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American Council of  
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Companies  
1015 15<sup>th</sup> St., NW  
Washington, D.C.  
20005-2605  
Ph.: 202.347.7474

American Road &  
Transportation  
Builders Association  
1219 28th Street,  
N.W., Washington,  
D.C., 20007-3389  
Ph.: 202.289.4434

Design Professionals  
Coalition  
901 New York  
Avenue, NW, Suite  
5100W  
Washington, D.C.  
20001  
Ph.: 202.393.2426

February 23, 2007

Ms. Rebecca Leng  
Deputy Assistant Inspector General  
U.S. Department of Transportation  
Nassif Building, Room 9228  
400 Seventh Street, S.W.  
Washington, D.C. 20590

Dear Ms. Leng:

As you know, in prior meetings we raised a number of serious concerns over the Office of the Inspector General's (OIG) faulty audit methodologies, inaccurate data and unsupported conclusions in the current audit on overhead and executive compensation.

In order to remedy these shortcomings, we suggested several steps, including the need for follow-up meetings between the OIG and audited firms to discuss individual audit findings. Doing so would enable audit staff and firm representatives to review and understand the OIG's interpretation of the data, and give the firms the opportunity to respond -- a necessary step to ensure that the final audit report presents an accurate picture of the issues.

We were therefore disappointed to find that letters from your office to the firms in question amounted to little more than a restatement of findings based on the same flawed methodologies and data that we have alerted you to previously. We are surprised to see the findings presented as if the review were complete, when to our knowledge no exit interviews have been conducted. **What we find even more troubling is that the OIG has embraced interpretations of the Federal Acquisition Regulations (FAR) that are questionable or wholly unsupported in either FAR or Board of Contract Appeals (BCA) interpretations.**

For this reason, we must again bring to your attention the serious, negative implications of presenting flawed data and conclusions as fact. As organizations dedicated to the promotion of sound public policy to support and enhance the nation's transportation infrastructure, we are deeply concerned that the findings of a flawed audit could result in flawed public policy or unnecessary efforts by other agencies in pursuit of unsupported claims.

Therefore, we strongly urge the OIG to retract the letters sent to the audited firms, and suspend the audit pending a thorough review of the procedures and methodologies used by your office. We are also requesting a meeting with the OIG, the Federal Highway Administration and the Defense Contract Audit Agency, so that we may fully understand the procedures used by your office. We feel this meeting needs to take place within the next 30 days and include all parties mentioned.

The problems we have identified in the communications sent by your office to our members are varied and numerous, but we will attempt to organize the issues into a few broad categories.

These categories include:

- **Clear Lack of Adherence to Existing DCAA Policy and BCA Decisions**
- **Flawed Use of Outside Survey Data**
- **Faulty Methodology in Determining Unreasonable Costs Allocable to State DOT's**
- **Failure to Comply with Cognizance Regulations**
- **Unfair Retroactive Application of "New" Rules**

#### **Clear Lack of Adherence to Existing DCAA Policy and BCA Decisions**

In performing the review, the OIG has not followed several key elements of the required approach to determining reasonableness of compensation documented in the DCAA Contract Audit Manual. For example, if the consultant performs an internal analysis of compensation reasonableness, auditors are required to assess the consultant's compensation system internal controls. Unless the auditor finds significant internal control deficiencies, the audit approach required is to evaluate the consultant's analysis of compensation. Only if significant deficiencies exist may the auditor set aside the consultant's analysis and perform an "independent assessment for reasonableness" (5-808.9(b)(1)). There is no discussion in the letter that internal controls were assessed; it appears that the step was bypassed in favor of performing an independent estimate for every consultant, regardless of the state of their internal controls, or the extent of their own internal compensation analysis.

We are also greatly concerned that the OIG has ignored the most prominent decision on the subject of executive compensation - Techplan Corporation (ASBCA Nos. 41470, 45387, 45388; July 2, 1996). As you should know, Techplan is the case cited in the DCAA Manual in the instructions on auditing Management Compensation (6-414.4 Review for Unreasonable Compensation).

In brief, that decision held that above-average compensation of a company's CEO was allowable because the FAR standard of reasonableness permitted adjustment of benchmark compensation derived from surveys of comparable companies. The BCA accepted the contractor's evidence of the CEO's involvement in the company's high growth rate, sustained profitability and reputation for quality as a basis to measure the CEO's compensation against the 75<sup>th</sup> percentile rather than the average CEO compensation. Section 6-414.4(h) of the DCAA Manual defines the criteria under which consultants may propose compensation above survey averages, noting that "such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry's average".

In the Techplan case, another adjustment was made to reflect an offset for the CEOs below-average fringe benefits package (see DCAA Manual 6-414.4(g)(7)). The OIG review does not incorporate any consideration for better than average performance or below average fringe benefits as required by both BCA decisions and the DCAA Audit Manual.

