

6

Chapter 6—Labor-Charging Systems and Other Considerations

The purpose of this chapter is to provide interpretive guidance only. This chapter is not intended to be authoritative or to supersede the FAR. The entire text of the FAR should be consulted when determining proper accounting treatment.

6.1—Background

Compensation for personal services is one of the largest components of cost incurred under Government contracts. It includes all remuneration paid currently or accrued, in whatever form, for services rendered by an engineering consultant's employees during contract performance.

The objective of a compensation system is to provide the level of pay and benefits necessary to attract, retain, and motivate employees to direct their efforts toward achieving the goals of the organization. To be considered adequate, an engineering consultant's compensation system must be reliable, be subject to applicable management control objectives and activities, and must result in allocable, allowable, and reasonable compensation costs to be charged to Government contracts in accordance with FAR provisions.

6.2—Labor Costs, Generally

As discussed previously in Chapter 5, labor costs typically are the most significant costs allocated to Government contracts and usually comprise the base used for allocating indirect costs. Historical labor costs frequently are used to estimate labor for follow-on or similar item Government contracts.

Unlike other cost items, labor is not supported by third party documentation such as an invoice, purchase order, or receipt. Instead, consultants' employees have complete control over the documents or devices of original entry, whether consisting of timecards, electronic media, or some other means.

Responsibility for labor reporting is diffused throughout the engineering consultant's organization. Consequently, there are significant risks associated with the accurate recording, distribution, and payment of labor costs.

6.3—Allowability and Reasonableness of Indirect Labor

[Reference: FAR 31.201-3]

Labor cost may take one of two paths—either as a direct charge to a project, or as an indirect charge to overhead. When consultants use an overhead rate to recover indirect costs, Government contracts will participate in these costs. To assess the reasonableness of the labor cost pools in accordance with FAR 31.201-3, State DOTs may apply productivity or efficiency measurements. These measurements are compared to industry standards or State DOTs' 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). However, this type of ratio/measurement should not be used as the sole measure of reasonableness.

Note: Two areas of indirect labor costs, Bid and Proposal costs and Selling costs, provide consistent areas of concern to State DOTs and audit agencies. The allowability of these costs is discussed specifically below.

A. Bid and Proposal Costs (B&P)

[References: FAR 31.205-18, CAS 420.30(a)(2), CAS 420]

1. Definition

FAR 31.205-18(a) and CAS 420.30(a)(2) provide that Bid and Proposal (B&P) costs are the—
 [E]xpenses incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-government contracts, provided that the effort is neither sponsored by a grant, nor required in the performance of a contract.

FAR 31.205-18(b) further provides that all contracts, regardless of whether full CAS coverage applies, are subject to the cost identification and accumulation provisions of CAS 420.

2. Identification and Accumulation of B&P

As further discussed in CAS 420, consultants must identify and accumulate B&P costs by individual projects. CAS 420 also requires that costs for B&P projects be accounted for in the same manner as contracts and include costs that would be treated as direct costs of that contract, if incurred in like circumstances, and all allocable indirect costs, with the exception of general and administrative expenses. For example, if a consultant charges clerical and technical support costs directly to final cost objectives, then it must also charge them directly to B&P projects. If, however, the consultant charges these costs to indirect cost pools, such costs incurred in support of B&P efforts also should be allocated to indirect cost pools.

3. Efforts Sponsored by Grant or Required by Contract

In accordance with the B&P definition at FAR 31.205-18(a), any efforts that are “sponsored by a grant or required in the performance of a contract” are not B&P. Accordingly, consultants must not include costs in the B&P cost pools for developmental efforts that are specifically required in the performance of a contract, or those efforts that are not explicitly stated in the contract but are necessary to perform the contract.

- Consultants must consistently require senior managers and executives to accurately track and record their time associated with B&P activities as required by CAS 420. ***This issue is of particular concern, as many executives and managers do not track B&P activities separately from other overhead functions.***
- The consultant should establish clear guidance regarding the specific activities that comprise B&P activities and should ensure that all staff members are adequately trained. The consultant should regularly monitor the time coded by senior managers and executives to B&P activities to determine the accuracy of efforts expended. Labor costs associated with B&P activities should be clearly identified and must be segregated from other indirect labor activities.

