhere to pertinent FAR record-keeping provisions" (Analytical Assessments Corp., ASBCA Nos. 52393 & 52394).

Proposing Zero Fee Is OK

(Editor's Note. The following indicates the need to follow the form of the solicitation when engaging in creative pricing tactics.)

An Air Force fixed price, best value solicitation for travel services asked offerors to include a service fee for flights and other items. The incumbent contractor, Sato, included a service fee while N&N quoted a fee of "$Zero." The source selection found Sato's performance to be excellent while N&N also received a high rating for its past performance so it decided the price premium of $1.6 million ($1.4 million due to the difference in fee) was too high so it awarded the contract to N&N. Sato protested contending that N&N's pricing scheme was inconsistent with the solicitation and hence was a technically unacceptable proposal. The GAO disagreed stating it was acceptable for an offeror to elect not to charge for a certain item by inserting "$0" – though offerors were required to insert a service fee in their proposal they were not prohibited from proposing a fee of zero or even a negative fee, for that matter (SatoTravel, GAO, B-287655).

Court Allows GE to Base Depreciation on Historic Exchange Rates Rather than Current Rates

The US Court of Appeals reversed an appeals board decision that disallowed certain depreciation charges claimed by a Turkish subcontractor of General Electric. The original decision upheld the CO disallowing a portion of depreciation charges because they were converted into US dollars based on average historic exchange rates. The CO, based on recommendations from DCAA, said such practices resulted in more depreciation costs than the book value of assets which violated FAR 31.205-11 and should be computed using historic rates. On review, the Court stated the referenced FAR citation did not address currency exchange matters and disputed the assertion that depreciation exceeded the book value but produced an "equitable result." The Court noted that FAR 31.201-2(a)(3) directs that generally accepted accounting principles (GAAP) should be used to determine allowability of costs when FAR and the cost accounting standards are silent. The court referenced the Financial Accounting Standards Board as the highest authority on GAAP and using Financial Accounting Standard 52 (Foreign Currency Translation) as a guide concluded the standard recommends use of historic exchange rates when converting costs expressed in a local currency to the functional currency (dollars) (General Electric Cp., v. Delaney, etc. Fed. Cir., No. 00-1401).

Legal Costs Defending Fraud Suit is an Allowable Direct Cost and "Benefits" Government Work

In a previous case, DynCorp's costs spent defending itself against allegations that it violated the Major Fraud Act (MFA) were ruled allowable because it was the contractor's, not employee's, misconduct that was the criteria for disallowing recovery. Under the current case, the government disallowed the legal costs as a direct cost to the contract, asserting the MFA allowed only indirect legal costs. The Board disagreed with the government stating under the MFA all allowable defense costs incurred under a contract are to be reimbursed directly under that contract (DynCorp, ASBCA, No. 49714).

In a separate decision in the same month, the Army had attempted to avoid paying the legal expenses by arguing the government received no "benefit" from DynCorp providing legal representation to its employees. The Army cited two cases we have discussed in the past in supporting its no benefit position
– *Caldera v. Northrup Worldwide Aircraft* and *Boeing North American*. The Board disagreed that they were relevant. In *Caldera*, the court did not interpret the provisions of the Major Fraud Act and the disposition was against Northrup rather than an employee. In *Boeing North American*, the board found the costs were not allocable because they were clearly a result of a lawsuit in which the contractor had violated federal laws. In contrast, the board had found wrongdoing only by a contractor employee, not DynCorp.

In enacting the Major Fraud Act Congress provided a recovery of costs of legal proceedings (with an 80 percent limit) unless there was a conviction or its equivalent so the Board concluded it was “inconceivable” for Congress to allow proceeding costs when there was no conviction unless it saw a benefit. The board found no conflict between MFA and FAR 31.201-4 that addresses “benefit.” The Board stated “benefit” is a “slippery” concept which embraces distribution of costs among cost objectives and policy considerations. The distribution concept is satisfied here because the costs were incurred under one contract and allocated to that contract in accordance with company policy of charging direct costs and the Fraud Act that allows direct costing. The policy concept is satisfied by the Congressional intent which mandates how the Fraud Act will treat allowability of proceedings costs (DynCorp, ASBCA, No. 53098).

**QUESTIONS & ANSWERS**

**Q.** I occasionally hear the term “estoppel” bantered about as a possible defense against assertions of unallowable and unallocable costs. Could you clarify the term?

**A.** During an audit of your historical costs auditors may assert your practices of allocation are improper and recommend another method (that will usually result in lower costs allocated to cost type work) than what had been used in the past and was accepted. Recognizing that it would be impossible to conduct business when the ground rules keep changing, the courts have ruled they will not permit such “retroactive” disallowances of cost when the contractor can show he reasonably relied on the government’s prior conduct. This principle is known as “equitable estoppel” or “estoppel” and it applies when the contractor can show a history of acquiescence or approval of a particular accounting practice by the government. It should be stressed the doctrine applies to assertions of “unreasonableness” and “allocation of costs” but does not generally apply to costs that are deemed unallowable under FAR cost principles. This distinction is commonly overlooked. In order for the estoppel doctrine to apply, all of the following must be present:

- The government must have had actual notice of all relevant facts
- The contractor must have reasonably relied upon the government’s action or inaction
- The government must have realized, or should have realized, the contractor’s reliance
- The contractor would be prejudiced (suffer a loss) as a consequence of the retroactive application

Under these conditions several cases have not permitted retroactive changes (e.g. *Litton System, 449 F, 2nd 393*).
and Gould Defense Systems, ASBCA No. 24881). In Gould, the Board ruled that the estoppel doctrine is not limited to final audits but also when the government clearly accepted the accounting treatment in a proposal for forward pricing.

