



# *Uncompensated Overtime Interpretive Guidance*

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**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. <sup>1</sup>

### 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

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<sup>1</sup> 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".<sup>2</sup> 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.

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<sup>2</sup> 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.<sup>3</sup> 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):

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

**Uncompensated Overtime Interpretive Guidance**

<b>Employee A's Timesheets for July</b>			
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	
<b>Total</b>	<b>180 hours</b>	<b>\$4,221.00</b>	<b>\$4,064.67</b>

<b>Payroll Journal Entry for General Ledger</b>		
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

Exempt Employee	Salary	Standard Hrly Rate (based on 2,080) (1)	Total Hrs Worked (per t/sheets)	Direct Hrs	Direct Dollars	% Direct (2)	Indirect Hrs	Vac Hrs	Vac 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

### 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	<u>\$ 2,982</u>	(1)*1-(2)*(3)
C. Credit to Indirect – Payroll Variance/Uncompensated Overtime (\$19,882)		<b>A + B</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.

## Uncompensated Overtime Interpretive Guidance

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

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 Hrly Rate (based on 2,080) (1)	Total Hrs Worked (per t/sheets)	Direct Hrs	% Direct (2)	Indirect Hrs	Vac Hrs	Sick Hrs	Holiday Hrs	Est Hrs Worked > 2,080 (3)	Uncomp OT
<b>John Doe</b>	\$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	<u>\$ 973</u>	(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.

## Uncompensated Overtime Interpretive Guidance

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

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.**