

# An Update on Executive and Employee Compensation for Government Contractors

COHN  REZNICK

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ACCOUNTING • TAX • ADVISORY

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# Objectives

- FAR Part 31 Requirements for Allowable Employee Compensation
- Reporting Requirements for Executive Compensation and First-Tier Subcontract Awards
- Methods the DCAA and Other Civilian Audit Agencies Use to Determine the Reasonableness of Employee Compensation
- Strict Requirements Placed on Compensation for Owners
- Best Practices



# **FAR Part 31 Requirements for Allowable Employee Compensation**

# What's Included in FAR 31.205-6

- (a) General
- (b) Reasonableness
- (d) Form of Payment
- (e) Income Tax Differential Pay
- **(f) Bonuses and Incentive Compensation**
- (g) Severance Pay
- (h) Backpay
- **(i) Compensation Related to Changes in Prices of Corporate Securities/Ownership**
- **(j) Pension**
- **(k) Deferred Compensation Other Than Pensions**
- (l) Compensation Incidental to Business Acquisitions
- (m) Fringe Benefits
- (n) Employee Rebate and Purchase Discount Plans
- (o) Postretirement Benefits Other Than Pensions
- **(p) Limitation on Allowability of Compensation**
- (q) ESOP



# FAR 31.205-6 Exec Comp Focus Areas

- **General**

- “Total compensation for individual employees or job classes of employees must be reasonable for the work performed...specific restrictions on individual compensation elements apply when prescribed”
- “Compensation must be based upon and confirm to the terms and conditions of the contractor’s established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment”
- Major changes to plan should be presented to cognizant ACO to review allowability
- Because you call it compensation, it doesn’t make unallowable costs allowable (e.g. Entertainment Allowance)

# FAR 31.205-6 Exec Comp Focus Areas

- **General (continued)**

- Special Consideration

- Owners of closely held corporations/members of LLC/partners/sole proprietors or members of their immediate families
- Those contractually committed to acquire a substantial financial interest in the contractor's enterprise
- In above cases, compensation must be reasonable for services rendered and not be a distribution of profits

# FAR 31.205-6 Exec Comp Focus Areas

- **Reasonableness**

- The aggregate of each measurable and allowable compensation element must sum to a reasonable total
- Evaluation must be based on allowable elements
- Test of reasonableness based on factors determined relevant by the contracting officer to include conformity with compensation practices of others:
  - Of the same size
  - In the same industry
  - In the same geographic area; and
  - Engaged in similar non-government work under comparable circumstances



Reasonable Person

# FAR 31.205-6 Exec Comp Focus Areas

- **Bonuses/Incentive Compensation**
  - Awards are paid/accrued as per an agreement before the services are rendered or pursuant to an established plan or policy
  - Award basis must be supported
- **Compensation Related to Changes in Prices of Corporate Securities/Ownership**
  - Unallowable!
  - Examples include: stock options, stock appreciation rights, phantom stock plans, and junior stock conversions
  - Does **NOT** include ESOPs



# COURT CASE WARNING!



- **Exelis (ASBCA No. 58966, March 29, 2017)**
  - In FY06, Contractor claimed millions of dollars paid to 51 executives via a Long-Term Incentive Plan that was based on a “Total Shareholder Return,” which included an evaluation of stock price change and dividends paid and how that compared to its competitors.
  - DCAA questioned these costs as expressly unallowable
  - DACO sustained and applied penalties
  - Exelis appealed stating that the calculation was determined by company performance relative to competitors and TSR would not be paid if other companies did better.
  - ASBCA **denied** the appeal stating that TSR still significantly depended on stock price one way or another

