

CHAPTER 6/LABOR-CHARGING SYSTEMS AND OTHER CONSIDERATIONS

TABLE 6-1: LABOR-CHARGING CHECKLIST

Model Characteristics of Labor-Charging Systems:	Yes	No	N/A	Note
• Is there segregation of responsibilities for labor-related activities? For example, the responsibility for timekeeping and payroll accounting should be separated.				
• Do supervisors who are accountable for meeting contract budgets have the opportunity to initiate employee time charges? (It is recognized that, for a very small company, this type of segregation may not be possible, whereas for a larger company, this type of segregation would be required in order to have good internal controls over labor costs.)				
• Are individual employees routinely made aware of controls that act as effective deterrent against violations? Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through posting of signs throughout the workplace that reminds employees of the importance of accurate and current timecards.				
• Were detailed instructions for timecard preparation established through a timekeeping pamphlet and/or company procedure?				
• If a manual system is in place, were instructions published to inform employees that they are personally responsible for the following?				
(1) Recording his/her time on a daily basis.				
(2) Recording time on the timecard in ink.				
(3) The correct distribution of time by project numbers, contract number or name, or other identifiers for a particular assignment. To ensure accuracy, a listing of project numbers and their descriptions should be provided in writing to the employee.				
(4) Changes to the timecard. All changes should be lined through, with the employee's initials beside the change indicating the employee personally made the change and that the change is correct.				
(5) Recording all hours worked whether they are paid or not. This is necessary because labor costs and associated overheads are affected by total hours worked, not just paid hours worked. Therefore, labor rate computations and labor overhead costs should reflect all hours worked. Unpaid hours worked are termed "uncompensated overtime."				
(6) Signing the timecard at the end of each work period.				
• Do supervisors approve and cosign all timecards?				
• Are supervisors prohibited from completing an employee's timecard unless the employee is absent for a prolonged period of time on some form of authorized leave?				
• If the employee is on travel status, the supervisor for the employee may prepare a timesheet. Upon the employee's return, does the employee turn in his/her time sheet and attach it to the one prepared by the supervisor, or does the firm in some other way document the reason why the employee did not prepare and sign the original timesheet?				
• Does the consultant's published guidance/policy state that the nature of the work determines the proper distribution of time, not availability of funding, type of contract, or other factors? (Does the consultant emphasize that the proper characterization/categorization of labor hours is not dependent upon whether such labor hours are billable to a client?)				
• Does the consultant's policy state that the accurate and complete preparation of timecards is a part of each employee's job?				
• Does the consultant's policy state that careless or improper preparation of timecards may lead to disciplinary actions under company policies as well as applicable Federal statutes?				
Evaluation of Accounting System - Critical Elements:				
• Does the consultant's accounting system provide for proper segregation of direct and indirect costs?				
• Does the accounting system provide for identification and accumulation of direct costs by cost object (contract)?				
• Does the accounting system provide for a logical and consistent method for the allocation of indirect costs to intermediate and final cost objectives? (A contract is a final cost objective).				
• Does the accounting system articulate with a timekeeping system that identifies employees' labor by intermediate or final cost objectives?				
• Does the accounting system include interim (at least monthly) determination of costs charged to contracts through routine posting of books of account (i.e., project data is transferred from the labor distribution system to the cost accounting system)?				
• Does the accounting system include controls to exclude from costs charged to government contracts amounts that are unallowable, per the Cost Principles of FAR Part 31 and/or other applicable laws or regulations, including state audit guidance?				
• Is the accounting system currently in full operation? If not describe which portions of the system are:				
(1) operational;				
(2) set up, but not yet operational;				
(3) anticipate to be placed into operation; or				
(4) nonexistent.				
Final Assessment of Consultant's Accounting System:				
<input type="checkbox"/> Fully Acceptable.				
<input type="checkbox"/> Provisionally Acceptable - Describe requirements for status to be changed to Fully Acceptable.				
<input type="checkbox"/> Unacceptable.				

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CHAPTER 5/COST ACCOUNTING

TABLE 5-5: SAMPLE INDIRECT COST RATE SCHEDULE

SAMPLE CONSULTING COMPANY, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead
For the Year Ended December 31, 201x

