Illinois Department of Transportation

Office of Quality Compliance & Review
2300 South Dirksen Parkway / Springfield, Illinois 62764

To: Scott Stitt, Acting Bureau Chief
Bureau of Design & Environment

From: Ronald J. McKechan, Chief Financial Review Officer
Financial Review & Investigations Section

Subject: Audit of Overhead Cost Records of
McDonough Associates, Inc.

Date: July 22, 2011

Audit Report No.: 11-22-001

We have completed our review of the records of McDonough Associates, Inc. (MAI) for their fiscal years ended 12/31/00; 12/31/01; 12/31/02; 12/31/03; 12/31/04; 12/31/05; 12/31/06; 12/31/07; 12/31/08 and 12/31/09. The purpose of this review was to assess the factual basis for MAI's overhead rates reflected in its financial submissions to the Department for work performed on projects during these periods, as well as to determine whether MAI is utilizing an appropriate system of accounting practices and controls.

Our review was made in accordance with the standards set forth in the General Accountability Office's Government Auditing Standards. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the combined schedule of direct labor, fringe benefits, and general overhead. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. As part of this audit, we reviewed all records produced to us by MAI management in response to our information requests, spoke with MAI personnel about their financial practices, and considered written comments from MAI's Chief Financial Officer regarding our preliminary audit findings. We believe our audit provides a reasonable basis for our opinion.

As a result of this audit, we believe that MAI's overhead rates should be adjusted and that the appropriate rates for the relevant period should be as follows:

Fiscal Year	Overhead Rates
2000	76.26%
2001	85.67%
2002	80.13%
2003	79.48%
2004	96.71%
2005	80.34%
2006	88.17%
2007	91.16%
2008	95.77%
2009	95.69%

In order to calculate these overhead rates, we applied the cost principles and procedures set forth in Subparts 31.1 and 31.2 of the Federal Acquisition Regulations (FARs). The adjusted overhead rates above result primarily from the disallowance of certain payroll and cash disbursements expenses included by MAI that are ineligible cost items under the FARs. We recommend that these adjusted rates be applied to eligible direct productive labor costs to compute reimbursable overhead costs for this consultant. (See Findings section of this report for further explanation.) .

In addition to the improper inclusion of certain payroll and cash disbursements as part of MAI's overhead costs, our review disclosed a number of material findings and concerns regarding MAI's accounting policies, procedures and controls which have been reported to the department's management for further review and consideration. We have made appropriate and necessary adjustments in MAI's overhead rates as a result of the cited findings. (See Findings section of this report for further explanation.)

It is important to note that our study and evaluation focused on MAI's controls with respect to the payroll and cash disbursements categories identified above, and that the nature, timing and extent of our auditing procedures were generally limited to those considered necessary to express an opinion on the aforementioned overhead rate schedule. Due to inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or the degree of compliance with the procedures may deteriorate.

It is also important to note that our study and evaluation was more limited than that which would be necessary to express an opinion on MAI's system of internal accounting control taken as a whole. Our study and evaluation made for the limited purpose described above would not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal accounting controls of MAI as a whole.

Ronald J. McKechan
Chief Financial Review Officer
Financial Review &
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McDonough Associates, Inc.

Specific Audit Findings

Finding No. 1: $46.5 Million Included by MAI as Bonuses in Overhead Computations Disallowed as Disguised Dividends

From 2000 through 2009, MAI included as eligible compensation for the determination of its overhead rates $46,492,270 in bonus expenses which we have determined were actually distributions of profits (i.e., dividends) to stockholder investors. Inclusion of these ineligible costs in MAI's overhead rates resulted in a substantial and improper increase in MAI's overhead rates. For example, in FY2002, the effect of including disguised dividends as a performance bonus increases the overhead rate by 87.5%. On average, the effect of improperly including these disguised dividends as bonuses is to increase MAI's overhead rates an average of almost 61%. Our reasons for disallowing inclusion of this compensation are set forth below.

MAI business records reviewed in the course of our audit reflect the payment of two distinct types of bonuses to different, though overlapping, sets of employees: an incentive bonus (paid to large numbers of employees) and a shareholder bonus (paid to a far smaller group of employees). During our audit, the company did not produce a written description of either bonus plan identifying eligibility criteria or the financial basis and other performance criteria on which payments under either plan were based in each year. We also were unable to find any meaningful descriptive information concerning these bonus programs in MAI's corporate minutes. The corporate minutes of the MAI are similarly lacking in any declaration of dividends for the benefit of its shareholders or other description of its dividend policies.

According to its income tax returns (Forms 1120S), from 2004 through 2009, MAI claimed to have made property distributions to shareholders which affect their total basis in MAI stock. In their correspondence concerning this audit, MAI has subsequently referred to these payments as dividends. The Principals' bonus payments are indistinguishable from the dividend payments (distributions of property confirmed by MAI to have been cash) made in years 2004 through 2009. In each case, the amounts paid to shareholder-employees correspond directly to the percentage of outstanding company shares owned by that individual. As noted previously, MAI has failed to develop or maintain a set of written compensation plan policies, including eligibility criteria and performance determinations that support the treatment of the Principals' Plan as something other than disguised dividends. The fact that MAI also began to pay additional sums to these same shareholders in the form of dividends in later years does not alter this conclusion, and MAI has offered no explanation as to the reasons for its change in compensation practices beginning in 2004 or how those identified dividend payments differ in substance from the payments under the Principals' Plan.

During the course of the fieldwork for the review of years 2000 through 2007, we were told that the stockholder's bonuses were determined by one of the former founders of MAI who was absent, but that no one then at MAI was aware of how the bonuses were calculated or determined. We were informed only that the shareholder bonuses were paid solely to shareholder employees.

Prior to commencement of fieldwork for the review of years 2008 and 2009, we performed an analysis of shareholder bonus payments with respect to the percentage of stockholder equity held. From 2000 through 2009, there were 338 individual shareholder bonus payments made for a total of $46,492,270. Of these 338 bonus payments, all 338 were paid to the shareholder-

employee in direct proportion to the percentage of equity owned by the individual at the time of the payment. (See Exhibits L through U.) There was no information available to us indicating that these payments were incentive awards based on actual performance of the individual during the relevant period. Rather, the amount of these payments clearly reflected the amount of stock owned by each recipient, and were, in effect, distributions of corporate profits rather than compensatory payments for actual services rendered.

During the course of fieldwork for our review of years 2008 and 2009, we were again told by various MAI managers that they didn't know how the stockholder bonus was determined. After presenting our analysis showing that the shareholder bonus was allocated based on percentage of ownership and not employee performance, we were told by the same MAI managers that, "of course, everyone knows that."

In correspondence received after completion of our field work, MAI provided additional information regarding these two bonus programs, identifying them as the "Incentive Compensation Bonus Plan" and the "Principals' Payroll Bonus Plan." In that correspondence, MAI states that the two bonus plans have existed side-by-side for many years, and that the number of people participating in the Principals' Payroll Bonus Plan has grown over time from 2 to 36 shareholder-employees as a result of a "consistent policy of allowing the best performers in the company to purchase shares of stock." According to MAI, the Incentive Plan was used, from the outset, to provide bonus compensation to all non-shareholder employees. Finally, MAI states that the two or three largest shareholders serve as a de facto Compensation Committee responsible for all compensation decisions (including bonus payments) and that this Committee considers the "Incentive Compensation Plan and the Principals' Payroll Plan" to both be part of "one comprehensive incentive scheme." MAI offers no details as to the basis for any bonus payment determinations made by the Compensation Committee for either of the plans.

Under these facts, we believe there are substantial grounds to disallow payments under both plans. Nevertheless, we are not at this time proposing to disallow payments under the Incentive Compensation Bonus Plan for purposes of the overhead rate determinations insofar as those payments appear to be for the benefit of the majority of employees, irrespective of whether they own stock of the company. (In the future, however, we will expect to see far more extensive documentation regarding this incentive payment scheme supporting its characterization as a legitimate bonus plan for services provided during the relevant year.) Conversely, we believe that the $46,492,270 in payments pursuant to the Principals' Payroll Bonus Plan constitute disguised dividends and must be disallowed. These determinations are based upon the factual information available to us and the well-established requirements of FARs Subparts 31.1 and 31.2 (48 CFR Part 31), as well as related interpretive guidance, including the Defense Contract Audit Agency ("DCAA") Contract Audit Manual ("CAM"), FAR Cost Principles Guide, and the AASHTO Uniform Audit & Accounting Guide ("AASHTO Guide").