You are quite correct when you indicate the estoppel doctrine is a strong weapon against assertions of “unreasonableness” or “unallocability.” If an auditor questions the reasonableness of a certain cost or the method of allocation it is a good idea to ascertain how these costs were presented in prior periods or proposals and whether DCAA or other auditors previously reviewed these costs. If these conditions are met, demands that impose undesirable retroactive changes should be resisted on “estoppel” grounds.

Q. We provided certain of our senior executives what we considered reasonable severance payments of about one year's salary. DCAA questioned about one half of the severance by alluding to a survey we never heard of that indicated the mean severance payment for executives was 26 weeks. How can we challenge this?

A. DCAA has eliminated its highly trained, specialized compensation teams so now often untrained auditors are, in our opinion, sometimes inappropriately relying on surveys to evaluate individual elements of compensation. Unless the method is clearly improper or DCAA comes up with more strict guidelines on how to use survey results, contractors will need to convince the ACO (rather than go up the DCAA chain of command) of the reasonableness of its costs. Reasonableness of the severance costs you mention may be demonstrated by showing they are (1) consistent with company policies (if severance policies provide for exceptions to the usual 1-2 weeks severance pay for each year worked) (2) follow retention agreements prepared for executives who were going to be let go and (3) are needed to provide an incentive and provide value to the company for certain terms of separation or additional services needed during a transition period.

If these are not sufficient to prevail, you will have to directly attack the survey results DCAA relied on by either impugning the survey (it is not comparable because locality, type of business, size, etc. is different) or finding another survey that validates your practice. If your company library has lots of compensation surveys then, great, use them – for the rest of us, it's tougher. In our efforts to challenge similar DCAA findings, we were quite disappointed to find that no public libraries or universities seem to have these surveys available for inspection by the public. We found, however, one great asset – the internet. Using key words in google and library databases (electronic copies of most articles are replacing hard copies of a small selection of periodicals) we were able to find numerous articles containing detailed summaries of surveys which we have used to challenge DCAA assertions with the ACO. In a couple of cases, we even found summaries of the survey used by DCAA where their interpretations were shown to be incorrect.

**SMALL/NEW CONTRACTORS**

**Labor Interviews**

Though veteran contractor personnel are very aware of what happens during a floorcheck, we find that both new contractors and many people within veteran contractors’ organizations are unfamiliar with DCAA’s approach. Based upon our experience as consultants and former DCAA auditors as well as their own guidance we have set forth what you can expect during a labor interview. Feel free to copy this article and distribute it to people within your organization - employees likely to be interviewed, project managers, supervisors, internal auditors, human resources - who may benefit.

**Pre-interview Analysis.** Auditors are instructed to review DCAA’s Contract Audit Manual Chapter 6-404, identify high risk areas (e.g. locations where employees work on cost type and T&M federal contracts), determine which employees to interview (e.g. all or a sample, depending on the number) and evaluate time cards of selected employees looking for changing charge patterns, corrections, alterations, white outs, indications of someone other than the employee entering information, etc.

**What to look for during the interview.** Auditors are told to conduct their interviews at the employee’s work location, attempt to ascertain labor mischarging and level of compliance with the contractor’s timekeeping controls, record employees’ complete responses noting inconsistencies or reactions, obtain available documentation to substantiate labor efforts, seek leads that other people may be involved in labor mischarging and, if appropriate, interview management, accounting, timekeeping and other personnel to clarify employees’ statements.
The actual interview will be conducted by two auditors – one asking questions, the other writing responses and taking notes. Auditors may have pre-written questionnaires that can vary somewhat or none at all but you can be reasonably sure they will cover the following:

1. Identify basic information – date, time, location, employee name, number, job title, department and supervisor.

2. Determine if the employee is present and if not find out where he/she is.

3. If absent, they may pick another employee for their followup. If a follow-up on the missing employee is not planned, then they will, at least, conduct steps to verify the employee's existence (e.g. observe work areas, review personnel/security file, conduct a telephone interview).

4. Examine the timecard to determine:
   - Is it in employee's possession
   - In ink
   - Completed through yesterday's date
   - Signed only after completed being filled out
   - Free of alterations

5. Separately list the labor charges (hours and accounts by day) from the timecard. If the timecard is incomplete, the employee is asked to complete it and the auditor will add the changes to their list.

6. To verify the timecards, the auditor will ask the employee what they were working on when they were approached (job number, project name, indirect function and account) and to describe the employee's work related activities for each job as well as when the employee first began work. The auditor will likely ask for technical instructions (e.g. job description, blueprints, project report) or other work-related documentation where the auditor can verify that the appropriate job was charged to work performed. He will either visually examine the documentation or ask for copies.

7. Other questions most like to be asked are:
   a. Was the employee preparing the timecard when the auditor arrived
   b. What basis – hourly, daily, weekly, other – does the employee usually complete the timecard
   c. What administrative instructions was the employee provided for completing the timecard
   d. Who approves the timecard
   e. When are timecards turned in
   f. Give a few examples of indirect effort and codes/accounts for indirect effort
   g. If employee is salaried, are they paid overtime. If not, how is overtime recorded; if yes, how is salary equitably allocated to all effort

If overtime is not paid and total time is not recorded, the auditor will attempt to determine whether the failure to report total time will have a material impact on charging contracts. The auditor will ask whether overtime was generally worked in the last several weeks and whether the employee typically works on more than one assignment during a pay period.