B. Selling Effort and Activities

This section contains general guidance in determining the allocability, allowability, and reasonableness of selling costs under Government contracts, as discussed in FAR 31.205-38.

1. Direct Selling

[Reference: FAR 31.205-38(b)(5)]

Direct selling is characterized by person-to-person contact and includes such efforts as familiarizing a potential customer with the consultant's products or services, conditions of sale, service capabilities, and similar items. It also includes negotiation, liaison between customer and consultant personnel, technical and consulting efforts, individual demonstrations, and any other efforts having as their purpose the application or adaptation of the consultant's products or services for a particular customer's use. Generally, the costs of direct selling efforts are allowable.

2. Brokerage Fees, Commissions, and Similar Costs

[Reference: FAR 31.205-38(c)]

Notwithstanding any other provision of FAR 31.205-38, sellers' or agents' compensation, fees, commissions, percentages, retainer or brokerage fees, whether or not contingent upon the award of contracts, are allowable only when paid to bona fide employees or established commercial or selling agencies maintained by the consultant for the purpose of securing business.

3. Other Cost Principles Related to Selling Efforts

[References: FAR 31.205-1, FAR 31.205-12, FAR 31.205-14, FAR 31.205-18, FAR 31.205-27, FAR 31.205-38, CAM Section 7-1200, CAM Section 7-1500]

The nature of costs classified and allocated as selling expense should be compatible with the provisions of FAR 31.205-38. Although the generic term "selling" encompasses all effort to market a consultant's products, the acceptability of the costs of this effort is governed by several subsections of FAR 31.205. Costs that fall into the following categories should be classified accordingly. These costs should be evaluated using the appropriate subsection of FAR 31.205 as discussed below:

- **Advertising Costs (FAR 31.205-1 & -38).** Also see DCAA Contract Audit Manual Section 7-1200. In most instances, allowable advertising is limited to help-wanted advertisements.
- **Corporate Image Enhancement and Public Relations Costs (FAR 31.205-1 & -38).** Also see DCAA Contract Audit Manual Section 7-1200.

Allowable public relations costs include the following examples: costs specifically required by contract, costs of communicating with the public, costs for participating in community service activities, and costs of plant tours and open houses (excluding any entertainment costs associated with these efforts).

Unallowable public relations costs include costs for disseminating messages calling favorable attention to the firm's products or services; most costs for trade shows; and costs of sponsoring meetings, conventions, seminars, and other events when the principal purpose of the event is other than the dissemination of technical information or the stimulation of production.
- **Bid and Proposal/Independent Research and Development Costs (FAR 31.205-18).** Also see DCAA Contract Audit Manual Section 7-1500. These costs generally are allowable, subject to the limitations provided in FAR 31.205-18.
- **Entertainment Costs (FAR 31.205-14).** Entertainment costs are expressly unallowable, regardless of the purpose or intent of the entertainment. Costs made specifically unallowable under FAR 31.205-14 are not allowable under any other cost principle.
- **Long-Range Market Planning Costs (FAR 31.205-12).** Costs associated with general long-range management planning are allowable; however, organizational or reorganizational costs are unallowable (see FAR 31.205-27 for more details).

4. Recordkeeping Requirements

[References: FAR 31.201-2(d)]

Pursuant with FAR 31.201-2(d), consultants must maintain adequate records to demonstrate that claimed costs have been incurred and are allocable to the FAHP contracts. Accordingly, consultants must require all employees, including senior managers and executives, to maintain a contemporaneous record of all time devoted to selling activities. To accomplish this, the consultant must establish clear guidance regarding the specific activities that comprise selling activities and must ensure that all staff members are adequately trained.

Note: *The consultant must regularly monitor the time recorded by all employees, including senior managers and executives, to determine the accuracy of efforts expended. Labor costs associated with selling activities must be easily identified and must be segregated from other indirect labor activities.*

6.4—DCAA Accounting Guide

[References: FAR 31.002, DCAAP No. 7641.90]

The Defense Contract Audit Agency (DCAA) issued Pamphlet No. 7641.90 (DCAAP 7641.90), *Information for Contractors*.¹⁴ The DCAAP provides useful guidance but does not have the effect of law. The DCAAP is referenced at FAR 31.002 and provides extensive guidance regarding labor-charging systems. Specifically, sections 2-301 through 2-302.2 provide guidance regarding the—

- Accounting system,
- Labor charging system,
- Timecard preparation methods, and
- Timekeeping policy.