The starting point of our analysis is to determine whether the costs included by MAI in its overhead charges are allowable. See FAR 31.201-1 ("the allowable costs to the Government are limited to those allocable costs which are allowable pursuant to Part 31 and applicable agency supplements.") A cost incurred by the contractor "is allowable only when the cost complies with all of" five specified requirements, including the limitations of Part 31. See FAR 31.201-2(a) (emphasis added). As the contractor, MAI "is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed . . . comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is

inadequately supported." See FAR 31.201-2(d). See also AASHTO Guide Chapter 8.1 (costs are "allowable only if they are reasonable in amount . . . and are not otherwise prohibited by FAR Part 31 and/or related Federal and State laws, regulations, and policies," and contractor bears burden of proof of showing that claimed costs are allowable).

Compensation for personal services is generally allowable, provided such costs are (1) "for work performed by the employee in the current year," (2) the "total compensation for individual employees or job classes of employees must be reasonable for the work performed," and (3) the "compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment." See FAR 31.205-6(a)(1)-(3). Costs that are "unallowable under other" parts of Subpart 31.2 "are not allowable solely on the basis" that they are part of an employee's compensation. FAR 31.205-6(a)(5). Pursuant to the FAR, compensation paid to owners of closely held corporations deserves special scrutiny to assure that such payments are (A) "reasonable for the services rendered" and (B) "not be a distribution of profits (which is not an allowable contract cost)," and (C) not otherwise "in excess of the costs that are deductible as compensation under the Internal Revenue Code (26 U.S.C.)". FAR 31.205-6(a)(6). See also AASHTO Guide Chapter 7.12, p. 63 (for owners of closely-held firms, "allowable bonus amounts may not represent a distribution of profits. Accordingly, there must be clear distinctions of the various portions of total compensation; specifically, which portion is a true bonus based on stated objectives and which portion is a profit distribution.") Finally, compensation based on corporate security ownership that is "represented by dividend payments or which is calculated based on dividend payments is unallowable." FAR 31.205-6(i). See also DCAA CAM 7-213.2(d) ("Compensation based on changes in the prices of corporate securities or corporate security ownership . . . are expressly unallowable under FAR 31.205-6(i)" and compensation represented by dividend payments is expressly disallowed.)

As previously stated, MAI has identified two separate and distinct bonus types: the incentive bonus paid broadly to its employees and the principals' bonus paid to a comparatively small group of shareholders. Unfortunately, neither bonus plan is documented in a manner that satisfies contractor's burden of establishing these expenses as allowable costs. While payments under these plans may, as MAI insists, be a long-standing practice, the fact that no employees are able to explain the criteria on which such bonuses are paid raises a serious question as to whether there is, in effect, an agreement to make such a payment as required by FAR 31.205-6(a)(3). Moreover, the existence of the two plans and overlapping participation strongly supports disallowance of the payments to the shareholder-employees under the Principals' Plan. All of the stockholders received payments under the Principals' program in direct proportion to the amount of stock they owned, and nearly all stockholder-employees also received payments pursuant to the Incentive Plan. While the two plans may be part of one broad compensations scheme, the factual record also demonstrates that they serve different purposes and payments under each are based on differing sets of considerations. The fact that MAI has long-established incentive bonus program in which shareholder-employees continue to participate strongly supports the conclusion that payments under the Principals' Plan are, in reality, disguised dividends.

In its correspondence to the Department, MAI argues that payments to the shareholders under the Principals' Bonus Program should be allowable costs because they are reasonable in amount and that the Department has failed to prove otherwise. In support of this position, MAI

cites DCAA CAM Sections 6-414.1, 6-414.3, and 6-414.4(e), as well as case law addressing whether compensation paid to owners of closely held corporations is deductable as a business expense under IRS Code 162(a). MAI's arguments are flawed in several critical respects.

First, the fundamental issue here is not, as MAI would like to frame it, whether these payments are "reasonable" in amount: they may or may not be. We have not undertaken that factual analysis and we need not do so, because the payments, by their nature not by their size, are disallowed under FARs. As FAR 31.201-2(a) makes clear, "reasonableness" is only one of the five criteria that must be satisfied for a cost to be allowable. For the reasons explained previously, MAI's payments to its shareholder-employees under the Principals' Plan based on the amount of their share ownership are inconsistent with multiple FARs provisions.

MAI's reliance on various provisions in DCAA CAM 6-414 is also misplaced. Those provisions offer guidance as to why careful scrutiny of the reasonableness of payments to corporate owners is necessary and how those assessments should be performed. They do not support the proposition that compensation expenses that are otherwise unallowable under FAR should nevertheless be allowed by the auditor if they are "reasonable" in amount. On the contrary, DCAA CAM 6-413.2(d) shows that MAI continues to put the proverbial cart before the horse: it states, "[when] determining the reasonableness of total compensation, consider only allowable individual elements of compensation." Moreover, DCAA CAM 6-414(e), cited by MAI, acknowledges that distributions of profits to owners is an unallowable cost under FARs, before noting that the mere identification of payments as distributions in the accounting records of a company does not itself automatically render such payments unallowable. Here, our determination that the payments under the Principals' Plan are unallowable is not based on how those expenses are characterized in the company's accounting records, but rather on the basis of their strict correlation to shareholder ownership percentages coupled with a separate incentive bonus payment plan in which those shareholder-owners also participate.

More instructive is the following guidance from AASHTO Uniform Audit & Accounting Guide (2010 Edition), pp. 62-63:

7.12 – BONUS AND INCENTIVE PAY PLANS
[Reference: FAR 31.205-6(f)(1), FAR 31.205-6(a)(6)(ii)(B)]

Payments made under bonus and incentive-pay plans frequently represent a large portion of the total compensation costs claimed by consultants. To be allowable charges against Government contracts, bonus payments must be allocable to Government contracts, reasonable in amount, and must not represent a distribution of profits to owners. {ft. nt 13: See FAR 31.201-3, FAR 31.201-4 and FAR 31.205-6(a)(6)(ii)(B), respectively.} FAR 31.205-6(f)(1) further specifies that bonus payments are allowable, provided the:

> Awards are paid or accrued under an agreement entered into in good faith between the contractor [consultant] and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor [consultant] so consistently as to imply, in effect, an agreement to make such payment; and . . . basis for the award is supported.

FAR 31.205-6(a)(6)(ii)(B) states that for owners of closely-held firms, allowable bonus amounts may not represent a distribution of profits. Accordingly, there must be clear distinctions of the various portions of total compensation; specifically, which portion is a true bonus based on stated objectives and which portion is a profit distribution. (emphasis added)

A. Bonus Plans

Typically, bonus plans are applicable to a broad class of employees. Some plans include eligibility for all employees, while others limit eligibility to professional and management staff. Individual participation may be based on the productivity of an individual, team, overall company, or some combination of these factors. Bonuses may be based on a percentage of an employee's base salary, or alternatively may be issued as lump sum distributions, based on the available pool of money to be distributed.

B. Profit-Distribution Plans

By contrast, profit-distribution plans involve a distribution of net earnings to owners. Individual distributions are based on partners' capital account balances, level of partnership (e.g., junior versus senior partner), number of owned shares, or some other factor linked to ownership.

C. Documentation of Bonus and Profit-Distribution Plans

Some companies have both bonus plans *and* profit-distribution plans. However, only the portion that is a valid bonus is allowable as a recoverable overhead expense. Consultants should prepare and maintain written bonus plans that identify eligibility requirements and provide details regarding how bonus payments are determined. Profit-distribution agreements also should be in writing. This will serve to reduce

confusion as to what is a bonus and what is a profit distribution. An acceptable bonus policy should include an adequate description of the performance measures used to determine bonus amounts, such as employee performance evaluation ratings, contributions toward the firm's revenue growth, and responsibilities for cost containment.

Written bonus plans should include, at a minimum, the following components:

- Eligibility criteria.
- Period of bonus plan.
- Performance criteria (e.g., individual expectations—must be measurable and verifiable criteria).
- Incentives awards/spot bonuses must be related to performance, as measured by quantitative and qualitative factors.
- Form of payment to be received.
- Distribution timeline.