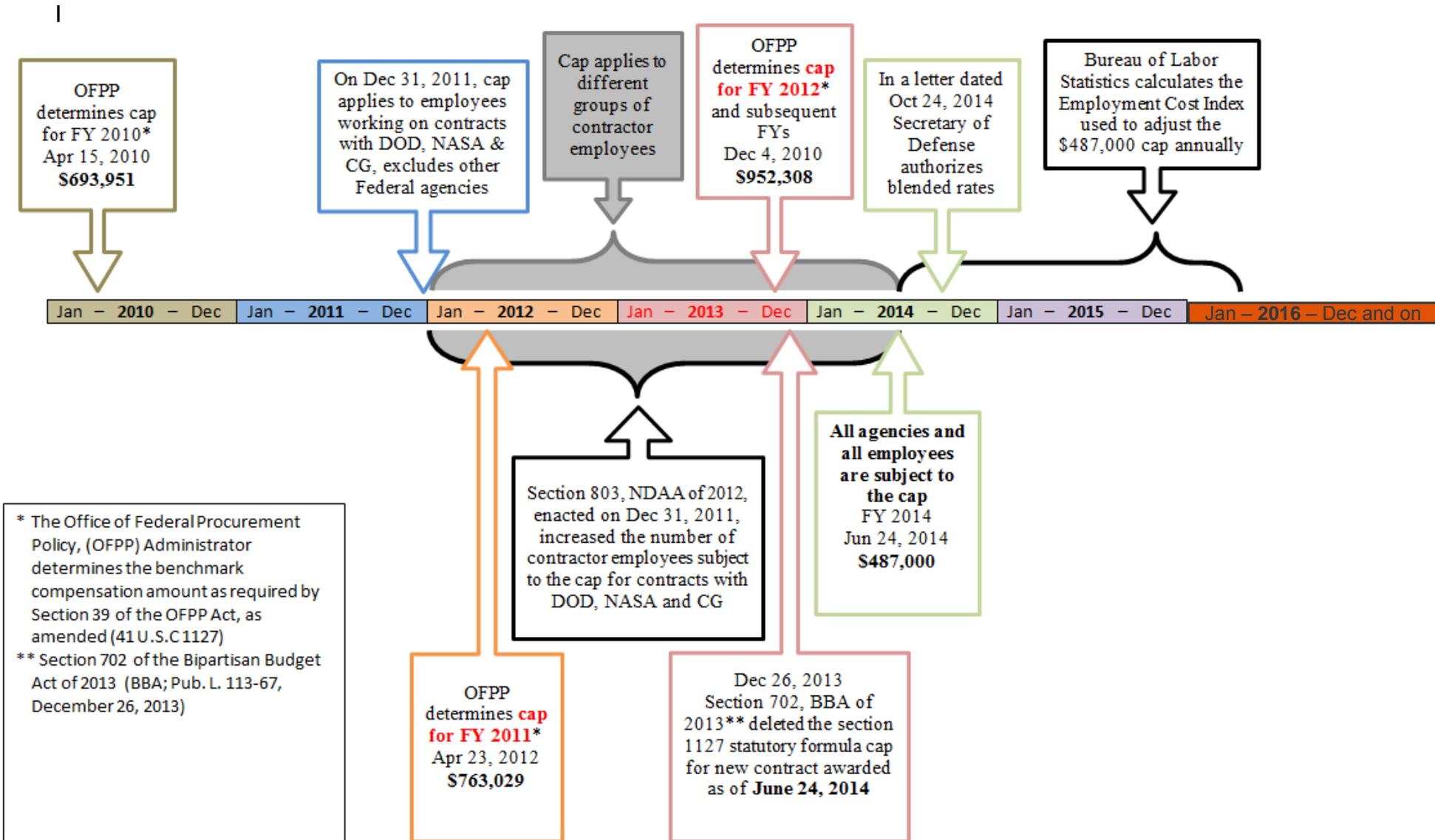
# FAR 31.205-6 Exec Comp Focus Areas

- **Limitation on Allowability of Compensation**

Contract award date	Applicable agencies	Covered employees	31.205-6
Before June 24, 2014	Executive Agencies Other than DoD, NASA and Coast Guard	Senior Executive	(p)(2)
Before December 31, 2011	DoD, NASA, and Coast Guard	Senior Executive	(p)(2)
On/after December 31, 2011 and before June 24, 2014	DoD, NASA, and Coast Guard	All Employees	(p)(3)
On/after June 24, 2014	All Executive Agencies	All Employees	(p)(4)

# FAR 31.205-6 Exec Comp Focus Areas

- Limitation on Allowability of Compensation (Cont.)



# FAR 31.205-6 Exec Comp Focus Areas

- Limitation on Allowability of Compensation (Cont.)