Note: *Pertinent sections of DCAAP No. 7641.90 have been extracted and paraphrased below for emphasis and further discussion.*

A. Accounting System Internal Control

When performing work in connection with Government contracts, it is essential for engineering consultants to maintain an operable accounting system under general ledger control. A properly designed system includes the following attributes:

- Proper segregation of direct costs and indirect costs.
- Identification and accumulation of direct costs by cost objective/contract.
- A logical and consistent method for allocating indirect costs to intermediate and final cost objectives.
- Accumulation of costs under general ledger control.
- A timekeeping system that identifies employees' labor by intermediate and final cost objectives.
- A labor distribution system that charges direct and indirect labor to the appropriate cost objectives.
- Interim (at least monthly) determination of costs charged to a contract through routine posting to books of account.
- Exclusion from costs charged to Government contracts of amounts that are not allowable pursuant to FAR Part 31 or other contract provisions.
- Identification of costs by appropriate units, if required by the contract.

¹⁴ Dated January 2005. The DCAAP is available via the Internet at <http://www.dcaa.mil/chap6.pdf>.

B. Labor Charging System Internal Control

1. Generally

The key link in any sound labor time charging system is the individual employee. It is critical to labor charging internal control systems that management indoctrinates employees on their independent responsibilities for accurately recording time charges. This is the single most important feature management can emphasize in recognizing its responsibility to owners, creditors, and customers to guard against fraud and waste in the labor charging function.

To be effective, the internal controls over labor charging should meet the following criteria:

- The engineering consultant should have adequate segregation of duties for labor-related activities; for example, the responsibility for timekeeping and payroll accounting should be separated.
- Supervisors who are accountable for meeting contract budgets should not 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.)
- The engineering consultant's procedures and controls must be evident, well defined, and reasonable so there is no confusion concerning the reason for the controls and no misunderstanding as to what is and what is not permissible.
- The engineering consultant must continuously maintain the controls and verify their effectiveness. Controls must be updated to correct any deficiencies, and violations must be remedied through prompt and effective action to serve as a deterrent to prospective violations.
- Individual employees must be constantly, although unobtrusively, made aware of controls that act as an effective deterrent against violations. Many businesses accomplish this by emphasizing the importance of timecard preparation in staff meetings, employee orientation, and through the posting of signs throughout the workplace to remind employees of the importance of accurate and current timecards.
- The engineering consultant should have a system of feedback to provide employees with opportunities to report to management any suspected mischarging or violations of the consultant's system of internal controls, with anonymity guaranteed.

2. Timecard Preparation

The engineering consultant should provide detailed instructions for timecard preparation in a timekeeping pamphlet and/or company procedure. Specific issues associated with automated and manual timecard systems are provided below:

(a) Automated Timekeeping System. When an automated timekeeping system is in place, procedures should provide for the accurate and current recording of labor hours by authorized employees, as well as appropriate controls to ensure corrections to labor charges are accurate and authorized. Generally, controls should be in place to ensure the following:

- Only the employee uses his or her labor charging instrument to access the labor system.
- 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.
- When an engineering consultant uses an employee badge system, badge issuance must be sufficiently controlled so that no badge number is duplicated and badges are not issued to unauthorized persons. Additionally, procedures must be in place to require employees to report lost badges promptly.

(b) Manual Timekeeping System. When a manual system is in place, procedures should provide for the accurate and complete recording of labor hours, as well as appropriate controls to ensure corrections to labor records are accurate and authorized. Generally, controls should be in place to ensure—

- Supervisory observation of employee arrival and departure to prevent improper clock-in/clock-out.
- Employee possession of timecard/timesheet.
- The employee prepares his or her timecard/timesheet in ink, as work is performed.
- Only one timecard/timesheet is prepared per employee per period; timecards/timesheets are preprinted with employee name and identification number; and timecards/timesheets are submitted to the designated timekeeping office or are collected by an authorized person.
- Pre-coded data is printed on job cards for identification purposes (e.g., codes for various leave types or indirect labor).
- Direct labor employees record their time no less often than daily. Sufficient formal subsidiary records must be maintained, if necessary, to ensure accuracy in labor recording and the proper allocation of labor costs to intermediate and final cost objectives when multiple jobs are worked in a day.
- Corrections are made in ink, initialed by the employee, properly authorized, and provide a sufficient and relevant explanation for the correction.
- 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.
- 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.”
- Employees and supervisors sign the timecards/timesheets in accordance with procedures, verifying the accuracy of the recorded effort.
- The job cost system is reconciled to the general ledger on a regular and consistent basis. This reconciliation should occur no less frequently than once every 30 days.