Account Number & Description	General Ledger Account Balance	Direct Costs	Disallowed Costs	Proposed Company Wide	% of Direct Labor
DIRECT LABOR	\$ 1,950,501	\$ 1,950,501	\$ -	\$ 1,950,501	100.00%
INDIRECT COSTS:					
FRINGE BENEFITS					
6300 Benefits: Bonuses.....	\$ 234,060	\$ -	\$ (28,560) (a)	\$ 205,500	10.54%
6310 Benefits: 401(k).....	97,525	-	-	97,525	5.00%
6320 Benefits: PTO (vac., sick, and holiday).....	253,565	-	-	253,565	13.00%
6820 Insurance: Disability.....	58,515	-	-	58,515	3.00%
6830 Insurance: Life.....	21,846	-	(800) (b)	21,046	1.08%
6840 Insurance: Medical.....	136,535	-	-	136,535	7.00%
6850 Insurance: Workers' Comp.....	15,799	-	-	15,799	0.81%
7500 Payroll Taxes: FICA and Med.....	180,421	-	-	180,421	9.25%
7510 Payroll Taxes: FUTA and SUTA.....	78,020	-	-	78,020	4.00%
TOTAL FRINGE BENEFITS	\$ 1,076,286	\$ -	\$ (29,360)	\$ 1,046,926	53.67%
GENERAL OVERHEAD					
6700 Indirect Labor.....	\$ 741,190	\$ -	\$ (3,300) (c)	\$ 737,890	37.83%
5010 Direct: Lodging, Meals, and Travel.....	122,101	(122,101)	- (d)	-	0.00%
5020 Direct: Employee Mileage Reimbursements.....	159,941	(159,941)	- (d)	-	0.00%
5030 Direct: Rentals and Supplies.....	21,651	(21,651)	- (d)	-	0.00%
5040 Direct: Subconsultants.....	44,862	(44,862)	- (d)	-	0.00%
6000 Advertising and Marketing.....	23,991	-	(6,750) (e)	17,241	0.88%
6100 Automobile Expense.....	68,268	-	(13,580) (f)	54,688	2.80%
6200 Bank Service Charges.....	9,753	-	-	9,753	0.50%
6400 Contributions and Gifts.....	14,629	-	(14,629) (g)	-	0.00%
6500 Depreciation Expense.....	117,030	-	-	117,030	6.00%
6600 Dues and Subscriptions.....	16,189	-	(350) (h)	15,839	0.81%
6800 Insurance: Automotive.....	15,409	-	-	15,409	0.79%
6810 Insurance: Business Liability.....	23,406	-	-	23,406	1.20%
6900 Interest Expense.....	36,084	-	(36,084) (i)	-	0.00%
7000 Licenses and Permits.....	21,456	-	-	21,456	1.10%
7100 Maintenance and Repairs.....	97,135	-	-	97,135	4.98%
7200 Meals & Entertainment.....	19,310	-	(1,050) (j)	18,260	0.94%
7300 Misc. Fees, Fines, Penalties.....	6,827	-	(6,827) (k)	-	0.00%
7400 Office Expense: Cleaning.....	8,192	-	-	8,192	0.42%
7410 Office Expense: Postage and Delivery.....	4,486	-	-	4,486	0.23%
7420 Office Expense: Office Supplies.....	32,183	-	-	32,183	1.65%
7430 Office Expense: Other Office Expense.....	35,889	-	-	35,889	1.84%
7600 Personal Property Tax.....	42,911	-	-	42,911	2.20%
7700 Prof Fees: Accounting and Legal.....	30,428	-	-	30,428	1.56%
7800 Rent.....	180,049	-	(2,400) (l)	177,649	9.11%
7900 Telephone.....	60,466	-	-	60,466	3.10%
8000 Utilities.....	29,472	-	-	29,472	1.51%
Credit for Internal Allocations.....	-	-	(107,278) (m)	(107,278)	-5.50%
TOTAL GENERAL OVERHEAD	\$ 1,983,306	\$ (348,555)	\$ (192,247)	\$ 1,442,505	73.96%
TOTAL INDIRECT COSTS & OVERHEAD RATE	\$ 3,059,593	\$ (348,555)	\$ (221,607)	\$ 2,489,431	127.63%

FAR Reference and Notes:

- (a) 31.205-6(a)(6)(ii)(B): Owners' compensation in excess of reasonable amount is disallowed (distribution of profits).
- (b) 31.205-19(a)(2)(v): Officers' life insurance is disallowed.
- (c) 31.201-6(e)(2): Marketing, lobbying, and any labor associated with unallowable activities is disallowed.
- (d) 31.202: Excluded direct project costs (both billable & non-billable costs) from indirect cost pool.
- (e) 31.205-1: Costs for general marketing materials are disallowed.
- (f) 31.205-6(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
- (g) 31.205-8 & 31.205-13(b): Contributions and gifts are disallowed.
- (h) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
- (i) 31.205-20: Interest is disallowed.
- (j) 31.205-14 & 31.205-51: Costs for entertainment and alcoholic beverages are disallowed. (The entertainment cost principle supersedes all others.)
- (k) 31.201-4, 31.205-15, & 31.205-20: Disallowed late fees; Government-imposed fines and penalties; and credit card interest.
- (l) 31.205-36(b)(3): Related-party rent (not an arm's-length transaction) is limited to actual cost of ownership, net of interest and other unallowable items.
- (m) 31.202: Direct costs segregated and removed from indirect cost pool.

CHAPTER 5/COST ACCOUNTING

TABLE 5-6: SAMPLE INDIRECT COST RATE SCHEDULE (WITH FIELD RATE)

SAMPLE CONSULTING COMPANY, Inc.
Statement of Direct Labor, Fringe Benefits, and General Overhead (with Field Rate)
For the Year Ended December 31, 201x