(emphasis added)

While MAI is free to compensate its employees, including its shareholder-employees, as it chooses, not all compensation and not all compensation schemes are allowable under FARs. In this case, MAI has failed to design and maintain its compensation scheme in a way that supports treatment of the Principals' bonus payments as allowed costs.[1]

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[1] Earlier versions of the AASHTO Guide warn contractors that incentive compensation schemes not strictly based on production, cost reduction, or efficient performance are highly suspect, especially when paid to owners of closely held companies. See, for example, the following passage from AASHTO Uniform Audit and Accounting Guide (2005 Edition), p. 5-2:

> **Bonuses and Incentive Compensation (FAR 31.205-6(f))**
> The following types of bonuses and incentive compensation are usually **allowable**: incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance.
>
> To be **allowable**, bonus or incentive compensation must be:
> **1.** granted under an agreement entered into in good faith between the employer and the
> employee, before the services are rendered; **or**
> **2.** granted pursuant to an established plan or policy followed consistently (to the point of implying an agreement).
>
> Auditors may challenge bonus plans that are not based strictly on production, cost reduction, or efficient performance. Bonuses and other forms of compensation for owners of closely held companies should be reviewed carefully to ensure they are not dividends that would be considered distribution of profits. **Distributions of profits** are **unallowable** for inclusion in either direct or indirect labor costs. [emphasis added.]

In its correspondence dated September 17, 2010, MAI also argues that it has found many tax court decisions relating to the reasonableness of owner's compensation for purposes of IRS Code 162(a) relating to the deductibility of those payments as an ordinary business expense when that compensation is a combination of salary and bonus payments. The cases referenced by MAI do indeed rule in favor of the taxpayer on the question of the reasonableness of the owner's total compensation, and permit deduction of those payments as a business expense for purposes of corporate income tax. There are, of course, also many cases going the other way.[2] Few such cases reach the issue here: namely, whether the payment may be disallowed regardless of whether it is deemed reasonable in size on the basis that the payment was not made purely for services. One that does explicitly reach this question is OSC & Associates v. Commissioner, 187 F.3d 1116 (9th Cir. 1999). In OSC, the court framed the issue and applicable legal test as follows:

> Section 162(a)(1) of the Internal Revenue Code permits a corporation to deduct "a reasonable allowance for salaries or other compensation for services personally rendered." 26U.S.C. S 162(a)(1). The payment of dividends to shareholders, however, is not deductible. When payments are made to an individual who is both a corporate employee and a principal shareholder, a two-prong test is applied to determine whether the distribution is truly compensatory. First, the amount of compensation must be reasonable; second, the payment must be purely for services, or have a purely compensatory purpose. OSC, 1119-1120.

The court then observed that judicial inquiry normally stops at the first prong (i.e., was the compensation reasonable), because the compensatory intent of such payments is often subjective and may, in the absence of contrary information, be inferred if the amount of the purported compensatory payment is reasonable. OSC, at 1120, citing Elliots, Inc. v. Commissioner, 716 F.2d 1241, 1243 (9th Cir 1983). However, when there is contrary information indicating that the "purported compensation payments, although reasonable in amount, were in fact disguised dividends," then the second prong of the test must be independently considered and "reasonableness alone will not suffice." OSC at 120-21.[3]

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[2] For example, on facts closely paralleling those of MAI, the court in Nor-Cal Adjusters v. Commissioner, 503 F.2d 359, 362 (9th Cir. 1974), disallowed the deduction of payments to shareholder-employees on the basis that:

1. The bonuses were in exact proportion to the officers' stockholdings.
2. Payments were in lump sums rather than as the services were rendered.
3. There was a complete absence of formal dividend distributions by an expanding corporation.
4. The system of bonuses was completely unstructured having no relation to services performed.
5. The company's consistently negligible taxable income was an indication that the bonus system was based on funds available rather than on services rendered.
6. Bonus payments were made only to the four officer stockholders, no other employees.

[3] See also, Exacto Spring Corp. v Commissioner, 196 F.3d 833, 839 (7th Cir 1999) (government could still prevail if, notwithstanding reasonable amount of payment, the company did not in fact intend the bonus as a bona fide reward for services performed).

The court in OSC then went on to uphold disallowance of the bonuses, notwithstanding whether they could be justified as reasonable in amount, on the grounds that (1) a high percentage of corporate earnings were being paid out in the form of such bonuses, (2) the company had never paid or declared a dividend despite a history of profitability, (3) the owners were being paid more than authorized by the bonus plan, (4) the disputed payments were made only to the corporation's shareholders and not to other employees, (5) the payments were calculated in reference to their proportionate stock ownership, and (6) the payment was not related to the value of services rendered. Id., at 1121.[4]

The fundamental problem with MAI's argument is that it again seeks to collapse the question of whether the Principals' bonus payment is allowable into a narrow, albeit factually complex, question of whether the total amounts received by those shareholder-employees is reasonable. Under FARs, as explained previously, that is not the appropriate and exclusive focus of the inquiry. If the payment at issue is a distribution of profits based on ownership of shares, the cost is unallowable, regardless of whether the amount of that payment (whether alone or in combination with other elements of the individual's compensation) might be regarded as reasonable in amount.

Finally, MAI urges the Department to adopt a "safe harbor" provision that would allow all bonuses paid to shareholders of closely held corporations that do not exceed, as a percentage of salary, the highest percentage bonus paid to a "non-owner," where non-owner is defined as anyone owning less than 5% of the outstanding common stock. In support of this approach, MAI directs our attention to Wisconsin DOT Facilities Development Manual Ch.8, Sec. 10, Part 20.2 , as well as DCAA CAM 6-414.3 (supporting a 10% ownership threshold for determining which employee compensation arrangements are most likely to require testing for reasonableness). As noted above, the DCAA CAM provisions cited by MAI are concerned with only the "reasonableness" element of allowability, not with the other elements of whether a cost is eligible such as that cost being inconsistent with FAR 31.205-6(a)(6) and 31.205-6(i). To paraphrase the court in OSC, 187 F.3d at 1121, we decline the invitation to "fixate entirely on the reasonableness of the amounts involved and then draw an inference of compensatory intent, without regard to the other evidence. Reasonableness alone will not suffice." Wisconsin DOT officials provided additional clarification of their policies and emphasized to us that distributions of profits and dividend payments are not eligible for consideration as bonuses and eligible compensation components irrespective of the level of stock ownership of the recipients.

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[4] As the court in Elliots, 716 F.2d at 1243, explained:

> The general problem is that of distinguishing between dividends and compensation for services received by a shareholder-employee of a closely held corporation. What makes this situation troublesome is that the shareholder-employee and the corporation are not dealing with each other at arm's length. It is likely to be in the interests of both the corporation and the shareholder-employee to characterize any payments to the shareholder-employee as compensation rather than dividends. . . . If a corporation has multiple shareholders, the existence of a plan which compensates shareholder-employees in proportion to their ownership interests may be evidence that compensation payments contain disguised dividends. (emphasis added.)

Summary:

To summarize, we believe that treating the Incentive bonuses as allowable costs, with the exception of some routine adjustments, can be justified on the grounds that all employees were eligible and those payments were, presumably, awarded based on actual performance during the relevant year. In contrast, we find no supporting rationale for treating payments under the Principals' plan as allowable costs.

Based on our analysis of stockholder bonus payments, the application of applicable FARs, consideration of additional guidance provided in the DCAA Contract Audit Manual and review of numerous Internal Revenue Service and Federal court decisions regarding compensation issues, we have determined that the $46.5 Million in stockholder bonus payments are dividends disguised as bonus payments which are a distinct and measurable ineligible component of compensation. As such, these payments will be excluded from inclusion as eligible compensation components in the calculation of overhead expenses for MAI's fiscal years 2000 through 2009.

For individual audit adjustment amounts for this audit finding, see Exhibits A through J.

Recommendation:

We recommend that MAI exclude all dividends from inclusion as eligible compensation.

(Note: MAI's responses to all of the findings cited and the Tables that they reference in their responses are included at the end of this report.)

Comments of Responsible Officials:

We request that the figures presented in the draft letter be discussed. The actual amount should be $15,460,555, as $31, 031,715 was excluded from our submittal. As can be seen in Table 1, of the $46.5 million indicated to be disallowed from inclusion in the overhead, MAI had already voluntarily disallowed $31,031,715. MAI understood the general IDOT practice concerning allowable incentive compensation in place at the time and prepared its SEFC's accordingly. Only the remaining $15, 460,555 is in question.

The $15,460,555 million at issue was paid in aggregate over a ten-year period and represents compensation to an average of 34 employee/shareholders. This averages out to $45,472 per employee/shareholder per year. We understand the guidelines for making these distributions along the lines of ownership, but our intent is clear that only a reasonable amount of the total compensation was considered allowable. We believe the question of reasonableness is appropriate and should be applied to this issue as outlined in the guidelines. Table 2 shows the larger share of incentive compensation which MAI disallowed and the smaller portion included in the overhead. By contrast, Table 3 illustrates the proposed disallowance from the Audit Report, an amount which claims virtually all of this compensation as disallowed. The reasonableness of our approach was endorsed by BDO Seidman, our independent accounting reviewers.