It is clear that the OIG has not followed current BCA findings or all applicable DCAA requirements in determining reasonable compensation. The process followed to date is not only at odds with current case law, but incomplete regarding matters that must be considered after the initial testing produces “possible” excessive compensation.

### **Flawed Use of Outside Survey Data**

In comparing firm data to various compensation surveys, a number of violations of DCAA and FAR requirements occurred. A few examples: (1) misapplication of the concept of revenue responsibility, (2) mismatching of management titles, and (3) no consideration of offsets with a class of employees.

(1) Misapplication of Revenue Responsibility: A major problem with the methodology used by your office is the revenue responsibility factor and how it was applied. FAR 31.205-6 clearly states the criteria for comparison to survey data includes **firm** size, and this is also the basis cited in the DCAA Manual for review of Executive Compensation (DCAAM 6-414.4 Review for Unreasonable Compensation), which incorporates the current BCA rulings. However, in many instances, you compared survey data to a “divisional” operating unit revenue base, which is not supported in either FAR or current BCA case law. In our research of the salary surveys used as comparables, the firm’s total size was used in all cases and not the size of the divisional business unit. We therefore believe that the firm’s total size should be used in the analysis and not the revenue responsibility of the divisional business unit being supervised.

(2) Mismatching of Management Titles: The use of divisional revenue units as a basis for comparison also opens the question of titles being used. For example, consider a Vice President in a division with \$30 million in revenues in a \$500 million firm. If the Vice President is the lead manager in that division, then he/she would have 100% responsibility, and thus be, in effect, the Chief Executive Officer (CEO) or Chief Operating Officer of a firm at that revenue level. It appears that the audit findings have incorrectly compared a Vice President in this capacity to a VP of a \$30 million firm who may only have partial responsibility for firm revenue and less than firm-wide authority. Comparing the two is a clear violation of DCAA audit standards which require a proper matching of employees to pay survey data.

In addition, in some cases senior executives are involved in both corporate and regional roles. For example, consider a Senior Vice President of a \$500 million firm who plays a major role in corporate decision making, and serves on the Board of Directors, but also has regional responsibilities. It appears that this individual has been compared to survey data for a divisional Vice President, clearly not an accurate comparison.

The use of smaller levels of revenue responsibility and the lower management title level methodology used by the OIG results in an approximate 15% understatement of total direct allowable management compensation, which is a material difference. This approximates the

“excess compensation” claims in several firms, including firms where the divisional revenue responsibility was used as the comparable basis.

(3) **No Consideration of Offsets**: In addition, the OIG’s methodology presents a lack of offsets for individuals below the presumed reasonable compensation limits. The OIG’s approach accepts compensation below the median level (plus 10%) without exception, but allows compensation of anyone paid more than the median level with only an amount at the median compensation level (plus 10%). This amounts to state DOTs reimbursing compensation on the basis of the “lower of cost or median.”

As executives progress within the upper ranks of an organization, it can be expected that their compensation will increase. A newly appointed Vice President will likely be compensated below the median level, whereas a Vice President who might be a “President in waiting” will likely be compensated more than the median level. This inequity should be mitigated by allowing offsets between higher and lower compensated employees within the same job class, as prescribed by DCAA Contract Audit Manual Section 6-413.7(d). In the case of some firms, between 30% to 50% of their reported “excess compensation” was due to the fact that offsets were not considered.

#### **Faulty Methodology in Determining Unreasonable Costs Allocable to State DOT’s**

The OIG’s estimate of unreasonable costs charged to State Departments of Transportation (DOTs) were based on estimated gross revenues from those DOTs. However, gross revenues include Other Direct Costs which by definition would not include any internal costs of a firm and thus would not have received any allocation of these costs. Including Other Direct Costs in the equation overly inflates the estimated cost impact on state DOTs. Firms typically include 10% to 30% of gross revenues as Other Direct Costs, and while the percentage may vary among DOTs from the overall firm-wide total, this substantially reduces any amounts claimed by the Other Direct Cost percentage firms billed to DOTs. We estimate this factor would reduce the claimed overcharge amount by 20% or more.

Another flaw in the determination of unreasonable costs allocable to State DOT’s is the failure to adjust for the extent to which the firms’ key managers who are directly involved on projects must also be considered in calculating the claimed over billing. In this case a portion of their salary is applied to individual final cost objectives (projects). These final cost objectives may or may not have been state DOT projects, and if they were not state DOT projects, these costs would not have been billed to state DOTs.

In addition, thirteen states had “opted-out” of overall compliance with FAR Part 31 Cost Principles. These states had overhead and administrative salary caps that are below many firm’s actual overhead rates and actual salaries for the year 2003. Thus any reduction on actual overhead may not be applicable to these state DOTs as the capped rate and billed rates are below the actual, or proposed revised allowable indirect cost rate. Furthermore, a number of states that did not opt out apply caps to contracts that are not funded with federal funds. Detailed analysis would be required to determine the effect of these adjustments on individual contracts.