Account Number & Description	General Ledger Account Balance	Direct Costs	Disallowed Costs	Proposed Company Wide	ALLOCATIONS			Percent to Field Office
					Proposed Home Office	Proposed Field Office		
DIRECT LABOR	\$ 1,950,501	\$ 1,950,501	\$ -	\$ 1,950,501	\$ 1,826,853	\$ 123,648	(n)	6.34%
INDIRECT COSTS:								
FRINGE BENEFITS								
6300 Benefits: Bonuses.....	\$ 234,060	\$ -	\$ (28,560) (a)	\$ 205,500	\$ 193,000	\$ 12,500	(n)	
6310 Benefits: 401(k).....	97,525	-	-	97,525	91,255	6,270	(n)	
6320 Benefits: PTO (vac., sick, and holiday).....	253,565	-	-	253,565	241,421	12,144	(n)	
6820 Insurance: Disability.....	58,515	-	-	58,515	54,806	3,709		6.34%
6830 Insurance: Life.....	21,846	-	(800) (b)	21,046	19,711	1,334		6.34%
6840 Insurance: Medical.....	136,535	-	-	136,535	127,880	8,655		6.34%
6850 Insurance: Workers' Comp.....	15,799	-	-	15,799	14,798	1,002		6.34%
7500 Payroll Taxes: FICA and Med.....	180,421	-	-	180,421	168,984	11,437		6.34%
7510 Payroll Taxes: FUTA and SUTA.....	78,020	-	-	78,020	73,074	4,946		6.34%
TOTAL FRINGE BENEFITS	\$ 1,076,286	\$ -	\$ (29,360)	\$ 1,046,926	\$ 984,928	\$ 61,998		
GENERAL OVERHEAD								
6700 Indirect Labor (G&A and support allocation).....	\$ 741,190	\$ -	\$ (3,300) (c)	\$ 737,890	\$ 680,506	\$ 38,736	(o)	5.25%
6700 Indirect Labor (field labor allocation).....	-	-	-	-	-	18,648	(n)	
5010 Direct: Lodging, Meals, and Travel.....	122,101	(122,101)	-	-	-	-		5.25%
5020 Direct: Employee Mileage Reimbursements.....	159,941	(159,941)	-	-	-	-		5.25%
5030 Direct: Rentals and Supplies.....	21,651	(21,651)	-	-	-	-		5.25%
5040 Direct: Subconsultants.....	44,862	(44,862)	-	-	-	-		5.25%
6000 Advertising and Marketing.....	23,991	-	(6,750) (e)	17,241	16,336	905		5.25%
6100 Automobile Expense.....	68,268	-	(13,580) (f)	54,688	51,817	2,871		5.25%
6200 Bank Service Charges.....	9,753	-	-	9,753	9,241	512		5.25%
6400 Contributions and Gifts.....	14,629	-	(14,629) (g)	-	-	-		5.25%
6500 Depreciation Expense.....	117,030	-	-	117,030	117,030	-	(p)	
6600 Dues and Subscriptions.....	16,189	-	(350) (h)	15,839	15,008	831		5.25%
6800 Insurance: Automobile.....	15,409	-	-	15,409	14,600	809		5.25%
6810 Insurance: Business Liability.....	23,406	-	-	23,406	22,177	1,229		5.25%
6900 Interest Expense.....	36,084	-	(36,084) (i)	-	-	-		5.25%
7000 Licenses and Permits.....	21,456	-	-	21,456	20,329	1,126		5.25%
7100 Maintenance and Repairs.....	97,135	-	-	97,135	92,036	5,099		5.25%
7200 Meals & Entertainment.....	19,310	-	(1,050) (j)	18,260	17,301	959		5.25%
7300 Misc. Fees, Fines, Penalties.....	6,827	-	(6,827) (k)	-	-	-		5.25%
7400 Office Expense: Cleaning.....	8,192	-	-	8,192	8,192	-	(p)	
7410 Office Expense: Postage and Delivery.....	4,486	-	-	4,486	4,486	-	(p)	
7420 Office Expense: Office Supplies.....	32,183	-	-	32,183	32,183	-	(p)	
7430 Office Expense: Other Office Expense.....	35,889	-	-	35,889	35,889	-	(p)	
7600 Personal Property Tax.....	42,911	-	-	42,911	42,911	-	(p)	
7700 Prof Fees: Accounting and Legal.....	30,428	-	-	30,428	28,830	1,597		5.25%
7800 Rent.....	180,049	-	(2,400) (l)	177,649	177,649	-	(p)	
7900 Telephone.....	60,466	-	-	60,466	57,291	3,174		5.25%
8000 Utilities.....	29,472	-	-	29,472	29,472	-	(p)	
Credit for Internal Allocations.....	-	-	(107,278) (m)	(107,278)	(107,278)	-	(p)	
TOTAL GENERAL OVERHEAD	\$ 1,983,306	\$ (348,555)	\$ (192,247)	\$ 1,442,505	\$ 1,366,008	\$ 76,497		
TOTAL INDIRECT COSTS	\$ 3,059,593	\$ (348,555)	\$ (221,607)	\$ 2,489,431	\$ 2,350,936	\$ 138,495		
OVERHEAD RATES (as percentages of direct labor cost).....				127.63% Company Wide	128.69% Home Office	112.01% Field Office		

FAR References and Notes:

- (a) 31.205-6(a)(6)(ii)(B): Owners' compensation in excess of reasonable amount is disallowed (distribution of profits).
- (b) 31.205-19(e)(2)(v): Officers' life insurance is disallowed.
- (c) 31.201-6(e)(2): Marketing, lobbying, and any labor associated with unallowable activities is disallowed.
- (d) 31.202: Excluded direct project costs (both billable & non-billable costs) from indirect cost pool.
- (e) 31.205-1: Costs for general marketing materials are disallowed.
- (f) 31.205-6(m)(2) & 31.205-46(d): Personal use of a company asset (automobile) is disallowed.
- (g) 31.205-8 & 31.205-13(b): Contributions and gifts are disallowed.
- (h) 31.205-22: Lobbying costs, paid as a percentage of professional dues, are disallowed.
- (i) 31.205-20: Interest is disallowed.
- (j) 31.205-14 & 31.205-51: Costs for entertainment and alcoholic beverages are disallowed. (The entertainment cost principle supersedes all others.)
- (k) 31.201-4, 31.205-15, & 31.205-20: Disallowed late fees; Government-imposed fines and penalties; and credit card interest.
- (l) 31.205-36(b)(3): Related-party rent (not an arm's-length transaction) is limited to actual cost of ownership, net of interest and other unallowable items.
- (m) 31.202: Direct costs segregated and removed from indirect cost pool.
- (n) Field employee labor and fringe specifically identified.
- (o) Indirect general administrative and support labor less identified field portion is allocated.
- (p) Accounts specifically identified as home office only.



