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Auditing Payroll Burden Costs

We have been asked repeatedly to write a definitive article on how to audit the costs of payroll burden. While the subject may seem simple, because of the complexity of the various parts and pieces, it is far from simple to describe how to calculate. Nevertheless, here is an attempt, but there is much that is not covered in this writing. Also, keep in mind that each company does not have only one payroll burden rate. Most construction companies have both salaried and hourly employees and each group has its own very distinct payroll burden cost profiles. Also within groups, the cost profile can change dramatically, such as between regular pay and overtime pay. So any company trying to sell you one burden rate for all three types of cost is typically doing so for a reason, and it is not for your benefit.

First, is a definition of the subject matter, payroll burden. Payroll burden is a commonly used term, but other terms that are also used to connote the same thing are labor burden, payroll fringe costs, PT&I, PTIB, and labor fringe cost. These all typically consist of three distinct types of costs, payroll taxes, payroll related insurance, and employee benefits. These costs are all mentioned in Article 7.2.4 of the AIA A102 contract. Over the next three newsletters we will take each of the three elements and attempt to explain each.

Payroll Taxes – Payroll taxes are almost universally made up of three taxes; FICA, Federal Unemployment (which often is called either FUI or FUTA), and State Unemployment (SUI or SUTA).

FICA consists of both Social Security Tax and Medicare. SS is currently calculated at 6.2% of the first $110,100 (2012) in each employee’s wages earned each year, and 0% for earnings in excess. Medicare is calculated at 1.45% on all wages.

State Unemployment tax also is subject to a maximum per year, yet the maximum varies by state. The rate (%) that applies to those wages also varies by State and often by company. Maximums range from $7000 for California to $38,800, in Hawaii. The rates also vary from as little as 1% to as much as 10%.

Federal Unemployment is largely the same for all companies and all states (except if the State has borrowed from the Federal government and has not paid the money back, in which case the amount can increase slightly). The current rate is .6% of the first $7000 each employee earns in a given year.

Given the above, it should be obvious, that a company that fails to reflect the earnings maximums can greatly overstate the payroll burden related to payroll tax. An easy method of determining if the Contractor is attempting to apply an average cost is to look at their percentage used for FUI. If it is stated at .6% then you can be fairly confident that they are not calculating an average payroll tax rate. Assuming this event, a shorthand attempt at developing an average is to assume a weighted average wage per year for the GC. For an hourly payroll burden calculation it could be based on what a typical hourly employee makes per hour (say a carpenter) and some assumption of how many hours that typical worker works for the company in a year. Since not all employees work a full 2080 hours, a more realistic guess is around 1600. Then applying the hourly rate times 1600, tells you what that person may earn per year. Next, divide the FUI maximum of 0.6% x $7000 ($42) by the employees' average payroll cost per year (1600 x hrly rate) and arrive at a more valid percentage for FUI (vs. the full 0.6% as proposed by the contractor).

The same calculation should be performed for both FICA and SUTA. Most hourly employee calculations will not modify the FICA rate, given the max is $110,100, but will change the SUTA rate. However, when the same logic is applied to a salaried payroll tax rate, some FICA difference may be noted.

Depending on the state and the contractor, we have seen differences of 7% and 8%, between the assumption that all employees are fired at $7000 (the logic associated with the contractor not limiting the charges to the maximums $7,000) and our use of a company average.

Ignoring the Obvious

As auditors, we are often asked to review the pricing of Change Orders. Most of the time, we are asked to do this after the Change order is already signed. Even though many contracts seem to obligate the CM to adhere to the contract terms, and not allow subcontractor markups in excess of some stated amount, these CM's seem to often ignore obvious overstatements of cost. As Owners, you may already be aware of some of the most common tools, readily available to you and the CM, to spot check sub pricing.

Many of the projects we work on are OCIP or CCIP projects (Owner Controlled Insurance Programs or Contractor Controlled). We also work on many projects that have some requirement for a minimum prevailing wage. One common element of these types of projects is that the subcontractors are required to submit certified wage schedules to the CM or the Owner. Our experience is that these reports, which list the true hourly base labor costs, are never used by the CM in evaluating the reasonableness of subs labor pricing. On one recent project, the subs actual base labor was $21 per hour but their CO's had $30 per hour. This $30 per hour "estimate" was used on pricing of $800,000 worth of CO's.

Another obvious tool in evaluating sub material pricing is on line prices at the large warehouse type tool and supply stores. You can readily check prices for EMT, plywood, wire, PVC, etc. On a recent project, the CM allowed ¾" EMT pricing from their electrical sub that was double what that sub could have bought EMT for at Home Depot. The check took about 3 minutes. Further checks on common material items showed the same markup. This sub was given almost $1,000,000 in CO's.

Charging for the Insurance Deductible

How many of you have experienced an issue on a project where a relatively small claim against the CM's general liability insurance should have taken place? If so, did the CM inform you that the claim was too small to involve the insurance company, due to the CM's deductible?

We have seen this scenario numerous times on GL, Auto, and even Workers Comp. claim situations. At issue, is whether the amount charged by the CM for these types of insurances, include a factor for the deductible risk. Our experience is that almost 100% of CM's/GC's include some value for the small claims that are paid out of pocket, rather than covered by insurance. These estimated deductible claims sometimes make up 30% of the total estimated insurance cost. If your CM can charge the actual deductible claim to you directly, they have made money, of course at your expense.