Additionally, several firms have indicated that these “new” claims are for costs already removed from their allowable cost pools for government contracting purposes, and thus would not have billed to or paid by the various DOTs.

### **Failure to Comply with Cognizance Regulations**

We strongly object to the OIG’s statements which imply that any correction of individual firm findings is settled and that the next step is to try to reclaim “overpayments” by contacting each state DOT to which a recipient firm provides services.

If the intent of the OIG is to contact each state DOT, this is not in conformity with current FHWA Guidance on Audit Cognizance. Current FHWA Guidance on Cognizance is contained in “Administration of Engineering and Design Related Services Contracts” (10/23/2002). This document provides guidance that supplements 23 C.F.R. Part 172 relating to the procurement of engineering and design related service contracts using Federal-aid funds, which would include the contracts covered by the OIG review.

This guidance states that if an audited indirect cost rate has been established by a cognizant agency, it must be used for Federal-aid contracts. In addition, a cognizant agency is any of the following (in order of priority): (1) Federal Agency, (2) The State where the firm’s accounting and financial records are located (Home State), or (3) A Non-Home State to which the Home State has transferred cognizance in writing for the particular indirect cost audit of a firm.

As you know, some of the firms in the OIG sample have federal agency cognizance and thus no information on these firms may be reported to state DOTs. For other firms, contact must be with their “Home State” as that state is cognizant. Any distribution of these findings on individual firms should not be provided to any other agency under this guidance, and any final determinations should be made solely by the cognizant agency.

Cognizance or single audit authority has been addressed in several federal laws including the Single Audit Act of 1996. FAR 42.703-1(a), Policy, states “A single agency (see 42.705-1) shall be responsible for establishing final indirect cost rates for each business unit. These rates shall be binding on all agencies and their contracting officers, unless otherwise specifically prohibited by statute. An agency shall not perform an audit of indirect cost rates when the contracting officer determines that the objectives of the audit can reasonably be met by accepting the results of an audit that was conducted by any other department or agency of the Federal Government (10 U.S.C. 2313(d) and 41 U.S.C. 254d(d)).”

### **Unfair Retroactive Application of “New” Rules**

Up to this point, we have touched upon what we consider to be either inaccurate or new interpretations of the rules governing executive compensation. If it is the latter, we would argue in the name of fairness that if new and previously unsupported rules are being applied, any cost disallowances should be *prospective* only, and not retroactive.

2003 executive compensation issues, in particular the issue of divisional revenue responsibility for determining reasonable compensation, has been raised for the first time in 2007. Any

retroactive change is inappropriate because the contractor is harmed due to reliance on the rules, regulations and methods available at the time (in this case, 2003 and 2004).

The concept that precludes a government retroactive disallowance of costs was established in the landmark Claims Court decision *Litton Systems, Inc. v. The United States*, October 15, 1971, (196 CtCl 133 449 F2d 392). Making new rules in 2007 to apply to 2003 and 2004 is a clear violation of this longstanding BCA-supported process requirement.

### **Conclusion**

As we have discussed several times during the duration of this audit, we have serious concerns regarding the OIG's methodology and inaccurate interpretation of the FAR. The faulty nature of this audit highlights the reasons why your results have yielded a 67% margin of error and an unusually wide range of probability (\$24 - \$126 million). In addition, as stated in our last meeting with you by your own statistician, a six-year extrapolation of the data is "not statistically valid". The data is uncertain, at best, for 2003 and cannot be used as the basis of a six-year finding.

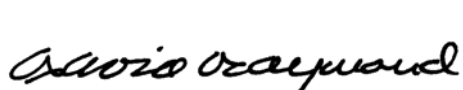
In addition, the guidance on executive compensation is subjective. The A/E industry indicated early in the process that better guidance is needed for both firms and DOTs on how to properly determine reasonable executive compensation; the current OIG approach compounds the problem.

Given the uncertainty in the data, the wide margin of error, and the subjective nature of the guidance on executive compensation, the OIG should have met individually with the firms found to have presumed excessive compensation in their overhead to review in detail how the figures were calculated. Individual exit interviews with these firms would have avoided the difficult situation we are in today.


Therefore, we once again strongly urge the OIG to retract the letters sent to the audited firms, and suspend the audit pending a thorough review of the processes, procedures, and methodologies used by your office. We also believe a meeting with the OIG, the Federal Highway Administration and DCAA is necessary to clarify audit procedures used by your office.

The industry and their DOT partners are committed to ensuring that the rules governing the expenditure of public funds are closely followed, and we will continue to do everything necessary to protect the integrity of the program.

Respectfully,



David A. Raymond  
President  
American Council of  
Engineering Companies



Richard L. Corrigan  
Vice Chairman  
Design Professionals  
Coalition



T. Peter Ruane  
President & CEO  
American Road &  
Transportation Builders  
Association