We wish to resolve the issues surrounding our overhead rates. Our request is that the disputed amounts be judged by their reasonableness. If that is not acceptable then we are very anxious to reach a settlement on this issue. For future compensation, MAI will

design a compensation program in keeping with the Audit recommendation. This program will include a written incentive policy.

Auditor's Note:

MAI did exclude a considerable portion of the dividends disguised as a bonus; however, the adjustments were based on "reasonableness". The criterion used for exclusion, "reasonableness", is not a valid criterion for exclusion of costs in the case of disguised dividends, which is an entirely ineligible account. MAI's response does not refute the case law, statutes and criteria cited in our finding concerning the eligibility of disguised dividends; however, they continue to request that "the disputed amounts be judged by their reasonableness".

Finding No. 2: Need to Properly Code Time to Direct Labor

During our audit of fiscal years 2000 through 2007, we reviewed the labor accounting system of MAI. Though it initially appeared labor charges were being posted to the Time Journal and the Project Control Post Entries Report properly, our further review of employee time sheets indicated that project related costs were being charged to MAI's indirect labor accounts "Precontract" and "Office." During our review of June 2007 time records, we found 12 incidents by 9 different employees who were charging the Office or Precontract accounts while working on specific projects. Our interviews of MAI employees confirmed that employees had, as a practice, been charging the Precontract and Office accounts for various reasons, while working directly on specific projects. In a June 25, 2008 meeting, the MAI Senior Vice President stated that Precontract could include work prior to authorization or actual proposal work. He also noted that work on the Olympics was being charged to Office.

Labor for specific projects should be charged to those projects as a direct cost, regardless of whether these costs may be reimbursed subsequently. Because these direct costs were improperly included in Precontract and Office indirect cost accounts, the overhead rate was inflated considerably.

During our fieldwork of 2000 through 2007 records, we informed MAI of these issues. Accounting personnel then adjusted the FY2007 labor base to correct for these issues in order to alleviate the affects to some degree of overhead adjustments. It was necessary to remove amounts from "Office" and "Precontract" to direct labor accounts.

According to FAR 31.202:

(a) A direct cost is any cost that can be indentified specifically with a particular final cost objective. No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any direct cost pool to be allocated to that or any other final cost objective. Costs indentified specifically with the contract are direct costs of the contract. All costs specifically indentified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.

The AASHTO Uniform Audit & Accounting Guide (8.14) states, "Precontract costs are associated with specific contracts and therefore may not be included in the indirect cost pool."

Because both the Precontract and Office accounts were being charged direct costs, it was problematic to determine an absolute amount by which the affected accounts should be adjusted. In order to move forward with rate development, a negotiated agreement was made with MAI to exclude 50% of the Precontract and Office accounts as indirect expenses. Adjustments were made accordingly to the overhead rate calculation.

During our subsequent fieldwork for the review of FY2008 and FY2009 records, we found that MAI had now eliminated or combined the Precontract account with a number of "Office" type accounts. While MAI had also now implemented a new time keeping system, we found systemic control weaknesses with the new system in as much as employee and management corrections and edits to timekeeping records are not tracked and available for audit and review.

Because of concerns regarding FY2008 and FY2009 timekeeping records and the absence of any documentation of corrective instruction and training being provided to employees with respect to charging time to Precontract and office type accounts for these years, we will apply the weighted average direct labor percentage adjustment made for 2000 through 2007, as a result of the adjustments to the Precontract and Office account amounts for 2000 through 2007, to the direct labor bases for 2008 and 2009 and adjust overhead expenses accordingly as shown on Exhibit K.

For individual audit adjustment amounts for this audit finding, see Exhibits A through J.

Recommendation:

We recommend MAI implement an adequate timekeeping and job cost accounting system in accordance with FAR 31.201-4; and 31.203 to ensure project/direct labor is segregated from overhead and included in direct labor, and follow DCAAP No 7641.90 to establish a timekeeping policy and ensure the employees follow the policy. The time keeping system should provide documentation of all edits, corrections and adjustments.

Comments of Responsible Officials:

We agree that some costs that ended up in "Pre-Contract" accounts were possibly project related. Many of those costs were coded this way in anticipation of a new contract or additional services agreement. A review of the time charged to the "Office" account shows that it substantially included individuals such as secretaries, accounting staff, company Administrators and marketing personnel whose responsibilities were clearly administrative. However, the Draft Letter reports that, "In order to move forward with rate development, a negotiated agreement was made with MAI to exclude 50% of the Precontract and Office accounts as indirect expenses." We wish to move forward to a resolution of these issues and will accept the 50% disallowance for audit years 2000 thru 2007.

In response to our discussions with the Audit Section field staff and to be more precise, MAI expanded the number of indirect labor codes in 2008 and went to an electronic time sheet system in 2009. That system includes electronic notations as to what exactly the employee did while charging the time. For example, if "Office-Proposal" was charged, the specific proposal was noted. When time sheets are reviewed and it is found that an incorrect job number was used or the incorrect number of hours was charged, neither the employee nor the reviewer can independently change the incorrectly coded charge. A reviewer must "Reject" the entry and the employee must re-enter the correct codes and/or hours. This provides added security to changes made. See attached Table 4 for details regarding this process.

The Draft Letter has suggested that the same 50% reduction should apply to Indirect Labor categories in '08 and '09. We respectfully request reconsideration of that action. We adopted the Axium iTime system which is used nation-wide by 400 of our peer firms. The Audit report was concerned about built-in controls in this system when mistaken entries need to be corrected. Please note that any changes require both a "Rejection" by a reviewer and a separate recoding of the time by the employee. These changes have been instituted for 2008, 2009 and beyond. We have as suggested taken

corrective action and the time keeping system will provide documentation of all edits, corrections and adjustments.

Finding No. 3: Direct Costs Included in Transportation Expenses

During our examination of account no. 7150-Transportation, we found numerous examples of direct project costs having been improperly charged to this overhead account. MAI argues that this practice is unobjectionable, because correcting entries removing those charges are later made when those costs can be reassigned to reimbursable projects. Although we did, in fact, observe many reversals of prior charges to the Transportation account, the problem with MAI's practice is that there remains substantial risk of over-inclusion of charges to the Transportation account when a portion of these transportation expenses are not associated with specific projects for which reimbursement is later possible (i.e., where a specific project with associated direct transportation expenses is not ultimately awarded to contractor). There is no simple way to determine whether all direct costs initially lodged in the Transportation account are later reversed. Similarly, the amount of indirect total costs which should remain in account 7150 cannot be determined.

During our initial fieldwork of fiscal years 2000 through 2007, we found 35 individual reports showing that employees were charging the transportation overhead account while working on direct projects, as determined from the project name completed by the employee on the expense report. We then verified the project descriptions and job numbers to the employee's time card.

During our review of fiscal years 2008 and 2009 transportation expenses (Acct. 7150), we found 22 examples in the Expense Report files of removable "Post-It" notes being left on transportation expense reports for four different individuals during 2009. The "Post-It" notes indicated a direct project description and number that the employee was actually working on; however, the employee's expense report only included the project name as being "Office" and the expense was incorrectly charged to the transportation overhead account- 7150 instead of to the direct project that was being worked on. Examples of these "Post-It" notes can be found on Exhibits V through X.

Had the "Post-It" notes been removed from the expense reports prior to our examination and testing, we would have had no indication that misleading information had been entered into the accounting record. Whether "Post- It" notes may have been removed from files for other time periods related to this account is left to speculation. The use of "Post-It" notes showing which actual direct projects the costs should have been charged and then charging an overhead account for these costs raises serious questions concerning the integrity of entries in the entire account.

Based on the results of our review of this account, total charges in account 7150 will be removed from consideration for overhead allowability. For individual audit adjustment amounts for this audit finding, see Exhibits A through J. Ethical and integrity issues regarding the use of "Post-It" notes will be discussed further in a subsequent finding.

Comments of Responsible Officials:

Our response to this Finding applies to any adjustments made to the Transportation (7150) Account and the Auto Expense (705 in 2000 and 7160 in 2001 through 2009) Account. MAI used one account for transportation costs with Transportation referring to the reimbursement of personal car usage and Auto Expense being the cost of gas, maintenance, etc. of MAI-owned vehicles. When specific travel is assigned to a specific

project, the expense is then credited against our overhead calculation within the Travel (706 in 2000) and Daily Vehicle Usage (7030) accounts. The attached Table 5 summarizes all automobile related additions and subtractions to our overhead with the net over the 10 years being only $1,392. Since our original overhead rate submittals already subtracted out these costs from the allowable indirect expenses, no further adjustment may be necessary.

