



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

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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

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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)

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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

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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.

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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

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- 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)