**Table of Statutory Formula Compensation Cap**

Statutory Formula Cap Amount	Fiscal Year	For Costs Incurred After	Federal Register Notice	FR Date Published
\$1,144,888	2014	Jan 1, 2014	81 FR 13833	March 15, 2016
\$980,796	2013	Jan 1, 2013	81 FR 13833	March 15, 2016
\$952,308	2012	Jan 1, 2012	78 FR 72930	Dec 4, 2013
\$763,029	2011	Jan 1, 2011	77 FR 24226	Apr 23, 2012
\$693,951	2010	Jan 1, 2010	75 FR 19661	Apr 15, 2010
\$684,181	2009	Jan 1, 2009	74 FR 23893	May 21, 2009
\$612,196	2008	Jan 1, 2008	73 FR 15779	Mar 25, 2008
\$597,912	2007	Jan 1, 2007	72 FR 14300	Mar 27, 2007
\$546,689	2006	Jan 1, 2006	71 FR 26114	May 3, 2006
\$473,318	2005	Jan 1, 2005	70 FR 23888	May 5, 2005
\$432,851	2004	Jan 1, 2004	69 FR 26897	May 14, 2004

# So I Can Claim Up to the Cap, Right?

- Probably not...
- Remember the reasonableness requirements and the need to have plans in place **prior** to determining compensation and bonuses/incentive payments
- You may use multiple G&A rates for covered contracts let prior to June 24, 2014, if it helps and you can support it

# Future of FAR 31.205-6

- Top U.S. Government Salaries
  - President - \$400,000
  - Chief Justice - \$263,300
  - Vice-President - \$230,700
  - Speaker of the House - \$223,500
  - Senator/Representative - \$174,000
  
- FAR 31.205-6 - More than 32 revisions in 34 years





# **Reporting Requirements for Executive Compensation and First- Tier Subcontract Awards**



## Federal Funding Accountability and Transparency Act Subaward Reporting System (FSRS)



The Federal Funding Accountability and Transparency Act (FFATA) was signed on September 26, 2006. The intent is to empower every American with the ability to hold the government accountable for each spending decision. The end result is to reduce wasteful spending in the government. The FFATA legislation requires information on federal awards (federal financial assistance and expenditures) be made available to the public via a single, searchable website, which is [www.USASpending.gov](http://www.USASpending.gov).

The FFATA Subaward Reporting System (FSRS) is the reporting tool Federal prime awardees (i.e. prime contractors and prime grants recipients) use to capture and report subaward and executive compensation data regarding their first-tier subawards to meet the FFATA reporting requirements. Prime contract awardees will report against sub-contracts awarded and prime grant awardees will report against sub-grants awarded. The sub-award information entered in FSRS will then be displayed on [www.USASpending.gov](http://www.USASpending.gov) associated with the prime award furthering Federal spending transparency.

# Reporting requirements for executive compensation and first-tier subcontract awards (FAR 52.204-10)

- **Prime**

- As a part of its annual registration requirement in the System for Award Management (SAM) database (FAR provision 52.204-7), the Contractor shall report the names and total compensation of each of the five most highly compensated executives for its preceding completed fiscal year, if—
  - (i) In the Contractor's preceding fiscal year, the Contractor received—
    - (A) 80 percent or more of its annual gross revenues from Federal contracts, and
    - (B) \$25,000,000 or more in annual gross revenues from Federal contracts, and
  - (ii) The public does not have access to information about the compensation of the executives through periodic reports filed under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a), 78o(d)) or section 6104 of the Internal Revenue Code of 1986.

# Reporting requirements for executive compensation and first-tier subcontract awards (FAR 52.204-10)

- **First-tier subcontract information**

- Unless otherwise directed by the contracting officer, or as provided in paragraph (g) of this clause, by the end of the month following the month of award of a first-tier subcontract with a value of \$30,000 or more, the Contractor shall report the following information at <http://www.fsrs.gov> for that first-tier subcontract.
- (i) In the subcontractor's preceding fiscal year, the subcontractor received
  - (A) 80 percent or more of its annual gross revenues from Federal contracts, and
  - (B) \$25,000,000 or more in annual gross revenues from Federal contracts, and
- (ii) The public does not have access to information about the compensation of the executives through periodic reports filed under section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a), 78o(d)) or section 6104 of the Internal Revenue Code of 1986.