Labor Costs Interpretive Guidance

*Labor Costs: Timekeeping, Direct Labor Base,
Labor Transfers & Direct to Indirect Labor Ratio*

External Audits – Architectural and Engineering (A&E) Contracts

November 6, 2015

Labor Costs Interpretive Guidance

This Document will address **labor costs**. Architectural and Engineering (A/E) consulting firms', both Prime consultants and Subconsultants (consultants) accounting records for labor costs must be accurate and supported. Labor is typically the most significant cost on the Indirect Cost Rate (ICR) schedule. Further, Direct Labor is the allocation base for calculating the ICR. This Document will focus on four specific areas relating to labor:

- I. Timekeeping
- II. Direct Labor Base
- III. Labor Transfers
- IV. Indirect to Direct Labor Ratio

I. Timekeeping

Requirements for Timesheets

All employees of an A/E firm must keep timesheets and are required to record *all* labor hours worked. This includes Executives, Principals, Owners, and Senior Managers. These requirements apply to very small firms, as well – even firms with only one person. Firms should have clear, established guidance that emphasizes that employees are responsible for accurately recording all labor hours, and management is responsible for ensuring the established guidance is followed by all employees. This guidance should include the firm's best practices and should be shared with all employees of the firm.

Internal Controls

All consultants should have labor charging and accounting system internal controls in place that are evident and well defined. Internal controls should be regularly maintained, updated as necessary, and should verify effectiveness.¹

Internal controls should be designed to provide reasonable assurance for accurate and proper labor accounting and charging objectives:

- Effective and efficient operations,
- Reliable reporting for internal and external use, and
- Compliance with applicable laws and regulations.

Labor Charging System

Reliability and accuracy of a firm's labor charging system is essential. Whether a firm has an automated or manual timekeeping system, there must be procedures, controls, and an audit trail

¹ Reference AASHTO Audit Guide (2012), Chapter 5.4, Section F.4, Page 35 and Table 6-1, Labor Charging Checklist, p. 54

Labor Costs Interpretive Guidance

of documentation to support the labor costs. The AASHTO Uniform Audit & Accounting Guide for Transportation Consultants 2012 Edition (AASHTO Audit Guide) and the Defense Contract Audit Agency (DCAA) Pamphlet No. 7641-90 are resources that should be incorporated into the labor charging system.²

The following is a list of some elements that must be provided for in the labor charging system:

- Employees have sole access for entering own time.
- Employee signature and Supervisor approval of labor hours (verifiable whether your timekeeping is electronic or manual).
- Labor hour changes initialed, dated, authorized, and documented (described below in “Labor Transfers”).
- Timekeeping is performed in accordance with company policies and procedures.
- A labor distribution system must document direct and indirect labor hours and dollars by employee, by project name or job code.
- Regular and timely reconciliation of labor costs per the overhead schedule reconciled to total labor costs per payroll tax returns (941s), the general ledger/financial statement, and the labor distribution system/summary, to be completed every thirty days at a minimum.

Bid & Proposal, Direct Selling, and Public Relations Labor

Employees must identify and segregate labor hours on their timesheets associated with Bid & Proposal, Direct Selling, and/or Public Relations activities. Each of these should be shown as a separate line item on the ICR schedule. Timesheet coding and training should be provided to all employees regarding segregation and allowability of the labor associated with these activities, as identified in Part 31 of the Federal Acquisition Regulations (FAR).³

Source Documents

Timesheets are source documents and are used to support labor hours worked, in part, on California Department of Transportation (CA DOT) agreements. CA DOT standard agreement language states that the all consultants must keep cost records and accounts for three (3) years after receipt of final payment.⁴ These records include timesheets.

For example – A subconsultant provided services in 2008 and they billed their final invoice for those services in July 2008. The agreement with the prime did not close and final payment was

² Reference AASHTO Audit Guide (2012), Chapter 6.4, Page 48

³ Reference AASHTO Audit Guide (2012), Chapter 8, Pages 69-84

⁴ Reference 48 CFR 4.703 (a) (1)

Labor Costs Interpretive Guidance

not made to the prime, however, until October 2014. In this example, the subconsultant must keep all documentation to support billed costs, including labor, until October 2017.⁵

II. Direct Labor Base

Direct labor charges reported on timesheets are generally accumulated into Labor Distribution Reports (LDR) and the ICR schedule. The direct labor amount on the ICR schedule must be supported by a consultant's LDR and internal accounting system. Reconciliation of the labor costs should be performed between the LDR, ICR schedule and Year-End Payroll report. These amounts should also tie to the general ledger labor accounts and the financial statements. If applicable, upon review or audit, CA DOT Audits & Investigations may request a copy of the reconciliation to be provided as an aid in the review of a consultant's labor cost.

Direct Labor costs must be computed for salary personnel based on the standard 2,080 hour work year. Direct labor hours includes all labor hours worked (whether billable to the client or not), including hours both paid and unpaid. For further information regarding uncompensated overtime, please refer to the CA DOT **Uncompensated Overtime Interpretive Guidance**.

III. Labor Transfers

The term **labor transfers** refers to the movement of labor hours/dollars from one charge number to another charge number. These transfers typically take place after timesheets have been posted for the period, but prior to invoicing.

It is best practice for a consultant to have a written **Labor Transfer Policy** that details the established policies and procedures for labor transfers. This Labor Transfer Policy will detail the internal controls and support documentation we should expect to see from the consultant regarding labor transfers, and that we will need to be able to verify the consultant's labor.

As noted in Section I of this document, we emphasized that CA DOT's standard agreements and the AASHTO Audit Guide require that all labor must be documented and supported. This includes any labor transfers.

