



Design  
Professionals  
Coalition  
*Founded in 1983*

American Council of  
Engineering  
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  
5705 Trafton Place  
Bethesda, MD  
20817  
Ph.: 301.455.0822

## **ISSUES SURROUNDING IMPLEMENTATION OF SECTION 174**

**AUGUST 2008**

## **BACKGROUND**

Sec. 307 of the National Highway System Designation Act of 1995 required states to follow the standard Federal procurement requirements under the Federal Acquisition Regulations (FAR) for determining overhead rates. This provision also allowed for a single cognizant audit to suffice for all states and prohibited the establishment of administrative or de facto caps on indirect costs.

However, a small number of states took advantage of a one-year timeframe to adopt alternative procedures. Specifically, the states had a one-year window to adopt overhead policies that, according to the law, “promote engineering and design quality and ensure maximum competition by professional companies of all sizes.” Thirteen states were designated as opting out of the federal procedures – Connecticut, Delaware, Florida, Kentucky, Louisiana, Maine, Maryland, Minnesota, New York, North Carolina, Utah, Tennessee, and West Virginia.

Over time, we found that the policies in many opt out states, particularly as they relate to caps on overhead and/or salaries and redundant audit requirements, did not meet the letter of the law. Subsequently, on November 30, 2005 the 2006 Transportation Appropriations Act was signed into law.

Section 174 of this Act amends 23 U.S.C. §112(b)(2) as follows:

- 1) It requires that contracts “funded in whole or in part with Federal-aid highway funds shall be performed and audited in compliance with [FAR].”
- 2) It eliminates the ability of 11 of the 13 “opt-out” states to impose arbitrary caps on overhead rates (currently only MN and WV retain this ability).
- 3) It reiterates and reinforces the cognizant audit requirements previously incorporated into 23 U.S.C. §112 (b)(2).

The provisions of Section 174 are intended, in part, to eliminate the need for duplication of audits for the purpose of establishing indirect cost rates for use on Federal-aid projects – a single cognizant audit will now suffice. The consultant may provide the contracting agency with a copy of an accepted (not in dispute) audit from a cognizant government entity having knowledge of the cost principles contained in FAR Part 31 of Title 48.

Once indirect cost rates established in accordance with the FAR are accepted, they shall be used in contract estimating, negotiations, administration, reporting and contract payment for the one-year applicable period and shall not be limited by administrative or de facto ceilings of any kind.

FHWA issued implementation guidance to the states in December 2005. Despite this guidance and the passage of more than two and one half years, there continue to be numerous state practices which do not comply with Section 174, indicating that in many cases, the requirements of Section 174 were poorly understood, misinterpreted or simply never fully implemented.

The purpose of this paper is to describe some of the most significant instances of noncompliance and to provide proposed solutions to address these issues.

The experience of our member firms - numbering more than 5,700 - over the past two and one half years has demonstrated substantial issues of noncompliance. Immediately after the enactment of Section 174, this would have been understandable. At this point, it is clear that action by FHWA is

required to correct these issues and ensure that all states understand and follow the requirements of 174.

The following list presents some of the more significant issues noted by our member firms, but does not represent an all-inclusive list.

### ***Compensation Related Issues***

The FAR rules addressing compensation are clearly defined in 31.205-6: compensation must be allowable and reasonable for the work performed. 31.205-6(b)(2) clarifies that “compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total.”

Many

states have taken an approach to defining reasonable compensation that is in direct conflict with this section of the FAR. Examples of improper positions states are currently taking are as follows:

- **Applying arbitrary compensation dollar limits at lower levels than the FAR.** The FAR has a statutory dollar limit on total compensation of certain executives, which is updated annually. Amounts below that level, and for all other executives, are to be evaluated for reasonableness subject to criteria set by Armed Services Board of Contract Appeals (“Board”) and court decisions, and probably best defined in the DCAA Contract Audit Manual. These criteria require an evaluation based on compensation survey data for similar sized firms in the same industry. However, some states currently mandate arbitrary limits on compensation – for both direct and indirect labor - below the FAR level and do not consider the reasonableness criteria required by FAR and Board/court decisions. Often these limits are based on the salary paid to an elected or appointed official in that state, and have no relationship to the actual total compensation paid in consulting firms. Such limits on compensation create a de facto cap on overhead. Proper tests of compensation reasonableness, as defined in the FAR, must be based on an examination of actual compensation data for executives in a similar firm and position. The current practice of several states to define a preset number as a one-size-fits-all definition of reasonable compensation does not meet FAR requirements.
- **Applying limits on bonus percentages in relation to salary.** The FAR rule on bonuses is that awards are made under an established plan or agreement and the basis for the awards must be supported. There is no FAR established limit on bonuses as a percentage of salary or total compensation. However, some states mandate a percentage limit for the relationship of bonuses to salary.
- **Applying arbitrary limits on the ratio of indirect labor to direct labor.** The FAR contains no limits on this ratio. Differences in direct and indirect labor categorizations by individual consultants make such a ratio meaningless. However, some states mandate that indirect labor cannot exceed a specified percentage of direct labor. This is in direct conflict with FAR requirements to evaluate the reasonableness of compensation in the aggregate.

### ***Allowable Cost Issues***

Outside the area of compensation, a number of other state DOT practices have been noted which are not in compliance with FAR or Section 174 provisions. Below are a few examples:

- **Use of overhead caps.** While no states other than Minnesota and West Virginia still publish an overhead cap for federally funded highway projects, a number of states have found creative ways to cap overhead. Some have a predefined range of overhead rates

that they consider reasonable. For contracts with overhead above this range, they require the consultant to decrease other cost factors, such as salary rates or hours, to meet the state's budgeted cost. This is a clear violation of Section 174.