# Reporting requirements for executive compensation and first-tier subcontract awards (FAR 52.204-10)

- **Exemption on reporting executive compensation on First-tier subcontracts**
  - (g)(1) If the Contractor in the previous tax year had gross income, from all sources, under \$300,000, the Contractor is exempt from the requirement to report subcontractor awards.
  - (2) If a subcontractor in the previous tax year had gross income from all sources under \$300,000, the Contractor does not need to report awards for that subcontractor.

# Total Compensation (FAR 52.204-10)

**Total compensation** means the cash and noncash dollar value earned by the executive during the Contractor's preceding fiscal year and includes the following (for more information see 17 CFR 229.402(c)(2)):

(1) **Salary and bonus.**

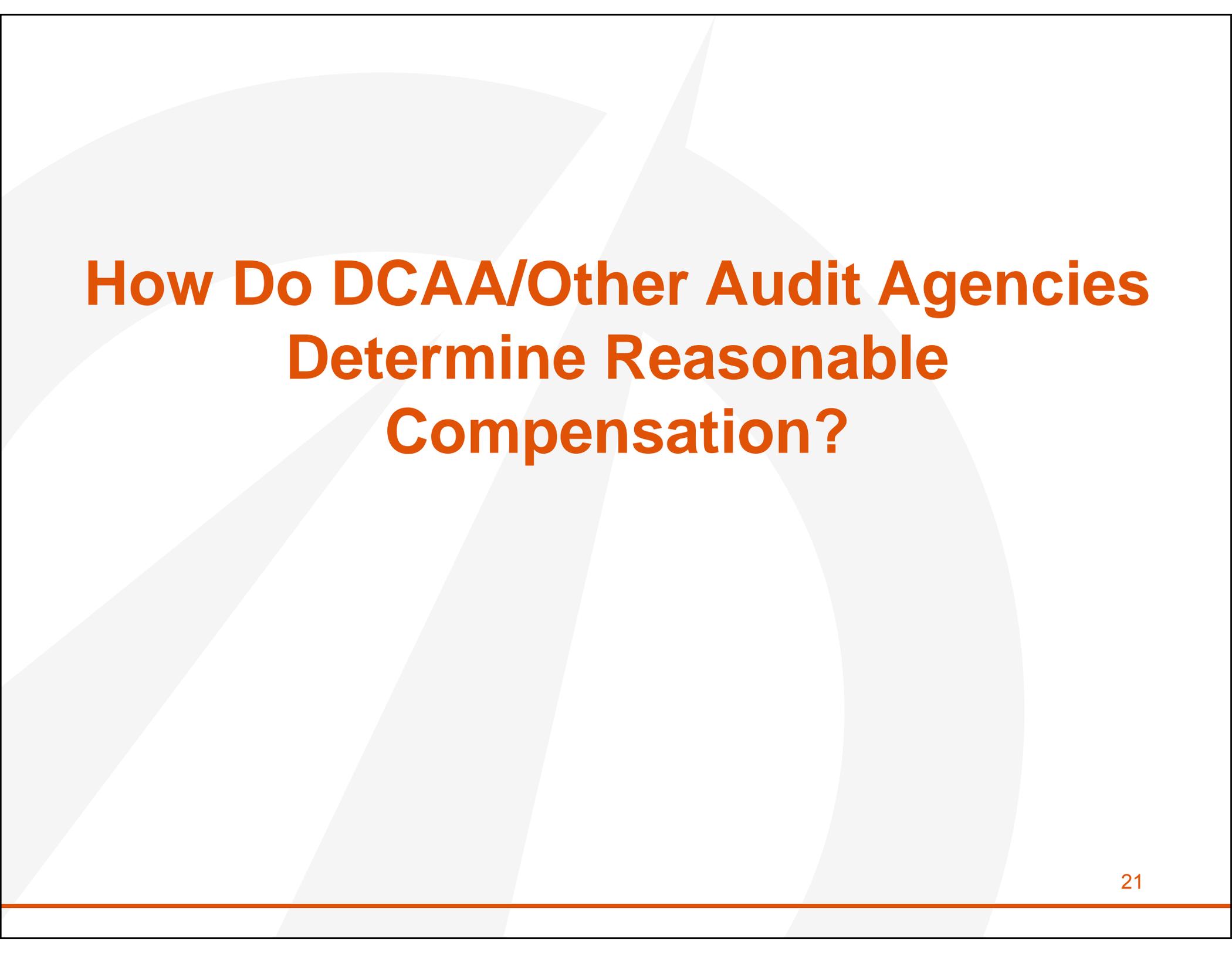
(2) **Awards of stock, stock options, and stock appreciation rights.** Use the dollar amount recognized for financial statement reporting purposes with respect to the fiscal year in accordance with the Financial Accounting Standards Board's Accounting Standards Codification (FASB ASC) 718, Compensation—Stock Compensation.