It is expected that consultants will have some transfer of labor hours/costs. In our experience, the most common type of labor transfers are due to employee error, such as hours miscoded to an incorrect project number or a transposition error. Labor transfers can also occur when multiple hours over a pay period need to be adjusted, and possibly for multiple employees. These can occur, for instance, due to project numbers closing out and being replaced with new project

⁵ Reference AASHTO Audit Guide (2012), Chapter 9.5, Section B, Pages 87-88

Labor Costs Interpretive Guidance

numbers. When these transfers occur, consultants should thoroughly document the transfer, the related purpose/reason, and the employee should initial and date the changes made to his/her timesheet. Labor that is billed on monthly invoices should be what was reported on the employee's timesheets, with very few exceptions for transferred labor.

The need for a labor transfer is usually found in the review of the preliminary labor report (pre-billing report) that details an employee's total labor hours for each project. This report is typically prepared after labor cutoff but before client invoicing. While labor transfers are expected, they should not be pervasive. A large amount of labor transfers can signify labor system weaknesses and be cause for concern for internal control measures.

For example, monthly meetings conducted by managers or owners to move labor hours between charge codes are considered unacceptable. This practice would appear to be tampering with employee time charges and considered a management override of time charging internal controls.

Labor transfers should be completed as documented in a **Labor Transfer Policy**. The **Labor Transfer Policy** is often a part of a firm's timekeeping policy and should include:

- Date of original hours worked, per the timesheet, original charge code, and original hours charged.
- Date of labor transfer, hours transferred, and the charge code(s) to which the labor is being transferred.
- Detailed purpose/reason of transfer (enough detail should be included to provide an audit trail and enable auditors to determine allowability ⁶).
- The labor transfer request (this should also include the name of applicable employee, applicable agreement, and/or task order or work element, etc.)
- Dollar value of the original hours and the dollar value of hours transferred. These should be the same rate dollar value – we often see labor recorded at one rate, but then transferred at a different rate.
- Supervisor's documented approval of the transfer.
- Employee's signature, or equivalent documentation, supporting that the employee who incurred the labor was notified of the transfer. Note, if this is done by an email, the consultant should retain a copy of the email with the employee's concurrence of the labor transfer.

An official labor transfer form should be developed to document the elements of the labor transfer. **Two examples of transfer forms are attached.** Supporting documentation is the key to all labor transfers. The most common allowability challenge that we find regarding labor

⁶ One-word purposes on transfer forms, such as "error", "transfer" or "other", are not acceptable without details.

Labor Costs Interpretive Guidance

transfers is lack of sufficient documentation. Reminder, per the AASHTO Audit Guide, labor must be supported and this includes labor transfers.⁷

Following is a typical list of unallowable transfers; however this list is not inclusive⁸:

- Labor worked over budget on one project transferred to an alternate project or task order.
- Labor worked on a closed task order transferred to an alternate task order.
- Labor worked for an employee not authorized on the project, transferred to an alternate project where that employee is authorized.
- Labor hours held over and billed in another monthly cycle – to another project.

For further guidance on determining allowability and reasonableness, please refer to the AASHTO Audit Guide, Chapter 8, Pages 69-84.

IV. Indirect to Direct Labor Ratio

State DOT's consider a high indirect to direct labor ratio as a risk indicator.⁹ We customarily perform an analysis of the indirect to direct labor ratio as part of our audit and review processes. We will continue to do this analysis to check for significant increases or decreases in direct labor with correlating increases or decreases in indirect labor. Further, we may verify that the indirect to direct labor ratio is in-line with accepted industry standards and/or make further inquiries of the consultant, perform additional analytical procedures, and/or may conduct intensive labor testing.

The decrease in direct labor and the correlating increase in indirect labor may cause concern related to a firm's efficiency and the extent to which government should reimburse indirect labor costs through the ICR. It also causes concerns regarding staffing levels and, specifically, the maximum utilization of employees to minimize excess or idle staff. When we note that a consultant that has had a decrease in the direct labor pool, with an increase in the indirect labor pool, we will provide our analysis with the consultant and discuss the issue for better understanding.

During times of business slowdowns, consultants attempt to keep experienced staff on board until the conditions improve, and they have sufficient work for all staff. Some of the areas that we will explore with the consultant are:

⁷ Sufficient documentation for transfers also applies to Other Direct Costs, such as travel, hotel, mileage, etc. Our expectation is that these types of transfers will be documented in the same manner as a labor transfer.

⁸ Reference AASHTO Audit Guide (2012) Chapter 5.4, Section F.1, Page 32-33 and Chapter 6.4, Section B.2 (a) and (b), Page 49-50

⁹ Reference AASHTO Audit Guide (2012) Chapter 5.4, Section F.5, Page 36

Labor Costs Interpretive Guidance

- Has anything been done to decrease the indirect labor?
- Have staff been down-sized or re-assigned to another office?
- What are staff, who were previously charging their time directly to projects, working on now?

If we determine that the indirect labor to direct labor cost ratio is above industry standard for a significant period (i.e. greater than one year), with no justification, a consultant may be asked to make the adjustment to their indirect labor cost to ensure it is in line with industry standards.¹⁰

Further, a potential additional cost of the underutilization of employees, is idle facilities due to labor fluctuations in a firm.¹¹ This could require more adjustments.

