Interpretive Guidance Document

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

Indirect Cost Rate for A/E Firms

WSDOT Internal Audit Office
May 29, 2013
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:

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, 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 labor hours. 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, and should verify effectiveness.

AASHTO Audit Guide chapter 5.4 – 4. Other Considerations Regarding Internal Labor Costs, Approvals and Authorizations
The engineering 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 are resources and references that should be reviewed and incorporated into a firm’s labor charging system.

The following is a list of some of the 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; 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 every thirty days at a minimum. See AASHTO chapter 6 – Labor Charging.

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 staff for all unallowable labor. For further detailed information regarding segregation and allowability of the labor associated with these activities, please see our WSDOT Interpretive Guidance Direct Selling, Public Relations, Advertising and Bid & Proposal document.

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 subconsultants, must keep cost records and accounts for a period of three (3) years after receipt of final payment, see FARS Subpart 4.703. These records include timesheets.

For example - A subcontractor 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
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this example, the subcontractor must keep all documentation to support billed costs, including labor, until October 2015.

48 CFR 4.703(a)(1) Contractor Records Retention Policy
...contractors shall make available records, which includes books, documents, accounting procedures and practices, and other data...audit requirements of the contracting agencies and the Comptroller General for 3 years after final payment ...

AASHTO Audit Guide – Chapter 5, 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, 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 Indirect Cost Rate (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 cost.

Direct labor costs must be computed for salary personnel based on the standard 2,080 hour work year. This ensures that there is proper allocation and distribution of labor costs. 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 WSDOT Interpretive Guidance Uncompensated Overtime.
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 a best practice for a firm to have a written Labor Transfer Policy that details the established policies and procedures for labor transfers. This Labor Transfer document will detail the internal controls and support documentation that we should expect to see from the firm in regard to labor transfers, and that we will need to be able to verify your firm’s labor.

As noted in Section I of this guidance document, we stressed that WSDOT’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 all firms 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 numbers. When these transfers occurs, firms 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.

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 for internal control measures.

Monthly meetings where managers or owners move labor hours around are unacceptable.
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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\(^1\)).
- 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.
- Dollar value of the original hours and the dollar value of hours the 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 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.

The firm should develop an official labor transfer form 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 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 I. This includes labor transfers.\(^2\)

\(^1\) 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.

\(^2\)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.

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There are some types of labor transfers that have been determined to be unallowable. 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.

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.

48 CFR 31.201-3 (a) Determining reasonableness.
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 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.
(Emphasis added.)

AASHTO Audit Guide – Chapter 5, 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.
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- 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. Indirect to Direct Labor Ratio

State DOT’s consider a high indirect/direct cost ratio as a risk indicator. As part of our annual desk review process, the WSDOT Internal Audit Office performs an analysis of the direct to indirect 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 the attached example of our direct to indirect ratio comparison analysis worksheet.

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 Indirect Cost Rate. 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 that has had a decrease in the direct labor pool, with an increase in the indirect labor pool, we will provide the firm with our analysis, and have a follow up discussion with the firm. 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?
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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) the firm will be asked to make the necessary adjustment to their indirect labor cost to ensure it is in-line with industry benchmarks.

Further, a potential ancillary cost of the underutilization of employees, is Idle Facilities due to Labor Fluctuations in a firm.3 This could require additional adjustments.

_AASHTO Chapter 5, section 5.4F. 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....Sufficient review should be performed to determine the nature of any significant increase or variance from prior years.

_AASHTO Chapter 6, section 6.3 Allowability & Reasonableness of Indirect Labor_
To assess the reasonableness of the labor cost pools in accordance with FAR 31.201-3, State DOT’s may apply productivity or efficiency measurements. These measurements are compared to industry standards or State DOT’s expectations to assess the reasonableness of the submitted labor costs. Productivity and/or other efficiency measures may be used by a State DOT to assess the reasonableness of a consultant’s labor distribution. If indirect labor appears to be unreasonably high, then the State DOT may make further inquiries of the consultant, may perform additional analytical procedures, and/or may conduct intensive labor testing. Conversely, consultants must consistently monitor the recording of direct and indirect labor cost to ensure accuracy and must monitor staffing levels to ensure the maximum utilization of employees to minimize excess or idle capacity. Productivity or efficiency measurements consistently below industry standards should warrant discussions between the consultant and the State DOT’s.

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

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Preparer acknowledges that he/she has received approval from the "Transfer To" Project Manager (PM). All transfer forms must be supported by PM’s authorized instructions to transfer.

Prepared by: __________________________ Employee: __________________________
Preparer Signature: ______________________ Employee #: ______________________
Request Date: __________________________ Supervisor: ______________________
"Transfer To" PM: ______________________ Location: ______________________

<table>
<thead>
<tr>
<th>Project/Task Number</th>
<th>Original timesheet date/dates</th>
<th>Transfer Type Code</th>
<th>Error Code</th>
<th>Regular Hours</th>
<th>Overtime Hours</th>
<th>Transfer Total Value</th>
<th>Detailed Explanation</th>
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Attach any applicable supporting documentation to support transfer - may include timesheet, emails, etc.

Employee signature ______________________ Date ______________________
Supervisor signature ____________________ Date ______________________
"Transfer To" PM signature __________________ Date ______________________

**Transfer Type Codes**
A. Client to Overhead
B. Overhead to Client
C. Client to Different Client
D. Client to Same Client Different Task
E. Overhead to Overhead

**Error Codes**
1. Person assigned work provided wrong project/task number.
2. Digit transposition entry error.
3. Other - if not error code 1 or 2 a detailed explanation is required.
Attach any applicable supporting documentation to support transfer - may include timesheet, emails, etc.

### Labor Transfer Form

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<th>Request from:</th>
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<td>Employee Number:</td>
<td>Request date:</td>
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<td>Supervisor:</td>
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<th>Date Hrs. Worked:</th>
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Transfer purpose and details:
*(to include reason for transfer and/or explanation for original error)*

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Employee signature: ___________________________ Date: _________________

Supervisor approval signature: ___________________________ Date: _________________

“To” Project Manager approval signature: ___________________________ Date: _________________