(3) **Earnings for services under non-equity incentive plans.** This does not include group life, health, hospitalization or medical reimbursement plans that do not discriminate in favor of executives, and are available generally to all salaried employees.

(4) **Change in pension value.** This is the change in present value of defined benefit and actuarial pension plans.

(5) **Above-market earnings on deferred compensation which is not tax-qualified.**

(6) **Other compensation,** if the aggregate value of all such other compensation (e.g., severance, termination payments, value of life insurance paid on behalf of the employee, perquisites or property) for the executive exceeds \$10,000.



# **How Do DCAA/Other Audit Agencies Determine Reasonable Compensation?**

# Internal Control Questionnaire

- Type of Organization
  - **Corporation**
    - Closely Held?
    - Family?
    - Who are the major stockholders?
  - **Partnership**
    - Partner's names/% Profits
- Names/Titles of Executives, Time Devoted to Business, Salary

# ICE Model Supplemental Schedule B

SUPPLEMENTAL B  
ICE (version 2.0.1f)

## GENERAL ORGANIZATIONAL INFORMATION AND EXECUTIVE COMPENSATION FOR THE FIVE MOST HIGHLY COMPENSATED EXECUTIVES

DCAA

### CONTRACTOR DATA FORM

FAO:	CONTRACTOR:
FAO ASSIGNMENT #:	CFYE (Month and Year) :

SIC/NAICS CODE:	CODE	DESCRIPTION	CONTRACTOR DATA:		%	%	#
			YEAR	SALES	GOVT	ADV	EMPLYS.
PRIMARY			20				
SECONDARY			20				

### EXECUTIVE DATA

CFY	EXEC POSITION	SALES SCOPE	% TIME DIRECT	BASE SALARY	BONUS	PENSION	HEALTH/LIFE INS.	AUTO	DEFERRED COMP.	LTI/OTHER*	VOL. DELS.	CLAIMED COMP.
20	1											
	2											
	3											
	4											
	5											

# Traditional DCAA Approach

- Survey Median plus 10% Range of Reasonableness
- Uses many different surveys (weigh equally)
- Ignores geography
- Uses Area of Responsibility
  
- Notes about AASHTO and State Dept.'s Approach



# COURT CASE WARNING!

- **J.F. Taylor (ASBCA No. 56105/56322, Jan 18, 2012)**
  - In FY's 2002-2005, DCAA questioned \$849,050 of unreasonable claimed compensation
  - DACO sustained the questioned costs and demanded repayment of about \$600,000.
  - J.F. Taylor appealed based on DCAA's methodology and alleged DCAA:
    - Ignored compensation survey data dispersion and employed an arbitrary 10% "range of reasonableness" allowance
    - Ignored differences in survey sizes
    - Failure to consider the company's financial performance and other relevant factors
  - ASBCA sided with J.F. Taylor and deemed DCAA's methodology to be unreasonable

# COURT CASE WARNING!

- J.F. Taylor (ASBCA No. 56105/56322, Jan 18, 2012)

## DCAA's response to the case:

- The Board hears specific cases and makes decisions based upon the evidence presented.
- Board takes a case-dependent to these compensation claims
- Contractor's expert witness deemed DCAA's approach to be "fatally flawed" and not the Board.
- Board merely noted that, due to the government's failure to present a statistics expert, the Contractor's expert witness' testimony was "unrebutted."

