Washington State
Department of Transportation

Interpretive Guidance Document

Labor Costs

Timekeeping, Direct Labor Base, Labor Transfers, & Indirect to Direct Labor Ratio

Indirect Cost Rate for Architectural & Engineering Firms

WSDOT Internal Audit Office

December 6, 2016 Update

(Originally published May 29, 2013; the guidance in this document applies to indirect costs incurred after December 5, 2016)

Interpretive Guidance for Labor Costs

This Interpretive Guidance Document will address labor costs. Architecture & Engineering (A&E) consulting firms' accounting records for labor costs must be accurate and supported. Labor is the most significant cost on the Indirect Cost Rate (ICR) schedule. Further, direct labor is the allocation base for calculating the indirect cost rate. This guidance document will focus on four specific areas relating to labor:

1. Timekeeping
2. Direct Labor Base
3. Labor Transfers
4. Indirect to Direct Labor Ratio

I. Timekeeping

Requirements for Timesheets

All employees must keep timesheets and are required to record all hours worked. This includes executives, owners & principals, and senior managers. These requirements apply to very small firms as well; even firms consisting of only one person. Firms should have clear, established guidance that emphasizes that employees are responsible for accurately recording all hours worked. This guidance should include the firm's best practices and should be shared with all employees of the firm.

Internal Controls

The firm should have internal controls in place that are evident and well defined. Internal controls should be regularly maintained and updated as necessary, to ensure effectiveness.

AASHTO Audit Guide Chapter 5, Section 5.4, F. Internal Labor Costs, 4. Other Considerations Regarding Internal Labor Costs, Approvals and Authorizations:
The consultant should have procedures to ensure that labor hours are recorded accurately and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals.

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 of documentation to support the labor costs. The AASHTO Audit Guide Chapter 6 and DCAAP No. 7641-90 discuss timekeeping internal control procedures that can benefit any firm.

The following is a list of some of the elements that the WSDOT Audit Office would expect to see with regards to a firm's labor charging system:

- Employees have sole access for entering their 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; see also section below "*Labor Transfers*".
- Timekeeping is performed in accordance with company policies and procedures.
- Regular and timely reconciliation of labor costs to payroll and job cost system, to be completed at a minimum monthly.
  (The table at the end of Chapter 6 of the 2016 AASHTO Audit Guide, on page 51, is a good tool to use when developing or improving a firm's timekeeping policy and procedures)

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/advertising 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 staff to adequately distinguish between allowable and unallowable selling efforts. For further detailed information regarding segregation and the allowability of the labor associated with these activities, please see our WSDOT Interpretive Guidance - Direct Selling, Public Relations, Advertising and Bid & Proposal document. Also see the AASHTO Guide Sections 6.3, 8.2 (A), (B) and (C), 8.13 and 8.24.

Source Documents

Timesheets are source documents and are used to support labor hours worked, in part, on WSDOT agreements. WSDOT standard agreement language states that the consultant, and the sub-consultants, must keep cost records and accounts for a period of three or six years (contingent on the agreement) after receipt of final payment to the prime consultant. These records include timesheets.

For example - A subconsultant provided services in 2003, and they billed their final invoice for those services in July 2003. However, the agreement with the prime did not close and final payment was not made to the prime until October 2012. In this example, the subcontractor must keep all documentation to support billed costs, including labor, using October 2012 as the starting point for the record retention timeline.

> *AASHTO Audit Guide – Chapter 5, Section 5.4, F. Internal Labor Costs, 1. Direct Labor:*
> Labor costs are usually the most significant costs incurred by design and engineering firms….it is imperative that engineering consultants establish and maintain a proper, accurate system of internal control over the labor-charging function.
>
> *AASHTO Audit Guide – Chapter 9, Section 9.5, B. Labor Tracking:*
> Accurately accounting for labor is paramount to accurate cost based accounting. Detailed records must be maintained, accumulated, and controlled to ensure that both

> the direct labor and indirect labor amounts are accurate. Procedures must be in place to ensure that direct labor charges are distributed to respective contracts. Indirect labor must be captured and assigned to appropriate indirect labor categories…. ensure that the total cost of direct and indirect labor in the general ledger reconcile to the overall labor recorded in the payroll system…

II. Direct Labor Base

The direct labor amount on the ICR Schedule must be supported by the firm's labor distribution report (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, a reconciliation spreadsheet should be provided to the WSDOT Audit Office as an aide in the review of a firm's labor costs.