Note: A labor-charging checklist is attached at the end of this chapter to assist engineering consultants and accounting professionals in the assessment of the engineering consultant's labor-charging system. (See Table 6-1.)

3. Timekeeping Policy

The engineering consultant should implement a written policy that requires the following:

- Supervisors must approve and cosign all timecards.
- The supervisor is 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 time sheet. Upon his or her return, the employee should turn in his/her time sheet and attach it to the one prepared by the supervisor.
- The guidance should state that the nature of the work determines the proper distribution of time, not availability of funding, type of contract, or other factors. Accordingly, direct labor hours must be assigned to the cost objective/project that caused the hours to be incurred, regardless of whether the hours are billable to clients. Non-billable labor hours may not be allocated, or later reassigned, to other projects or to overhead.
- Procedures must be established to verify that the total labor hours reflected in labor distribution summaries agree with the total labor charges as entered into the timekeeping and payroll systems. This reconciliation attests that the labor charges to contracts represent actual paid or accrued costs and such costs are appropriately recorded in the accounting records. Each employee's time charge should be distributed as recorded, regardless of whether all the labor is billable to clients.

- The company policy should state that the accurate and complete preparation of timecards is a part of each employee's job. The policy also should state that careless or improper preparation of timecards may lead to disciplinary actions under company policies and/or applicable State and Federal statutes.

6.5—Compliance and Review

Auditors are encouraged to apply the requirements of DCAAP 7641.90 to their examinations of engineering consultants' labor-charging systems, as State DOTs may challenge any FAR audit or attestation engagement that does not adequately address the reliability and accuracy of a consultant's labor-charging system. In the absence of any deficiencies noted in such examinations, State DOTs generally will accept audit opinions that are developed in compliance with DCAAP criteria. This includes attestations or audits performed by independent CPAs or Government auditors, such as the DCAA.

TABLE 6-1. LABOR-CHARGING CHECKLIST

| Model Characteristics of Labor-Charging Systems: | | Yes | No | N/A | Note |
|--|--|------------|-----------|------------|-------------|
| <ul style="list-style-type: none"> Is there segregation of responsibilities for labor-related activities? For example, the responsibility for timekeeping and payroll accounting should be separated. | | | | | |
| <ul style="list-style-type: none"> 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.) | | | | | |
| <ul style="list-style-type: none"> 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. | | | | | |
| <ul style="list-style-type: none"> Were detailed instructions for timecard preparation established through a timekeeping pamphlet and/or company procedure? | | | | | |
| <ul style="list-style-type: none"> 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. | | | | | |
| <ul style="list-style-type: none"> Do supervisors approve and cosign all timecards? | | | | | |
| <ul style="list-style-type: none"> 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? | | | | | |
| <ul style="list-style-type: none"> 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? | | | | | |
| <ul style="list-style-type: none"> 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?) | | | | | |
| <ul style="list-style-type: none"> Does the consultant's policy state that the accurate and complete preparation of timecards is a part of each employee's job? | | | | | |
| <ul style="list-style-type: none"> 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: | | | | | |
| <ul style="list-style-type: none"> Does the consultant's accounting system provide for proper segregation of direct and indirect costs? | | | | | |
| <ul style="list-style-type: none"> Does the accounting system provide for identification and accumulation of direct costs by cost object (contract)? | | | | | |
| <ul style="list-style-type: none"> 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). | | | | | |
| <ul style="list-style-type: none"> Does the accounting system articulate with a timekeeping system that identifies employees' labor by intermediate or final cost objectives? | | | | | |
| <ul style="list-style-type: none"> 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)? | | | | | |
| <ul style="list-style-type: none"> 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? | | | | | |
| <ul style="list-style-type: none"> 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. | | | | | |