# COURT CASE WARNING!

- **Metron (ASBCA No. 55624/56751/56752 June 4, 2012)**
  - In FY's 2004-2005, for 10 executives, DCAA questioned costs totaling \$1.3M, stating the claimed compensation was unreasonable
  - DACO sustained the questioned costs and demanded repayment of about \$700,000 (DoD portion)
  - Metron appealed based on DCAA's methodology
  - Metron used the Radford Survey which they deemed most relevant to its industry
  - DCAA utilized multiple surveys and weighed them evenly, which resulted in a lower reasonableness determination
  - DCAA selected specific percentiles solely based on revenue
  - ASBCA deemed this methodology inappropriate based on the regulation

# COURT CASE WARNING!

- **Metron (ASBCA No. 55624/56751/56752 June 4, 2012)**

## **DCAA's response to the case:**

- It's a misconception that ASBCA endorsed using a single compensation survey
- Per the Board "the alternative surveys relied on by the government were less appropriate, comprehensive, technology-industry oriented, reliable, and/or persuasive...in this case"

# CohnReznick's Audit Approach

Starting Point

No.	Client Title	ERI Title	Employee Name	Basic Data				Revised Approach based on ASBCA Decisions			
				Total Compensation	Direct Labor \$	Indirect Labor	Indirect Labor \$ to Total #	65 Percentile	Excess over 65 Percentile	Statutory Limitation	Unallowable Indirect Cost
1	President		John Doe	\$800,000.00	\$80,000.00	\$720,000.00	90.00%	\$600,000.00	\$200,000.00	\$487,000.00	\$180,000.00
2											
3											
4											
5											
Total				\$800,000.00	\$80,000.00	\$720,000.00		\$600,000.00	\$200,000.00		\$180,000.00
	Cost Questioned due to Statutory Limit									0.00%	\$0.00
	Cost Questioned due to Reasonableness									100.00%	\$180,000.00

Key:			Sales	\$100,000,000	Location	Arlington	VA	SIC	123456	
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# **Strict Requirements Placed on Compensation for Owners**

# Strict Requirements Placed on Compensation for Owners

- Government is concerned Owners will pay themselves and family members unreasonable compensation at the expense of the Government on Cost-reimbursement contracts. FAR 31.205-6(a)

(6)(i) Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include:

(A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families; and

(B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.

(ii) For these individuals, compensation must—

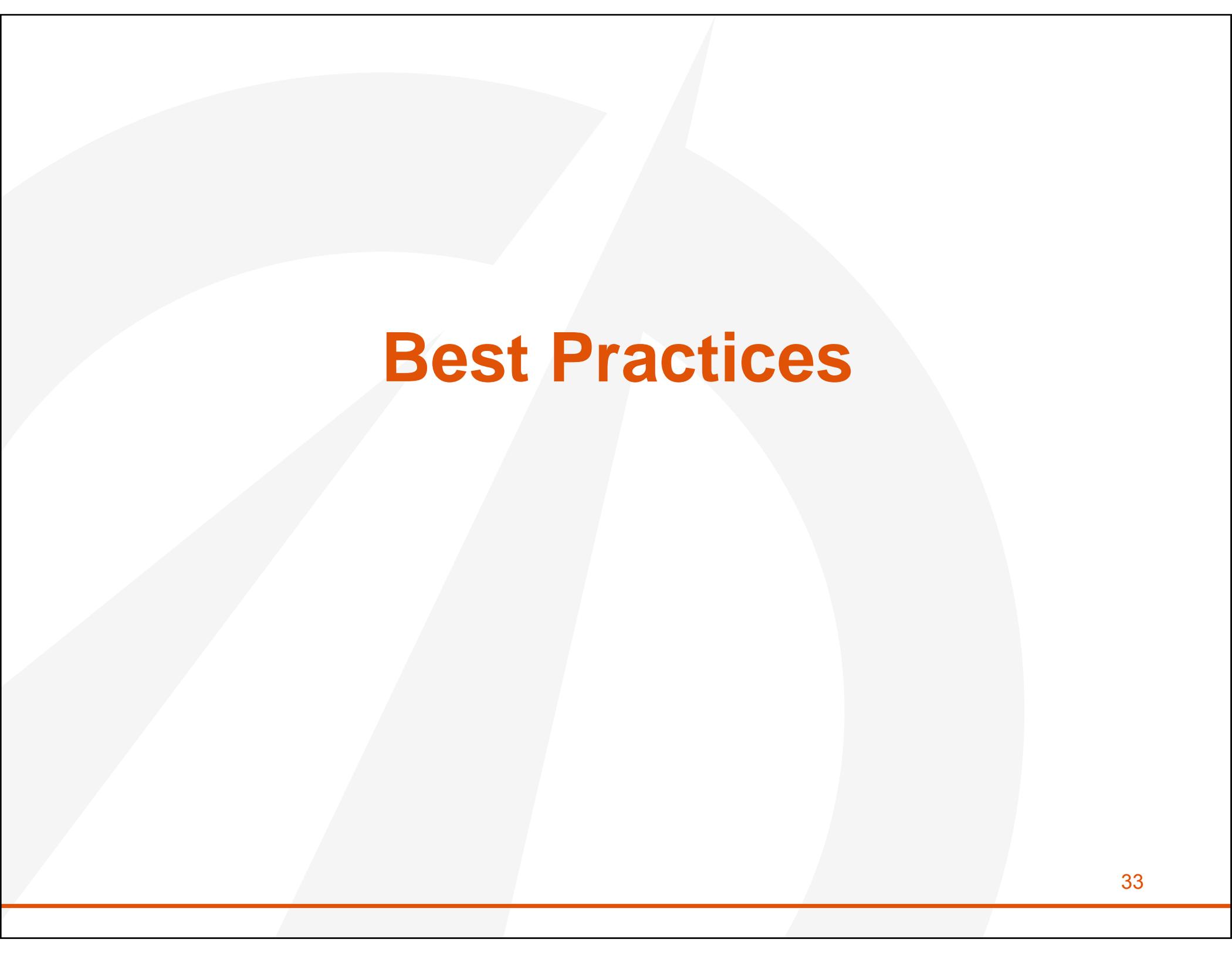
(A) Be reasonable for the personal services rendered; and

