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Auditing Payroll Burden Costs

We wrote last time that we have been asked repeatedly to write a definitive article on how to audit the costs of payroll burden. This is the second of three discussions on that subject. 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. Below is a discussion of second of these elements.

Payroll Insurance – Payroll insurance will almost always include workers compensation (but this may be incorrect if you have a CCIP or OCIP project) and may include GL insurance as well, since some GC's and the majority of subcontractors pay for their underlying GL insurance as a function of base labor. Payroll insurance cost is determined by an insurance policy. Therefore, to determine the true cost, one must see the policy, and specifically, the rate pages from the policy. These two types of insurance, W/C and GL are discussed below.

Workers Compensation Insurance – All construction companies are required to have W/C insurance. These insurance policies are typically unique to each construction company as to the rates and modifiers, but they usually have some common elements. Each W/C policy has different policy rates for different classifications of workers. These W/C classifications have their own W/C codes. A typical policy will have Carpentry (example; comp code 5403), Executive Supervisors (comp code 5606), and clerical (comp code 8810). The rate page from the policy almost always shows the expected payroll dollars, the policy rate by comp code, and the extended expected premium, before modification. The sum of all of these expected premiums for each classification is then modified by several different factors, including an experience modifier. An experience modifier is assigned to each company each year based on that company's past actual claim experience. Companies that have good safety records pay less than the policy rate (think of the policy rate as list price) and those with bad safety records pay more than the policy rates. Additionally, many insurance companies offer other policy discounts and credits. It is not uncommon to see a construction company pay only 50% of the policy rates. So the rates by classification can vary widely. A concrete rate can be 15% or more before credits, while a executive supervisor rate can be 1.5%, a difference of ten times. This is one example of why one burden rate does not fit all persons. It is also useful to know that in the vast majority of states these effective rates do not apply to overtime premium pay, only base pay. So a worker who gets paid $10 an hour and works 50 hours, actually earns $10 X 50, plus $5 X 10, or a total of $550, but the construction company

pays W/C on only base pay of $500 ($10 X 50 hours).

General Liability – Many construction companies pay for GL insurance on total revenues, however those companies that pay GL as a function of labor (like many subcontractors), would typically include GL in their calculation of payroll burden. GL insurance policies would show the rates per thousand dollars of earnings not per hundred as in W/C policies. Also the rates are broken down between BI and PD (Bodily Injury and Property Damage). So one must add the two policy rates together (by classification yet the GL classifications are different codes than W/C) and divide by 1000 to get the rate percentage. Again as with W/C these rates do not apply to the premium portion of OT.

How Do I Know If An OCIP Is Right For Me?

As you may know, OCIP is the acronym used to stand for Owner Controlled Insurance Program. Typically, an OCIP will include onsite W/C coverage, GL insurance and Excess Liability insurance, however some OCIP's will cover GL and Excess only. We have some clients that were contemplating these programs recently and have discovered that sometimes the costs and benefits had not been explained completely by their brokers. We thought that we would add to that conversation.

You probably are aware that the cost of the OCIP must be measured against the avoided cost. The cost of an OCIP is the insurance paid, the expected/actual claims paid and the brokers fees and commissions, at minimum. The avoided cost is the amount of money you will not have to pay to the Construction Manager/General Contractor and their subcontractors, since you are providing that insurance instead. The difference between the two is how most Owners measure if the OCIP saved them money. The concept is straightforward but the details and calculations can be tricky. Many Owners solicit advice on this expected value of avoided cost from their insurance brokers. Yes, the same persons trying to sell them the OCIP program. Is it any wonder that this advice is sometimes very inaccurate? We sat in on a meeting a couple of months age where a national broker told the Owner that the avoided cost of a W/C and GL/Excess OCIP could be between 20% and 30% of the entire construction cost. We tried to ask them if they had misspoken but they insisted that the figure was accurate. Obviously if an Owner were to believe numbers like this, then is it any wonder that they would consider buying an OCIP that might cost them only 2.25% of construction cost?

We have been involved in hundreds of OCIP projects over the last 20 years. On many of these projects, a true accounting of the avoided cost was not performed, however on the many projects where an accounting of the avoided cost was performed; the usual avoided cost is 2% to 2.75%. With this benchmark as a point of reference, you can roughly compare the highest, lowest and expected cost of an OCIP.

You may wonder how a true accounting of the avoided cost was accomplished. Tracking avoided cost is usually performed by the Owners insurance broker by asking the enrolled contractors and subcontractors to provide insurance cost documentation, through copies of policy rate pages (just as we discussed in the first article), and also site payroll data, through certified payroll reports. These two elements, along with the contract amounts, allow the broker to calculate the cost that the contractors would have incurred if they had been required to pay for the insurance themselves. Sometimes Owners will write into the contracts that the final calculation of the avoided cost will be deducted from the contractor's lump sum contracts. In these cases, those Owners know exactly what the avoided costs are and then can compare that credit amount with the actual cost of paying the insurance, claims, and broker's fees, to see if the effort saved money.

You can require your insurance broker to perform an estimate of the expected avoided cost in much the same manner, using estimated values for actual values. This would require them to analyze the expected on site labor cost, spread this labor into the expected W/C codes and values, and estimate the credit cost for GL and Excess Liability. If your broker is knowledgeable, they should have all of the data to perform such an analysis, even if they are reluctant to do so. If you do ask for this analysis, be prepared to review the details critically. We have seen brokers intentionally overstate W/C rates, experience modifiers, and GL and Excess Liability cost, just to make the estimated expected credits greater.

It was a wise person that first said "**buyers beware**".

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