MAI will redesign its chart of accounts to provide clear designation of various auto expense categories and will develop a clear written policy on reporting of automobile expenses.

Finding No. 4: Direct Project Settlement Costs Included in Legal and Accounting Expenses

During our examination of FY2002 costs, we found that MAI included in overhead account no. 7490- Legal and Accounting, $490,000, which was for the settlement of issues concerning two specific projects. These settlement costs are direct costs of the subject projects and should not be allocated to all projects through the overhead calculation. The cost of these settlements should be treated in much the same manner as errors and omissions insurance.

In a January 11, 2011 email from MAI concerning this issue, they noted:

> The **DCAA Contract Audit Manual, section 7-508.5** states:
>
> > "Professional Liability insurance (also referred to as architects and engineers or errors and omissions insurance) protects against damages to clients or third parties resulting from professional error or judgments. The cost of professional liability insurance **is allowable,** subject to tests of reasonableness and/or allocability."
>
> Therefore, following IDOT's analogy, since errors and omissions insurance is allowable, so are legal settlement costs.

MAI's quotation was actually from DCAA CAM 7-508.5(a). The relevant concern is not the allowability but the proper allocability of these costs. The following citation from DCAA 7-508.5(b) provides the appropriate criteria pertaining to the allocability of such costs:

> Reviewing policy coverage is the first and most important step in determining allocability and reasonableness. If a contractor's liability insurance policy provides coverage for its general practice, allocation of premiums to all contracts through overhead or general and administrative expense is usually acceptable. However, if this policy is written to provide unique liability coverage for a particular business segment or product, **costs should be directly allocated to the benefiting cost objective**.

DCAA CAM 7-802.2, Case by Case Determination, regarding labor settlement costs, provides a comparable discussion of the proper allocation of settlement costs:

> b(1) Where the violation which gave rise to the award can be identified to a specific contract(s), the entire award should be charged to that contract(s). The cost would not be allocable to any other contract and should not be included in an indirect cost pool. However, when the contract(s) which gave rise to the award is closed, consideration should be given to including the award in an indirect cost pool provided that the amount charged to Government contracts is no greater than that which would have been charged to the Government if the contract(s) was open. *[Note: the settlement costs in question would not have been approved costs chargeable to any government contracts.]*
>
> b(2) Other points to be considered are:
> (b) When a negotiated union contract calls for a retroactive increase, the additional costs should be charged to the same final cost objectives that the actual work performed was charged.

Because the settlements were expressly agreed to in relation to issues concerning specific projects, a broad based allocation to all government and other contracts is inappropriate. The subject costs will be removed from allocation to government projects for overhead rate development. For individual audit adjustment amounts for this audit finding, see Exhibits A through J.

Comments of Responsible Officials:

We believed our inclusion of these costs in the overhead was acceptable and the practice was endorsed by our outside accounting firm who reviewed our overhead submissions. Nevertheless, in the interest of resolving all overhead issues, we will accept the findings presented.

Finding No. 5: "Post- It" Notes and False or Improper Charging or Recording of Costs Indicate Material Weaknesses in MAI's Accounting Procedures and Controls and Raise Substantial Concerns Regarding Its Business Ethics

During our audit of fiscal years 2000 through 2007, we performed an extensive review of MAI expenses associated with providing lunches, dinners, golf outings, Christmas luncheons, and professional baseball and basketball game excursions involving IDOT employees. During this fieldwork, we informed MAI officials regarding the nature of our testing in this area. The field work for these reviews was performed at various dates during May 2008, June 2008, and April 2009. During this review, MAI employee expense records and credit card billing statements included, as required by Internal Revenue Service guidance, the names of clients for whom the entertainment or business meals and costs were incurred.

During a July 2010 site visit to discuss our preliminary draft report on fiscal years 2000 through 2007, we performed additional review of MAI employee expenses incurred to entertain IDOT employees during 2008 through 2010. Much of these costs were incurred by one MAI employee and had been detailed on his expense records, at least during the previous fieldwork for 2000 through 2007. During this subsequent review, we found that same MAI employee now had the details of his lunches included on removable "Post-It" notes which were stuck to the employee's business meals expense reports. The monthly expenses reports, the official accounting records used to enter cost information into the MAI accounting system, included a different explanation for the costs incurred and included no documentation showing that the costs were incurred on behalf of IDOT employees. In addition to the use of "Post-It" notes, MAI employee credit card billing statements now only indicated, for instance, that "clients" were taken to Cubs games and food and beverage costs were incurred. Previously, similar charges indicated the names, or at least the organization for which the clients worked.

For the subject MAI employee, we found 31 separate incidents of the use of "Post- It" notes on his business meals expense reports from 2008 through June 2010. Examples of these "Post-It" notes can be found on Exhibits Y through AA. Disguising entertainment expenses as allowable employee business meals could lead to an over allocation of expenses to government projects.

As noted in Audit Finding No. 3, in December 2010, during our review of fiscal years 2008 and 2009 transportation expenses (Acct. 7150), we found 22 examples in the Expense Report files of removable "Post-It" notes being left on expense reports for four different individuals during 2009. The "Post-It" notes indicated a direct project description and number that the employee was actually working on; however, the employee's expense report only included the project name as being "Office" and the expense was incorrectly charged to the transportation overhead account - 7150 instead of to the direct project that was being worked on. Examples of these "Post-It" notes can be found on Exhibits V through X.

Had the "Post-It" notes been removed from the transportation expense reports prior to our examination and testing, we would have had no indication that misleading information had been entered into the accounting records. The use of "Post-It" notes which show what actual direct projects the costs should have been charged to and then charging an overhead account for these costs questions the integrity of entries in the entire account.

In a December 2010 meeting, we informed MAI officials of our concerns over the use of removable "Post-It" notes being used which show that direct transportation expense charges are being entered as overhead expenses in the accounting records for inclusion in the overhead rate. MAI officials stated that it was a mistake and due in effect to an overzealous project manager; however, this does not explain why the accounting personnel were entering the information provided as overhead expenses and not direct expenses, while "Post-It" notes were attached to the accounting records disputing the accuracy of the accounting entries being made. In the December 2010 meeting with MAI, we did not inform them of the use of the "Post-It" notes being used on the business meals expense reports.

Summary:

We have identified Audit Findings 1 through 5 as Specific Audit Findings because each necessitates detailed exposition regarding specific accounting schemes and practices followed by MAI. To recap:

> Audit Finding No. 1, $46.5 Million in Dividends Disguised as Bonuses Included in Overhead Computations, leads to an average inflation of the overhead rates by 61% and increased profits to fund future dividend payments to stockholders in excess of the profit factors allowed in most government project agreements. MAI's error as to the allocability of its payments to shareholder-employees under the Principals' Plan, may have been a simple mistake, but the existence of two separate bonus programs and the decision by MAI, as a relatively large and sophisticated contractor, to maintain no written policies with respect to criteria used for determining major elements of its total compensation package suggests a more deliberate attempt to obscure the nature of those payments.
>
> Audit Finding No. 2, Need to Properly Code Time to Direct Labor, indicates that MAI management and employees were well aware that it was a practice to incorrectly charge direct project expenses to Precontract and Office overhead accounts.
>
> Audit Findings No. 3 and No. 5 concerning the use of "Post-It "notes and false or improper charging or recording of costs, indicate that MAI management and employees were well aware of their intentions to enter false information in the accounting records. If not, then why use "Post-It" notes at all? Whether there were "Post- It" notes removed from files for other time periods and other accounts is left to speculation. With respect to "Post-It" notes and other misleading information being entered into the accounting records, we don't know what we don't know.

Audit Findings 6 through 15 set forth in subsequent pages are categorized as General Audit Findings insofar as each involves a clear and repeated failure of MAI to follow some of the most common and explicit FARs requirements by improperly including ineligible costs in their overhead rate calculations. Common ineligible expenses such as advertising, lobbying, entertainment and contributions were all included and charged to government projects through the application of the overhead rate. The text of these findings includes the applicable FARs requirements which MAI failed to follow, regardless of any certifications they made when filing their annual Statement of Experience and Financial Condition (SEFC).