¹⁰ Reference AASHTO Audit Guide (2012) Chapter 6.3, Page 45

¹¹ Reference AASHTO Audit Guide (2012) Chapter 8.12, Page 75; 48 CFR 31.205-17 (b)

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Uncompensated Overtime Interpretive Guidance

External Audits – Architectural and Engineering (A&E) Contracts
November 6, 2015

Uncompensated Overtime Interpretive Guidance

This Document will address **Uncompensated Overtime**, which is an issue that affects many Architectural and Engineering (A&E) consultants. The California Department of Transportation (Caltrans) pays for labor and overhead costs based on what was accepted at the time a contract is executed. The true effect of this is that the indirect cost rate(s) and the fully loaded labor rates may be overstated on our specified rate (fixed rate) contracts. The fully loaded labor rates cannot be adjusted due to the nature of our fixed-rate contract, combined with the fact that the consultant is unable to submit weekly invoices with labor costs adjusted to the effective labor rates for that week. We continue to work with consultants to help them account for costs correctly and make appropriate adjustments in accordance with Part 31 of the Federal Acquisition Regulations (FAR). To ensure compliance, we discuss uncompensated overtime with CPA firms that perform audits of the consultant's indirect cost schedules.

Definition of Uncompensated Overtime

Per FAR 52.237-10, "*uncompensated overtime* means the hours worked without additional compensation in excess of an average of 40 hours per week by direct charge employees who are exempt [salaried] from the Fair Labor Standards Act. Compensated personal absences such as holidays, vacations, and sick leave must be included in the normal work week for purposes of computing uncompensated overtime hours."

Consultants contracting with Caltrans under A&E agreements must have procedures covering the consistent recording and accounting for hours worked, whether paid or unpaid, to ensure the correct distribution of labor costs. This is necessary because labor rates and labor overhead costs can be affected by total hours worked, not just paid hours worked.¹

Accounting for Uncompensated Overtime

The AASHTO Uniform Audit & Accounting Guide for Transportation Consultants, 2012 Edition (AASHTO Audit Guide) gives an example of the

Salary Variance Method (Standard Rate or Effective Rate) for calculating uncompensated overtime based on 2080 hours per year. Under the **Salary Variance (Standard Rate Method)**, the consultant calculates a standard hourly labor rate based on the employee's salary divided by 2,080 hours (for full-time employees) and records every hour worked at that standard cost rate. The cost recorded in excess of the salary paid represents uncompensated overtime, and is recorded in a salary variance account which is credited to indirect labor cost in the indirect cost rate calculation. For example, an employee with a salary of \$80,000 per year works 10% uncompensated overtime hours and a portion of his/her

¹ Reference AASHTO Uniform Audit & Accounting Guide for Transportation Consultants, 2012 Edition (AASHTO Audit Guide), Chapter 5.4, Section F.2; DCAA Audit Manual 5-910 and 6-410

Uncompensated Overtime Interpretive Guidance

time is spent working on projects. The company would record costs of \$88,000 to a combination of direct and indirect labor, and would record a salary variance of (\$8,000) to indirect labor.

Under the **Effective Rate (Effective Rate Method)**, consultants record labor costs at an effective hourly labor rate that is calculated by dividing the employee's salary for the week, pay period, or month by the actual hours worked in the period. For example, an employee who is paid a salary of \$52,000 per year (\$1,000 per week) would have a standard hourly rate of \$25 (\$1,000 / 40 hours). If the employee worked 50 hours in a given week, their effective hourly rate for that week would be \$20 (\$1,000 / 50 hours). The firm would record all hours for the employee for that week at \$20 per hour, with the result that the total labor cost recorded would be equal to the labor cost paid. No salary variance is recorded under the **Effective Rate Method**.

The **Effective Rate Method** does not apply to Caltrans A&E Cost Reimbursable Agreements. Instead, the **Standard Rate Method** must be used for determining labor costs associated with agreements between the consultant and Caltrans. This requires A&E firms to prepare cost proposals and invoices based on the standard hourly rate for each employee (salary/ 2080 hours for full-time staff). As noted above, an employee with a salary of \$52,000 should be included in cost proposals and invoices on Caltrans contracts at a standard hourly rate of \$25. For firms using the **Effective Rate Method**, the result is that the standard hourly rate billed may exceed the effective rate used to account for the labor costs, when there is uncompensated overtime. In the example above, the effective rate was \$20, which was less than the standard rate by \$5 per hour. Since Caltrans contracting method does not allow for billing of labor costs at effective hourly rates, another method must be used to adjust for the potential overbilling that may result from the excess of standard labor rates billed over the effective hourly labor rates used for internal costing.

If your firm accounts for labor at "effective rates" using the **Effective Rate Method**, the labor costs will need to be converted to an annual basis using 2,080 hours, and an adjustment will need to be made to the indirect cost schedule to convert to "standard rates" as described below in "Adjustments for Uncompensated Overtime".² These adjustments will ensure that each labor account, as well as the uncompensated overtime, is recorded at standard labor rates. Some labor systems have the capability to run a report to show the effective labor rate to standard labor rate conversion. If your system does not have this capability, the attached worksheet (*EXAMPLE A: Salary Variance Method - Effective Rate Worksheet*) can be used for this purpose. The adjustment increases direct labor (and possibly indirect labor) for the uncompensated overtime, and calculates the offsetting salary variance to be credited to indirect labor.

² Reference AASHTO Audit Guide (2012), Chapter 5.4, Section F.2, Table 5-2

Uncompensated Overtime Interpretive Guidance

If your firm accounts for labor at “standard rates,” adjustments for uncompensated overtime should be made using the **Standard Rate Method** as described in the AASHTO Audit Guide.³ Normally this should be done on a monthly basis. If you have a policy under which all employees are paid for all hours worked, there is no uncompensated overtime and therefore, no adjustments necessary.

If the Consultant Does Not Record Employee Hours Worked Over 2,080 per Year

If your firm is not currently recording hours worked over 2,080 per year for each employee, the attached worksheet can be used to compute the *estimated* value of uncompensated overtime (**EXAMPLE B: Salary Variance Method - Effective Rate Worksheet Estimate**). We will allow a one year estimate, but we expect consultants to implement procedures in subsequent fiscal years to account for all hours worked, and to record uncompensated overtime appropriately.