For firms that use an automated timekeeping system, a summary report, by individual employee, from that system can often fulfill the LDR requirement: The WSDOT Audit Office is looking for a system-generated report that shows the labor hours between direct and the various indirect categories, along with the cost of those hours.

Direct labor costs on the ICR schedule should be computed for salary personnel based on the standard rate of base pay (Annual Salary/2,080 hours[1]). This ensures that there is proper allocation and distribution of labor costs. This computation may require interim rate adjustments in the case of mid-year changes in base salary level. Direct labor hours include all labor hours worked (whether billable to the client or not), including hours both paid and unpaid.

For information regarding uncompensated overtime please refer to the WSDOT Interpretive Guidance - Uncompensated Overtime. The uncompensated overtime guidance also discusses how to convert labor from the effective rate to the standard rate. The WSDOT Audit Office understands some firms may record labor in its general ledger at the effective rate. The WSDOT Audit Office is not asking that firms modify their respective accounting system, merely convert the labor on the ICR schedule to the standard rate to be consistent with the WSDOT consultant agreement payment provisions.

III. Labor Transfers

The term "labor transfers" refer to the movement of labor hours/dollars from one project or task order to another. These transfers typically take place after timesheets have been posted for the period, but prior to invoicing.

<u>Labor Transfer Policy and Procedures</u>

[1] The standard hours may vary depending on company policy and employee work schedules.

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It is a best practice for a firm to have a written labor transfer policy that details the established policies and procedures for labor transfers. The policy will detail the internal controls and support documentation that substantiate the reason for the transfer and that the employee and supervisor concur with the transfer.

It is expected that all firms will have some transfer of labor hours/costs. In our experience the most common type of labor transfer is 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 numbers. When these transfers occur, firms should thoroughly document the transfer, the related purpose/reason, and the employee should initial and date the changes made to his/her timesheet and the supervisor should document his/her approval. Labor that is billed on monthly invoices should be what was reported on the employee's timesheets, with very few exceptions for transferred labor.

In most cases the need for a labor transfer is 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 pervasive amount of labor transfers can signify labor system weaknesses and cause for concern regarding internal control measures.

Monthly meetings where managers or owners move labor hours around are unacceptable. Labor transfers should be completed as documented in a firm's labor transfer policy. The labor transfer written policy is often a part of a firm's timekeeping policy. The policy should include the following attributes:

- Date of original hours worked, per the timesheet, original charge code, and the 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 enough detail for the auditors to be able to determine allowability[2]).
- Copy of email or memo of the request for the labor transfer, this should also include name of applicable employee, applicable agreement and/or task order or work element, etc.

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[2] Examples of an allowable transfer purpose would be: 1) "Email received May 6, 2012, from WSDOT project Manager, John Doe who asked us to move 6 hours worked on Date, from Task A to Task B. See attached email from John Doe with details." 2) "Jack Lake (employee) transposed agreement number – correction to original timesheet. Agreement number is 7901, Jack originally entered 7910." 3) "Firm provided the employee with the incorrect project number. Correction to coding made. See attached documentation."

We often see one word purposes on transfer forms such as "error", "transfer," or "other." The one word purposes are not acceptable without further details or supporting documentation.

- Dollar value of the original hours and the dollar value of hours when the transfer occurs; there should not be a fluctuation in the labor rate from when it was initially recorded to when the labor was transferred. Any variances should not be charged to WSDOT projects.
- Supervisor's signature to document 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 firm should retain a copy of the email with the employee's concurrence of the labor transfer.