(B) Not be a distribution of profits (which is not an allowable contract cost).

(iii) For owners of closely held companies, compensation in excess of the costs that are deductible as compensation under the Internal Revenue Code (26 U.S.C.) and regulations under it is unallowable.

# Issues related to Compensation for Owners

- Contractor only had fixed price contracts and the owners don't pay themselves a salary. One of the fixed price contracts is terminated which effectively converts that contract to a Cost-reimbursement contract and the owners are never compensated a reasonable amount for the work they performed on the contract.
- Profit sharing plans have been found unallowable when the majority of the profits were distributed to owners.
- When owners/employees are not compensated in the form of a salary, it creates an appearance of higher profits which can create an audit red flag.



# Best Practices

# Compensation and Benefits for Start-Up Companies

Many of the methods High Tech companies use to attract and retain top talent are unallowable cost for Government Contractors.

High Tech Startup	Government Contractor
Stock options	Unallowable cost
Phantom Stock plans	Unallowable cost
Unannounced Bonuses	Unallowable cost
Deferred compensation upon sale of the business	Unallowable cost
Company-furnished automobiles	Unallowable cost
Company Parties	Unallowable cost
Gifts	Unallowable cost

# What are Government Contractors doing to attract and retain employees

With DCAA's main focus on questioning the reasonableness of Salary and Bonuses, they often overlook fringe benefits

- Flexible work schedule
- Defined-contribution pension plans
  - Increased 401K contribution
  - Increased Profit sharing plan (unallowable cost)
- Increased healthcare and dental contribution
- Creating Employee stock ownership plans (ESOP)
- Increased training and education costs
- Increased Paid Time Off (PTO)

# Be Ready!



- Document, Document, Document
  - Compensation Plan and associated policies and procedures/employee handbook
  - Bonus Plan(s) – Employees and Officers/Executives
  - Maintain support for bonus/incentive compensation decisions
  - Salary Surveys – Pick one(s) that are most relevant to your industry, your geography (i.e., defensible!)
  - Carefully maintain all of the above documentation, you may not be audited until 6-7 years after you've documented the above

# Get Set!



- Understand your business
  - Security Clearances
  - Demonstrated high-level performance (CPARS)
  - Unique skills sets
  - Local labor market
- Know your contracts
  - Mix of flexibly priced and fixed price
  - Unique requirements

# Attack! (Well, if you must)



- Understand DCAA's (Auditor's) Basis for Questioning
  - Survey(s) used
  - Percentile/Range of Reasonableness
  - Position Descriptions
  - Composition of Compensation
    - Unallowables out?
    - Organizational Fringe benefits excluded?
    - Overtime/differentials excluded?
- Absence of market data  $\neq$  questioned costs/unreasonable compensation
  - Your contract(s) count
  - Your salary histories count

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