Key Points for Uncompensated Overtime Adjustments

- If your firm accounts for labor at “effective rates,” then the Direct and Indirect Labor must be converted to “standard rates” for agreements for services contracted with Caltrans under/for A&E services. **The labor rates included on cost proposals must be based on “standard rates.”**
- All hours worked must be recorded on timesheets for all employees (both direct & indirect hours).
- Compute hourly rates for employees based on the standard 2,080 hours per year.
- Make the appropriate adjustments to Direct and Indirect Labor costs for uncompensated overtime associated with exempt employees and their respective hours worked, but not paid. **The ICR(s) included on cost proposals must already be adjusted for uncompensated overtime.**
- Your uncompensated overtime calculation will not include those employees who have worked less than 2,080 hours per year.

Consultants will be notified of the above requirements as necessary and information related to uncompensated overtime will be available online at: <http://www.dot.ca.gov/hq/audits/> and <http://caltrans-opac.ca.gov/>

WORKSHEET: Procedures for Handling Uncompensated Overtime and Posting of Payroll

The following is an example of the calculation of the payroll variance/uncompensated overtime for the general ledger payroll journal entry (\$48,776/year; \$4,064.67/month; \$23.45/hour):

³ Reference AASHTO Audit Guide (2012), Chapter 5.4, Section F.2, Table 5-1

Uncompensated Overtime Interpretive Guidance

Employee A's Timesheets for July			
Projects	Timesheet Hours	Raw Hourly Cost	Monthly Salary
Direct – Project ABC	82 hours	\$1,922.90	
Direct – Project XYZ	80 hours	1,876.00	
Indirect Labor – Administration	10 hours	234.50	
Indirect Labor – Holiday	8 hours	187.60	
Total	180 hours	\$4,221.00	\$4,064.67

Payroll Journal Entry for General Ledger		
Checking Account Withdrawal/Monthly Salary	(\$4,064.67)	
Direct Labor	3,798.90	82 hours + 80 hours
Indirect Labor – Administration	234.50	10 hours
Indirect Labor – Holiday	187.60	8 hours
Payroll Variance/Uncompensated Overtime	(156.34)	

Salaried employees are required to work the minimum number of hours each semi-monthly pay period. All hours worked must be posted on timesheets whether billable or not. Exempt employees do not receive overtime pay for extra hours worked.

All hours contained on timesheets are posted to the project cost management system at the employee's standard rate (annual salary divided by 2,080 annual hours). At the end of each month, a payroll journal entry is computed by taking ALL direct labor hours posted on timesheets and multiplying that by the standard rate – that is the Direct Labor posting for the general ledger. For example, \$3,789.90 [= (82 hours + 80 hours) * \$23.45] is posted to the general ledger for direct labor. Then the indirect labor hours posted on timesheets (administration, proposals, business development, vacation, sick leave and holiday) are multiplied by standard rate– that is the Indirect Labor posting for the general ledger. For example, \$422.10 [= (10 hours + 8 hours) * \$23.45] is posted to the general ledger for the indirect labor.

For Indirect Cost Rate calculation purposes, Direct Labor is not adjusted down and remains unaffected by the negative figure contained in the Payroll Variance/Uncompensated Overtime account.

Uncompensated Overtime Interpretive Guidance

Employee	Standard Salary	Standard Rate	Hours Worked	Direct	Direct Hours	Direct %	Indirect	Indirect Hours	Indirect %	Standard Overtime	Standard Overtime Hours	Standard Overtime Rate	Standard Overtime Amount
John Doe	\$110,000	\$52.88	2,456	2,078	109,884.64	85.00%	146	145	7,667.60	29	1,533.52	58	3,067.04

EXAMPLE A: Salary Variance Method - Effective Rate Worksheet

Overhead Adjustments:

A. Debit to Direct Labor	\$16,900	(1)*(2)*(3)
B. Debit to Indirect Labor	\$ 2,982	(1)*1-(2)*(3)
C. Credit to Indirect – Payroll Variance/Uncompensated Overtime	(\$19,882)	A + B

The consultant records all hours worked on timesheets. Labor costs are recorded using the **Effective Rate Method**. The consultant computes effective hourly rates weekly, based on actual time charges. If the consultant records labor at effective hourly rates, then for consistency with Caltrans contracting methods, an adjustment must be made at year end (**and prior to submitting cost proposals to Caltrans**) to convert to the standard rates. Adjustments are calculated for each employee with uncompensated overtime, as follows:

- (A) The standard rate multiplied by the percentage of direct labor hours multiplied by the hours in excess of 2,080 is the debit adjustment to Direct Labor.
- (B) The standard rate multiplied by the percentage of indirect labor hours (1-percentage of direct labor hours) multiplied by the hours in excess of 2,080 is the debit adjustment to Indirect Labor.
- (C) The total uncompensated overtime for both direct and indirect labor is the credit to the indirect cost pool by way of a payroll variance.