In order to become prequalified to perform professional engineering services for IDOT, an engineering consultant is required to annually file a SEFC. The SEFC requires the consultant to certify to the correctness and completeness of all financial information submitted as well as to certify that they are following the applicable Cost Accounting Standards. An important part this information is the consultant's submittal of their self-computation of their overhead rates which are to be computed in compliance with Section 2.86 of the Department's "Standard Agreement Provisions for Consultant Services." Section 2.86 requires the following:

2.86 ITEMS ELIGIBLE FOR REIMBURSEMENT AS CONSULTANT'S COSTS

a) When the method of COMPENSATION includes payment of the CONSULTANT'S ACTUAL COSTS, the following items of cost are reimbursable to the extent that they are in compliance with FARs, Subparts 31.1 and 31.2 and FAPG Chapter 1, Subchapter B, Paragraph 172.

d) Indirect costs (or overhead costs) are the remaining costs of the CONSULTANT'S business operations after the assignment to all of their clients of all direct costs, exclusive of costs ineligible for COMPENSATION such as uncollectible charges, advertising, amusement, entertainment, contributions, donations, interest on borrowed money, and the like.

Each of our Audit Findings reflects certain deficiencies in MAI's accounting and audit control processes. Taken together, these Audit Findings reflect, at best, material weakness in MAI's processes and strikingly poor understanding of applicable requirements. More disturbingly, these Audit Findings also strongly suggest either deliberate non-compliance by MAI or willful ignorance of its responsibility to provide the Department with accurate billings in accordance with FARs and other applicable standards.

Recommendation:

Based on the totality of the audit findings cited in this report, we believe that MAI has significant internal control and business integrity and ethics weaknesses. We recommend that MAI develop and implement a corrective action plan to adequately address the internal accounting control and ethics and business integrity issues cited in the report. In light of the fact that MAI routinely has made inaccurate certifications during the filing of its SEFCs, we also recommend that MAI's prequalification status be suspended until acceptable corrective action protocols are implemented.

We believe the accounting adjustments we have made in relation to the audit findings cited will provide for the determination of reasonable and appropriate overhead rates for the time periods reviewed. We do, however, believe that the ethics and business integrity issues concerning MAI's conduct of its business and improper charging and recording of costs need to be addressed further by the appropriate IDOT officials. The totality of the issues cited in the audit findings should be taken into consideration during the assessment of whether appropriate sanctions are called for which address the past and current practices of MAI management. Accordingly, this report will be shared with the appropriate IDOT management to determine the need for any additional sanctions.

Comments of Responsible Officials:

We agree that "Post-It" Notes should not be used. An Expense Form has been developed to more completely describe and account for the expenses that MAI reimburses. Refer to attached Table 6. Regardless of how the expenses were recorded by the employees, they were correctly disallowed by MAI in our determination of overhead, as originally submitted to IDOT. As discussed under Finding 3, as much auto/travel expenses were subtracted out of the overhead as were added in.

We will improve the documentation of employee expenses and will require all employees to provide the required documentation in detail on the new expense form. These additional controls will resolve this issue.

We have summarized the totals for all ten Findings [findings 6 through 10] in Table 7. As you can see, all ten Findings in aggregate average out to $153,810 per year, which in turn would result in a change in the overhead rate of 0.0197. We hope this is not considered as a clear and repeated failure. That being said, we wish to conclude the audit process and will accept the auditors' quantitative disallowance under Findings 6 thru 15.

SUMMARY

Finding No. 1

1. In view if the fact that MAI voluntarily excluded a bulk of the distribution, we requests that these exclusions be recognized.
2. MAI requests that consideration be given to a reasonableness approach for this item.
3. MAI will develop an acceptable written compensation plan. Troy Washko will be engaged to help us develop an incentive program.

Finding No. 2

1. MAI accepts 50% settlement for 2000 through 2007.
2. MAI Requests further discussion for the years 2008 and 2009 based on our procedural change in time keeping.
3. MAI has instituted additional quality assurance procedures to ensure all time card changes are documented and electronically stored.
4. MAI will provide training to all existing and new employees regarding the appropriate time keeping procedures.
5. MAI has appointed a Quality Assurance Manager to ensure all instituted policies and procedures are followed.
6. MAI will implement a policy to allow employees to notify the Quality Assurance Manager regarding time card entry issues.

Finding No. 3

1. MAI will redesign its chart of accounts to provide clear designation of various auto expense categories and will develop a clear written policy on reporting of automobile expenses.

2. MAI will provide training to all existing and new employees regarding automobile usage and coding procedures.

Finding No. 4

1. MAI accepts this finding in the interest of overall resolution.

Finding No. 5

1. The use of "Post-It" Notes has been discontinued effective immediately.
2. A new expense form has been developed to provide appropriate level of detail.
3. MAI will provide training to all existing and new employees regarding the use of "Post-It" Notes and the proper procedures for recording expenses.
4. MAI will develop a written policy regarding the proper procedures for recording expenses and it shall be integral to our employee handbook.
5. MAI will implement a policy to allow employees to notify the Quality Assurance Manager regarding expense recording issues.

Finding No. 6 through No. 15

1. MAI accepts these findings in the interest of overall resolution.
2. MAI will add additional accounting codes to more accurately account for these activities.
3. Accounting staff will receive additional training regarding FAR and IDOT policies regarding handling of expenses.
4. MAI will continue to use expert, independent CPA firm auditors to provide independent analysis of our overhead calculation. MAI will use every reasonable effort to ascertain that the chosen firm is familiar with the FAR and IDOT policies regarding overhead analysis. Meticulous care will be taken in determining charges that go into overhead.

As indicated by our responses, MAI's intent is to cooperate fully with the Department in all areas. We sincerely regret the actions that have led to your preliminary draft findings. Although some audit findings may point to weaknesses in our internal controls, we wish to reassure you that MAI's intent has always been honest. We point to MAI's consistent record of highest and best practices in engineering services over the last 45 years. In this regard, our ethics and integrity have been unquestioned. In fact, as discussed in our meeting, MAI has at times been overprotective of items such as proper invoicing to the point where notes were used just to ensure no improper charges were made.

We hope that we have conveyed our heartfelt passion to be the best in all our endeavors. We do admit that MAI made some honest mistakes in accounting procedures, and we will take immediate corrective action. However, we wish to make it clear that our intent is pure. As in our engineering practices, we will incorporate best business practices to address all your concerns.

We humbly request that all language regarding MAI's "significant internal control and business integrity and ethics weakness", as mentioned in the Recommendations section of the Audit Report, be removed. Additionally, we request that the reference to our

prequalification suspension be eliminated. The findings discussed may demonstrate a deficiency in internal controls and a misunderstanding of FAR regulations, but it certainly is not an indication of our lack of integrity. Our reputation by far is our greatest asset and we hold it very dear. We stand by our integrity and our ethical approach to business. It is our hope that through our response and forthright discussions we have impressed upon you that we are a firm that conducts itself in a manner that is truly consistent with the professional requirements dictated by our licensing. Finally, as a partner with IDOT for 45 years, we would do nothing to jeopardize our relationship.

CONCLUSION
As suggested MAI will take corrective action in each instance and will ensure that information is properly documented. When in doubt we will err on the side of caution. Strict instructions will be given to the managers that, if need be, discussion should be held with the CFO on issues not readily discernable. A Quality Assurance Manager has been appointed to review timecards and expense reports on a test basis to determine if the controls are working. If further revisions are necessary, they will be implemented.

One Final Auditor's Note:

Following our review of MAI's responses to the audit findings, we find no compelling reason, argument or excuse to alter, adjust or deviate from the determinations made in the findings presented in the report or to make adjustments to the audited overhead rates presented in the audit. The effectiveness of MAI's corrective action plans will need to be evaluated subsequent to implementation.

We still believe that the description on the "Post It" Note should at least agree with what is entered in the accounting system and government projects should not be allocated dividends and profits as an eligible overhead cost or charged for work on the Chicago Olympics, which will never take place.

We still believe that the ethics and business integrity issues concerning MAI's conduct of its business and improper charging and recording of costs need to be addressed further by the appropriate IDOT officials. As noted, the totality of the issues cited in the audit findings should be taken into consideration during the assessment of whether appropriate sanctions are called for which address the past and current practices of MAI management. Accordingly, this report will be shared with the appropriate IDOT management to determine the need for any additional sanctions.

General Audit Findings

For individual audit adjustment amounts for General Audit Findings, see Exhibits A through J.

Finding No. 6: Unrecorded Direct Labor and Direct Costs

Necessary adjustments were made to properly account for unrecorded direct labor and direct costs pursuant to the FAR cited below:

FAR 31.202 -- Direct Costs
(a) No final cost objective shall have allocated to it as a direct cost any cost, if other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool to be allocated to that or any other final cost objective. Direct costs of the contract shall be charged directly to the contract. All costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract directly or indirectly.