- **Capping auto leases.** Several states apply an annual limit to automobile lease costs. The FAR does not define such a limit, but instead states that such “costs are allowable, if reasonable, to the extent that the automobiles are used for company business”. Consultants and the CPA firms preparing their overhead audit should examine these costs for proper treatment, but the costs should not be subject to arbitrary caps.
- **Exclusion of FAR allowable state taxes from allowed indirect expenses.** The FAR (31.205-41(a)(1)) specifically provides that state income taxes are allowable. However, some states disallow the cost of state income taxes.
- **Requiring specific costs such as CADD or overtime premium to be direct or indirect regardless of FAR provisions.** The FAR permits consultants to determine the classification of direct and indirect costs within FAR guidelines (FAR 31.202 and 31.203). If the cognizant auditor accepts these categorizations, they must be used for all FAR covered government contracts. However, some states mandate that certain costs must be direct or indirect despite the consultants FAR compliant, established and consistently applied categorizations.
- **Applying ownership percentages for common control not consistent with the FAR and case law.** The FAR (31.205-26(e)) has restrictions on cost transfers for parties under common control. Common control per the FAR, Board of Appeals and court decisions means that an individual controls or has the ability to control the two related parties—generally more than 50% ownership of both entities (FAR 19). At least one state has mandated that any percentage of ownership, no matter how insignificant, results in common control.
- **Applying arbitrary limitations on FAR-allowable cost of money calculations.** FAR section 31.205-10 establishes the imputed cost for facilities capital cost of money. This was enacted to offset the fact that interest expense is unallowable. However, some states either totally or partially deny cost of money.
- **Per diem expenses at lower levels than established by FAR.** The FAR (31.205-46(a)) establishes the Federal Travel Regulation as the measure of reasonableness for per diem rates. These rates are set by location and vary based on the local market. However, many states use one per diem rate for all locations or in other ways provide far less reimbursement than consultants actually spend and are permitted by the FAR. These state per diems are applied to both direct and indirect costs; application to indirect costs improperly limits the overhead rate.
- **Prohibiting cash basis accounting that is acceptable under IRS rules and the FAR.** The FAR (31.201-1) permits either cash or accrual accounting. Most small businesses are permitted by the Internal Revenue Service (IRS) rules to use cash accounting. However, at least one state mandates that accrual accounting must be used. This mandate places an undue burden on smaller consulting firms.
- **Disallowing business meals allowed by IRS and the FAR.** Both the FAR and IRS allow costs related to legitimate business meals. Federal audit guides recognize that if the meal expense is documented sufficiently for IRS purposes, it is an allowable FAR cost. However, many states mandate that no such expenses are allowable.

### ***Cognizance Issues***

23 U.S.C. §112(b)(2) states that indirect cost rates established by a cognizant audit must be accepted and “shall not be limited by administrative or de facto ceilings of any kind”. Section 174 and the implementing guidance FHWA published December 12, 2005 reiterated this requirement. However, certain states still refuse to accept cognizant audits without also applying state-specific adjustments which substantially limit the overhead rate.

The intent of Section 174 was to create conformity in the development of indirect cost rates by re-establishing the FAR as the uniform set of requirements for all states to follow. This purpose was supported through a renewed emphasis on cognizant audits. The use of a single set of rules held the promise of eliminating barriers to competition, allowing the best qualified firms to propose on every project, regardless of the location. The guidance issued by FHWA in December 2005 appeared to support the requirements and purpose of Section 174. However, the implementation of Section 174 has failed. Rather than a single set of rules (FAR), consultants must still contend with as many as twenty different sets of state rules that are applied to federally funded highway projects - in violation of Section 174. Many consultants who would like to expand their firms into other states are prohibited from doing so by de facto overhead caps created by state policy. Some of these firms have a cognizant audit in hand, but the new state will not accept that cognizant audit. This situation is difficult to comprehend, considering the requirement in 23 U.S.C. §112(b)(2)(C) and FHWA’s December 12, 2005 memo which states so clearly that “State and local agencies will also be required to use the indirect cost rates established by a cognizant agency audit based on the cost principles contained in 48 C.F.R. Part 31 for the consultant, eliminating the placing of caps on indirect cost rates.”

### **MOVING FORWARD**

On behalf of our member firms, we request FHWA’s assistance in resolving these issues. As the implementing agency for Section 174, the states look to FHWA for guidance on these matters. We would propose for FHWA to take the following steps:

- 1) **Publish interim guidance** to address the confusion that still exists over the proper implementation of Section 174.
- 2) **Proactively review state DOT practices** – both written policy and actual contracting practices (which sometimes differ) – and evaluate those practices against the requirements of Section 174. To the extent there is ambiguity, address those areas in the interim guidance.
- 3) **Issue additional clarifying guidance in the form of a rulemaking** to address possible areas of misunderstanding with regard to Section 174 and the underlying regulations in 23 U.S.C . §112 (b)(2).
- 4) **Actively promote the performance, issuance and acceptance of cognizant audits** by all states as a means to achieve uniform standards and to reduce the audit burden on states and consultants. This should include discussions with states that currently do not accept and/or perform cognizant audits.
- 5) **For those state practices determined to be noncompliant** with Section 174, use all available influence to compel the state to bring the practices into compliance.

We appreciate FHWA’s commitment to addressing these issues and we are willing to provide assistance in any way we can.