EXAMPLE B: Salary Variance Method - Effective Rate Worksheet for Estimate

Uncompensated Overtime Interpretive Guidance

The consultant did not record hours worked over 2,080 in the year (uncompensated overtime) for Executives/Principals/Owners/Senior Managers and non-management salaried employees. This worksheet is a tool that may be completed to determine the overhead adjustment and requires the consultant to estimate the amount of hours in excess of 2,080 that were worked **for all employees with uncompensated overtime.**

Exempt Employee	Salary	Standard Hrs Rate (based on 2,080) (1)	Total Hrs Worked (per Inhouse)	Direct Hrs	% Direct (2)	Indirect Hrs	Vac Hrs	Sick Hrs	Holiday Hrs	Est Hrs Worked (3)	Uncomp OT
John Doe	\$110,000	\$52.88	2,080	1,610	77.00%	238	145	29	58	80	\$4,230.40

Overhead Adjustments:

A. Debit to Direct Labor	\$3,257	(1)*(2)*(3)
B. Debit to Indirect Labor	\$ 973	(1)*1-(2)*(3)
C. Credit to Indirect – Payroll Variance/Uncompensated Overtime (\$4,230)		A + B

Uncompensated overtime requires the following adjustments:

- (A) The debit to Direct Labor adjusts the direct labor base for hours worked by the employee but not paid to the employee, including uncompensated overtime hours billed to the client and paid to the consultant, and uncompensated non-billable direct hours which must also be accounted for in the direct labor base.
- (B) The debit to Indirect Labor adjusts the indirect labor for indirect hours worked by the employee, but not paid to the employee.
- (C) The credit adjustment to Indirect Payroll Variance/Uncompensated Overtime balances the payroll so that it is not overstated after the first two adjustments.

EXAMPLE B: Salary Variance Method - Effective Rate Worksheet for Estimate (Continued)

Uncompensated Overtime Interpretive Guidance

The A&E consultant must estimate the amount of direct (and indirect labor hours, if appropriate) that were worked by each employee with uncompensated overtime. Since labor hours vary between consultants, the estimate must be specific to that A&E consultant and management should provide support for the basis used to estimate the direct (and indirect, if appropriate) labor hours. An estimate/percentage of Direct Labor was used in this instance. In the optimal situation, the hours would be tracked individually on timesheets. See *Worksheet: Procedures for Handling Uncompensated Overtime and Posting of Payroll*, and Section 5.4.F.2 of the AASHTO Audit Guide for more information.

Title – Uncompensated Overtime

EXAMPLE A: Effective Rate Worksheet

Employee	Standard Rate (2,080 Hrs) \$20.80 (1)	Actual Hours Worked (2,080 Hrs) (1)	Direct Hrs	Direct Dollars	% Direct (2)	Indirect Hrs	Vaca Hrs	Vaca Dollars	Sick Hrs	Sick Dollars	Holiday Hrs	Holiday Dollars	Hrs > 2,080 (3)	Uncomp OT	
John Doe	\$110,000	\$52.88	2,456	2,078	109,884.64	85.00%	146	145	7,667.60	29	1,533.52	58	3,067.04	376	\$19,882.88
Jane Day	\$105,500	\$50.72	2,123	1,595	80,898.40	75.00%	328	130	6,593.60	26	1,318.72	44	2,231.68	43	\$2,180.96
Total			4,579	3,673	190,783.04		474	275	14,261.20	55	2,852.24	102	6,639.04	419	\$22,063.84

ICR Adjustments:

Direct Labor \$18,536 (1)*(2)*(3) for each employee
 Indirect Labor \$ 3,527 (1)*1-(2)*(3) for each employee

Payroll Variance/Uncompensated Overtime (\$22,063)

The firm was recording all hours worked on timesheets. However, this firm had recorded their labor at the “effective rate”, not based on the standard 2,080 hours per year. Effective rates are computed weekly, based on actual time charges. If the Consultant records labor at effective hourly rates, then an adjustment must be made at year end to convert to the standard hourly rate. The total number of direct hours (for instance) is multiplied by the difference between standard and effective hourly rates. The difference between the labor totals at the effective rate, and the labor totals shown on the worksheet based on 2,080 hours is our adjustment.

Uncompensated overtime adjustments apply to direct and indirect only. The Paid Time Off (PTO) categories are used only to arrive at total hours worked. The main purpose of the uncompensated overtime worksheet is to correct direct and indirect labor as needed, we typically don't make an adjustment for PTO.

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CHAPTER 8/SELECTED AREAS OF COST

TABLE 8-1: LISTING OF COMMON UNALLOWABLE COSTS

FAR <u>Reference</u>	<u>Unallowable Costs</u>
31.205-1 & 31.205-38(b)(1)	Advertising
31.205-1(f)(2)	Trade Show Expenses
31.205-1(f)(2)	Trade Show Labor
31.205-1(f)(5)	Brochures and Other Promotional Material
31.205-1(d)(2)	Souvenirs/Imprinted Clothing Provided to Public
31.205-1(f)(7)	Membership in Civic and Community Organizations
31.205-3	Bad Debts
31.205-3	Collection Costs
31.205-6(m)(2)	Personal Use of Company Vehicles
31.205-8 & 31.205-1(e)(3)	Contributions or Donations
31.205-13(b)	Employee Gifts and Recreation
31.205-14	Membership in Social, Dining, and Country Clubs
31.205-14	Social Activities
31.205-15(a)	Fines, Penalties, and Mischarging Costs Related to Violation of Laws
31.205-19(e)(2)(v)	Life Insurance on Key Employees
31.205-19	Costs to Correct Defects in Materials and Workmanship
31.205-20	Interest Expense
31.205-22	Lobbying and Political Activity Costs.
31.205-27	Organization/Reorganization Legal Fees
31.205-27	Organization/Reorganization Accounting Fees
31.205-27	Organization/Reorganization Incorporation Fees
31.205-27	Organization/Reorganization Labor
31.205-27	Capital Raising (Equity or Long-Term Debt) Legal Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Accounting Fees
31.205-27	Capital Raising (Equity or Long-Term Debt) Lender Fees
31.205-30(c)	Patent Costs
31.205-33(e)	Retainer Agreements (unless properly supported)
31.205-35	Relocation Costs (in certain circumstances)
31.205-46	Travel Costs in Excess of FTR Rates
31.205-49	Goodwill
31.205-51	Alcoholic Beverages

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