(b) For reasons of practicality, the contractor may treat any direct cost of a minor dollar amount as an indirect cost if the accounting treatment –

(1) Is consistently applied to all final cost objectives; and

(2) Produces substantially the same results as treating the cost as a direct cost.

Finding No. 7: Excess Indirect Labor

Necessary adjustments were made to properly account for excess indirect labor costs pursuant to the FAR cited below and the September 20, 1988 IDOT letter from D. L. Wolaver (See Exhibit BB):

31.205-6 -- Compensation for Personal Services

(m) *Fringe benefits.*

(2) That portion of the cost of company-furnished automobiles that relates to personal use by employees (including transportation to and from work) is unallowable regardless of whether the cost is reported as taxable income to the employees (see 31.205-46(d)).

Finding No. 8: No Business Support or Lack of Supporting Documentation

Necessary adjustments were made to properly account for the lack of business support or supporting documentation for costs pursuant to the FAR cited below:

31.201-6 -- Accounting for Unallowable Costs

(a) Costs that are expressly unallowable or mutually agreed to be unallowable, including mutually agreed to be unallowable directly associated costs, shall be identified and excluded from any billing, claim, or proposal applicable to a Government contract. A directly associated cost is any cost that is generated solely as a result of incurring another cost, and that would not have been incurred had the other cost not been incurred. When an unallowable cost is incurred, its directly associated costs are also unallowable.

(b) Costs that specifically become designated as unallowable or as unallowable directly associated costs of unallowable costs as a result of a written decision furnished by a contracting officer shall be identified if included in or used in computing any billing, claim, or proposal applicable to a Government contract. This identification requirement applies also to any costs incurred for the same purpose under like circumstances as the costs specifically identified as unallowable under either this paragraph or paragraph (a) above.

(c)

(1) The practices for accounting for and presentation of unallowable costs must be those described in 48 CFR 9904.405, Accounting for Unallowable Costs.

(2) Statistical sampling is an acceptable practice for contractors to follow in accounting for and presenting unallowable costs provided the following criteria in paragraphs (c)(2)(i), (c)(2)(ii), and (c)(2)(iii) of this subsection are met:

(i) The statistical sampling results in an unbiased sample that is a reasonable representation of the sampling universe.

(ii) Any large dollar value or high risk transaction is separately reviewed for unallowable costs and excluded from the sampling process.

(iii) The statistical sampling permits audit verification.

(3) For any indirect cost in the selected sample that is subject to the penalty provisions at 42.709, the amount projected to the sampling universe from that sampled cost is also subject to the same penalty provisions.

(4) Use of statistical sampling methods for identifying and segregating unallowable costs should be the subject of an advance agreement under the provisions of 31.109 between the contractor and the cognizant administrative contracting officer or Federal official. The advance agreement should specify the basic characteristics of the sampling process. The cognizant administrative contracting officer or Federal official shall request input from the cognizant auditor before entering into any such agreements.

(5) In the absence of an advance agreement, if an initial review of the facts results in a challenge of the statistical sampling methods by the contracting officer or the contracting officer's representative, the burden of proof shall be on the contractor to establish that such a method meets the criteria in paragraph (c)(2) of this subsection.

(d) If a directly associated cost is included in a cost pool that is allocated over a base. that includes the unallowable cost with which it is associated, the directly associated cost shall remain in the cost pool. Since the unallowable costs will attract their allocable share of costs from the cost pool, no further action is required to assure disallowance of the directly associated costs. In all other cases, the directly associated costs, if material in amount, must be purged from the cost pool as unallowable costs.

(e)

(1) In determining the materiality of a directly associated cost, consideration should be given to the significance of --

(i) The actual dollar amount,

(ii) The cumulative effect of all directly associated costs in a cost pool, and

(iii) The ultimate effect on the cost of Government contracts.

(2) Salary expenses of employees who participate in activities that generate unallowable costs shall be treated as directly associated costs to the extent of the time spent on the proscribed activity, provided the costs are material in accordance with subparagraph (e)(1) above (except when such salary expenses are, themselves, unallowable). The time spent in proscribed activities should be compared to total time spent on company activities to determine if the costs are material. Time spent by employees outside the normal working hours should not be considered except when it is evident that an employee engages so frequently in company activities during periods outside normal working hours as to indicate that such activities are a part of the employee's regular duties.

(3) When a selected item of cost under 31.205 provides that directly associated costs be unallowable, such directly associated costs are unallowable only if determined to be material in amount in accordance with the criteria provided in paragraphs (e)(1) and (e)(2) of this section, except in those situations where allowance of any of the directly associated costs involved would be considered to be contrary to public policy.

Finding No. 9: Entertainment Costs

Necessary adjustments were made to properly account for entertainment costs pursuant to the FAR cited below:

31.205-14 -- Entertainment Costs.

Costs of amusement, diversions, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable. Costs made specifically unallowable under this cost principle are not allowable under any other cost principle. Costs of membership in social, dining, or country clubs or other organizations having the same purposes are also unallowable, regardless of whether the cost is reported as taxable income to the employees.

Finding No. 10: Lobbying

Necessary adjustments were made to properly account for lobbying costs pursuant to the FAR cited below:

31.205-22 -- Lobbying and Political Activity Costs

(a) Costs associated with the following activities are unallowable:

(1) Attempts to influence the outcomes of any Federal, State, or local election, referendum, initiative, or similar procedure, through in kind or cash contributions, endorsements, publicity, or similar activities;

(2) Establishing, administering, contributing to, or paying the expenses of a political party, campaign, political action committee, or other organization established for the purpose of influencing the outcomes of elections;

(3) Any attempt to influence --

(i) The introduction of Federal, state, or local legislation, or

(ii) The enactment or modification of any pending Federal, state, or local legislation through communication with any member or employee of the Congress or state legislature (including efforts to influence state or local officials to engage in similar lobbying activity), or with any government official or employee in connection with a decision to sign or veto enrolled legislation;

(4) Any attempt to influence

(i) The introduction of Federal, state, or local legislation, or

(ii) The enactment or modification of any pending Federal, state, or local legislation by preparing, distributing or using publicity or propaganda, or by urging members of the general public or any segment thereof to contribute to or participate in any mass demonstration, march, rally, fund raising drive, lobbying campaign or letter writing or telephone campaign;

(5) Legislative liaison activities, including attendance at legislative sessions or committee hearings, gathering information regarding legislation, and analyzing the effect of legislation, when such activities are carried on in support of or in knowing preparation for an effort to engage in unallowable activities; or

(6) Costs incurred in attempting to improperly influence (see 3.401), either directly or indirectly, an employee or officer of the Executive branch of the Federal Government to give consideration to or act regarding a regulatory or contract matter.

(b) The following activities are excepted from the coverage of (a) of this section:

(1) Providing a technical and factual presentation of information on a topic directly related to the performance of a contract through hearing testimony, statements or letters to the Congress or a state legislature, or subdivision, member, or cognizant staff member thereof, in response to a documented request (including a Congressional Record notice requesting testimony or statements for the record at a regularly scheduled hearing) made by the recipient member, legislative body or subdivision, or a cognizant staff member thereof; provided such information is readily obtainable and can be readily put in deliverable form; and further provided that costs under this section for transportation, lodging or meals are

unallowable unless incurred for the purpose of offering testimony at a regularly scheduled Congressional hearing pursuant to a written request for such presentation made by the Chairman or Ranking Minority Member of the Committee or Subcommittee conducting such hearing.
(2) Any lobbying made unallowable by paragraph (a)(3) of this subsection to influence state or local legislation in order to directly reduce contract cost, or to avoid material impairment of the contractor's authority to perform the contract.
(3) Any activity specifically authorized by statute to be undertaken with funds from the contract.

(c) When a contractor seeks reimbursement for indirect costs, total lobbying costs shall be separately identified in the indirect cost rate proposal, and thereafter treated as other unallowable activity costs.
(d) Contractors shall maintain adequate records to demonstrate that the certification of costs as being allowable or unallowable (see 42.703-2) pursuant to this subsection complies with the requirements of this subsection.
(e) Existing procedures should be utilized to resolve in advance any significant questions or disagreements concerning the interpretation or application of this subsection.

Finding No. 11: Advertising Costs

Necessary adjustments were made to properly account for advertising costs pursuant to the FAR cited below:

31.205-1 -- Public Relations and Advertising Costs

(a) "Public relations" means all functions and activities dedicated to --
(1) Maintaining, protecting, and enhancing the image of a concern or its products; or
(2) Maintaining or promoting reciprocal understanding and favorable relations with the public at large, or any segment of the public. The term public relations includes activities associated with areas such as advertising, customer relations, etc.

