

SELECTED AREAS OF COST

Chapter 59 - Purchased Labor: Personnel Procured from Outside Sources

Authoritative Sources

[48 CFR 9904.418](#) (CAS 418) Allocation of Direct and Indirect Costs

Introduction

Some contractors have adopted the practice of obtaining engineers, technical writers, technicians, craftsmen, and other personnel by subcontract (commonly called "Purchased Labor") rather than by direct hire. Such practice, if for any reason other than to meet temporary or emergency requirements, should be carefully studied to determine whether any additional costs resulting there from are reasonable, necessary, and properly allocable to Government contracts.

59-1 Audit Considerations

Contractors' accounting treatment of purchased labor varies depending on the circumstances under which purchased labor costs are incurred. For example, some contractors classify purchased labor as direct labor costs when the work is performed in the contractor's facilities and under their supervision and otherwise meets the FAR definition of direct costs. These contractors cost such effort using the average labor rate incurred by their own employees for comparable work. Differences between the amounts derived and purchased labor prices are treated as overhead costs and are allocated accordingly. Other contractors classify purchased labor as subcontract costs. The accounting treatment used should be evaluated on a case-by-case basis as discussed in 59-2.

Purchased labor most likely causes no fringe benefits and other employee-related costs to be incurred by the contractor. Such costs are generally paid by the entity providing personnel performing the effort.

A fundamental requirement of CAS 418 is that pooled costs shall be allocated to cost objectives in a reasonable proportion to the causal or beneficial relationship of the pooled costs to cost objectives. Purchased labor must share in an allocation of indirect expenses where there is a causal or beneficial relationship, and the allocation method must be consistent with the contractor's disclosed accounting practices. In accordance with CAS 418, a separate allocation base for purchased labor may be necessary to allocate significant overhead costs to purchased labor such as supervision and occupancy costs, or to eliminate other costs not benefiting purchased labor such as fringe benefits costs.

Where the effort of purchased labor is performed in-house using the contractor's supervision and facilities, overhead exclusive of fringe benefits and other employee related costs, if material in amount, should be allocated to purchased labor. Conversely, where the effort of purchased labor is performed offsite under the supervision and control of an entity other than the contractor, none of the contractor's labor overhead costs may be allocable to purchased labor.

59-2 Audit Procedures

The accounting treatment for purchased labor must be evaluated on a case-by-case basis with consideration given to the materiality of costs involved and the overall effect of the accounting treatment on final cost objectives. Acceptance or rejection of the contractor's treatment of purchased labor must be based upon:

(1) the causal and beneficial relationship of indirect expenses and purchased labor, and

(2) the nature of the employer/consultant relationship using the Internal Revenue Services' arms-length tests. In making this assessment, the auditor should:

a. Review the contractor's policy, with emphasis on the criteria used in determining whether personnel should be obtained from outside sources instead of by direct hire.

b. Analyze the purchased labor during the current or most recently completed fiscal year, whichever provides sufficient information, to:

- i. Determine the number of purchased labor personnel and the duration of their engagement.
- ii. Compare the number of employees on the contractor's payroll (in each classification of purchased labor involved) with the number of equivalent personnel obtained from outside sources.
- iii. Compare the cost per staff-year with the contractor's comparable personnel.
- iv. Evaluate the contractor's reasons for resorting to the practice. This is particularly important where the engagement extends beyond one year.
- v. Determine whether the contractor's practices are equitable with respect to the utilization of purchased labor on Government contracts as compared to commercial work, and on fixed-price contracts as compared to cost-type contracts; and whether the accounting treatments of the costs of such personnel and contractor personnel performing the same kind of work, including allocation of related overhead expenses, are equitable.

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c. Coordinate with Government production specialists, project engineers, purchase methods analysts, and others on matters such as the effectiveness of performance, staffing requirements, equivalent job classifications, and the award and pricing of the agreements.

d. Examine prior years' records to determine if the practice shows an increasing or decreasing trend.