For a firm that does not have an automated correction process that shows the audit trail from original to corrected timesheet, we recommend that the firm develop an official labor transfer form to document the elements of the labor transfer. Two examples of transfer forms are embedded at the end of this guidance document. The most common allowability challenge that we find regarding labor transfers is lack of sufficient documentation. Reminder, per the AASHTO Audit Guide, Chapter 6 Labor Charging, labor must be supported, as cited above in Section 1. This includes labor transfers[3].

There are some types of labor transfers that have been determined to be unallowable. The following is a typical list of unallowable transfers; however, this list is not inclusive:

- 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 alternated project where that employee is authorized.
- Labor hours held over and billed in another monthly cycle – to another project.

Sources for Criteria and Guidance

We included the following criteria below to help convey expectations for controls over labor transfers and how transferred costs can be evaluated for allowability.

> *48 CFR 31.201-2 (d) Determining allowability:*
> (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.
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> *48 CFR 31.201-3 (a) Determining reasonableness:*
> (a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. Reasonableness of specific costs must be examined with particular care in connection

[3]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. Supporting documentation is key to allowability of transfers of other direct costs, as well as labor.

with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the burden of proof shall be upon the contractor to establish that such cost is reasonable.

AASHTO Audit Guide – Chapter 5, Section 5.4, F. Internal Labor Costs, 1. Direct Labor:
The engineering consultant should have procedures to ensure that labor hours are accurately recorded and that any corrections to timekeeping records are documented, including appropriate authorizations and approvals.

AASHTO Chapter 6, Section 6.4, B. Labor Charging System Internal Control, 2. Timecard Preparation:
(a) *Automated Timekeeping System*. …Generally, controls should be in place to ensure the following:

- Changes are initialed, authorized, and dated by the employee and supervisor and include a description of the reason for the change. This may be done electronically.
- A verifiable audit trail process is in place that collects all initial entries and subsequent changes.

(b) *Manual Timekeeping System*. …Generally, controls should be in place to ensure:

- Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.

IV. Direct Labor Cost Utilization Ratio

State DOT's consider a low direct labor cost ratio as a potential risk indicator. As part of our annual desk review process, the WSDOT Audit Office performs an analysis of the indirect to direct labor ratio. We do this analysis to check for significant increases or decreases in direct labor with correlating increases or decreases in indirect labor. Further we verify that the indirect to direct ratio is within a normal range (i.e. in-line with industry standards). Please see a sample of the indirect to direct cost analysis embedded at the end of this guidance document.

In accordance with *48 CFR 31.201-3, Determining reasonableness*, State DOT's may challenge the reasonableness of any cost and burden of proof falls on the consultant to establish that such a cost is reasonable.

The drop 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 Schedule. The increase in indirect labor and decrease in direct labor also causes concerns regarding staffing levels and specifically the maximum utilization of employees to minimize excess of idle staff. When we note that a firm's indirect to direct labor ratio has increased we generally have some follow up questions regarding what the firm's plans are to

mitigate inefficiencies. During times of business slowdowns, we know that firms 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 firm are:

- What has your firm done to decrease the indirect labor?
- Have staff been laid off or re-assigned to another office?
- What are staff, who were previously charging their time directly, working on now?

If we determine that the indirect labor to direct labor cost ratio is above industry standard, commonly derived from nationally-published, independent industry surveys, we will speak with the firm about making a voluntary adjustment to its indirect labor cost to bring the ratio to a more reasonable level.

Further, a potential ancillary cost of the underutilization of employees, is idle facilities due to labor fluctuations in a firm[4]. This could require additional adjustments.

> *AASHTO Chapter 5, Section 5.4, F. Internal Labor Costs, 5. Potential Areas of Risk Regarding Internal Labor – Significant Increases in Direct/Indirect Labor Accounts:* Trend analyses may disclose instances where charges to direct or indirect labor accounts have increased significantly, a review should be performed to determine the nature of any significant changes from prior years.

Sample Transfer Form Option

Sample Labor Transfer Form

Direct-Indirect Labor Ratio Example

To open the documents listed above, please double click the document on the left under attachments.

If you have any questions, please contact us at (360)705-7003.

[4] Any reduction in force may result in idle facilities – see 48 CFR 31.205-17 (b) & AASHTO Chapter 8.12.