(b) "Advertising" means the use of media to promote the sale of products or services and to accomplish the activities referred to in paragraph (d) of this subsection, regardless of the medium employed, when the advertiser has control over the form and content of what will appear, the media in which it will appear, and when it will appear. Advertising media include but are not limited to conventions, exhibits, free goods, samples, magazines, newspapers, trade papers, direct mail, dealer cards, window displays, outdoor advertising, radio, and television.
(c) Public relations and advertising costs include the costs of media time and space, purchased services performed by outside organizations, as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions and activities identified in paragraphs (a) and (b) of this subsection.
(d) The only allowable advertising costs are those that are --
(1) Specifically required by contract, or that arise from requirements of Government contracts and that are exclusively for –
(i) Acquiring scarce items for contract performance; or
(ii) Disposing of scrap or surplus materials acquired for contract performance.

(2) Costs of activities to promote sales of products normally sold to the U.S. Government, including trade shows, which contain a significant effort to promote exports from the United States. Such costs are allowable, notwithstanding paragraphs (f)(1), (f)(3), (f)(4)(ii), and (f)(5) of this subsection. However, such costs do not include the costs of memorabilia (*e.g.*, models, gifts, and souvenirs), alcoholic beverages, entertainment, and physical facilities that are primarily used for entertainment rather than product promotion; or

(3) Allowable in accordance with 31.205-34.

(e) Allowable public relations costs include the following:

(1) Costs specifically required by contract.

(2) Costs of --

(i) Responding to inquiries on company policies and activities;

(ii) Communicating with the public, press, stockholders, creditors, and customers; and

(iii) Conducting general liaison with news media and Government public relations officers, to the extent that such activities are limited to communication and liaison necessary to keep the public informed on matters of public concern such as notice of contract awards, plant closings or openings, employee layoffs or rehires, financial information, etc.

(3) Costs of participation in community service activities (*e.g.*, blood bank drives, charity drives, savings bond drives, disaster assistance, etc.) (But see paragraph (f)(8) of this section.)

(4) Costs of plant tours and open houses (but see subparagraph (f)(5) of this subsection).

(5) Costs of keel laying, ship launching, commissioning, and roll-out ceremonies, to the extent specifically provided for by contract.

(f) Unallowable public relations and advertising costs include the following:

(1) All public relations and advertising costs, other than those specified in paragraphs (d) and (e) of this subsection, whose primary purpose is to promote the sale of products or services by stimulating interest in a product or product line (except for those costs made allowable under 31.205-38(b)(5)), or by disseminating messages calling favorable attention to the contractor for purposes of enhancing the company image to sell the company's products or services.

(2) All costs of trade shows and other special events which do not contain a significant effort to promote the export sales of products normally sold to the U.S. Government.

(3) Costs of sponsoring meetings, conventions, symposia, seminars, and other special events when the principal purpose of the event is other than dissemination of technical information or stimulation of production.

(4) Costs of ceremonies such as --

(i) Corporate celebrations and

(ii) New product announcements.

(5) Costs of promotional material, motion pictures, videotapes, brochures, handouts, magazines, and other media that are designed to call favorable attention to the contractor and its activities.

(6) Costs of souvenirs, models, imprinted clothing, buttons, and other mementos provided to customers or the public.

(7) Costs of memberships in civic and community organizations.
(8) Costs associated with the donation of excess food to nonprofit organizations in accordance with the Federal Food Donation Act of 2008 (Pub. L. 110-247) (see FAR subpart 26.4).

Finding No. 12: Contributions Costs

Necessary adjustments were made to properly account for contributions costs pursuant to the FAR cited below:

31.205-8 -- Contributions or Donations
Contributions or donations, including cash, property and services, regardless of recipient, are unallowable, except as provided in 31.205-1(e)(3).

Finding No. 13: Employee Morale Costs

Necessary adjustments were made to properly account for employee morale costs pursuant to the FAR cited below:

31.205-13 -- Employee Morale, Health, Welfare, Food Service, and Dormitory Costs and Credits
(a) Aggregate costs incurred on activities designed to improve working conditions, employer-employee relations, employee morale, and employee performance (less income generated by these activities) are allowable, subject to the limitations contained in this subsection. Some examples of allowable activities are--
(1) House publications;
(2) Health clinics;
(3) Wellness/fitness centers;
(4) Employee counseling services; and
(5) Food and dormitory services, for the contractor's employees at or near the contractor's facilities. These services include—
(i) Operating or furnishing facilities for cafeterias, dining roOms, canteens, lunch wagons, vending machines, living accommodations; and
(ii) Similar types of services.
(b) Costs of gifts are unallowable. (Gifts do not include awards for performance made pursuant to 31.205-6(f) or awards made in recognition of employee achievements pursuant to an established contractor plan or policy.)
(c) Costs of recreation are unallowable, except for the costs of employees' participation in company sponsored sports teams or employee organizations designed to improve company loyalty, team work, or physical fitness.
(d)
(1) The allowability of food and dormitory losses are determined by the following factors:
(i) Losses from operating food and dormitory services are allowable only if the contractor's objective is to operate such services on a break-even basis.

(ii) Losses sustained because food services or lodging accommodations are furnished without charge or at prices or rates which obviously would not be conducive to the accomplishment of the above objective in paragraph (d)(1)(i) of this subsection are not allowable, except as described in paragraph (d)(1)(iii) of this subsection.
(iii) A loss may be allowed to the extent that the contractor can demonstrate that unusual circumstances exist such that even with efficient management, operating the services on a break-even basis would require charging inordinately high prices, or prices or rates higher than those charged by commercial establishments offering the same services in the same geographical areas. The following are examples of unusual circumstances:
(A) The contractor must provide food or dormitory services at remote locations where adequate commercial facilities are not reasonably available.
(B) The contractor's charged (but unproductive) labor costs would be excessive if the services provided were not available.
(C) If cessation or reduction of food or dormitory operations will not otherwise yield net cost savings.
(2) Costs of food and dormitory services shall include an allocable share of indirect expenses pertaining to these activities.
(e) When the contractor has an arrangement authorizing an employee association to provide or operate a service, such as vending machines in the contractor's plant, and retain the profits, such profits shall be treated in the same manner as if the contractor were providing the service (but see paragraph (f) of this subsection).
(f) Contributions by the contractor to an employee organization, including funds from vending machine receipts or similar sources, are allowable only to the extent that the contractor demonstrates that an equivalent amount of the costs incurred by the employee organization would be allowable if directly incurred by the contractor.

Finding No. 14: Allowability of Costs

Necessary adjustments were made to properly account for only allowable costs pursuant to the FAR cited below:

31.201-2 -- Determining Allowability
(a) A cost is allowable only when the cost complies with all of the following requirements:
(1) Reasonableness.
(2) Allocability.
(3) Standards promulgated by the CAS Board, if applicable; otherwise, generally accepted accounting principles and practices appropriate to the circumstances.
(4) Terms of the contract.
(5) Any limitations set forth in this subpart.
(b) Certain cost principles in this subpart incorporate the measurement, assignment, and allocability rules of selected CAS and limit the allowability of costs to the amounts determined using the criteria in those selected standards. Only those CAS or portions of

standards specifically made applicable by the cost principles in this subpart are mandatory unless the contract is CAS-covered (see Part 30). Business units that are not otherwise subject to these standards under a CAS clause are subject to the selected standards only for the purpose of determining allowability of costs on Government contracts. Including the selected standards in the cost principles does not subject the business unit to any other CAS rules and regulations. The applicability of the CAS rules and regulations is determined by the CAS clause, if any, in the contract and the requirements of the standards themselves.
(c) When contractor accounting practices are inconsistent with this Subpart 31.2, costs resulting from such inconsistent practices in excess of the amount that would have resulted from using practices consistent with this subpart are unallowable.
(d) A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported

Finding No. 15: Lawsuit Settlement Costs

Necessary adjustments were made to properly account for lawsuit settlement costs pursuant to the FAR cited below:

31.205-15 -- Fines, Penalties, and Mischarging Costs
(a) Costs of fines and penalties resulting from violations of, or failure of the contractor to comply with, Federal, State, local, or foreign laws and regulations, are unallowable except when incurred as a result of compliance with specific terms and conditions of the contract or written instructions from the contracting officer.
(b) Costs incurred in connection with, or related to, the mischarging of costs on Government contracts are unallowable when the costs are caused by, or result from, alteration or destruction of records, or other false or improper charging or recording of costs. Such costs include those incurred to measure or otherwise determine the magnitude of the improper charging, and costs incurred to remedy or correct the mischarging, such as costs to rescreen and reconstruct records.