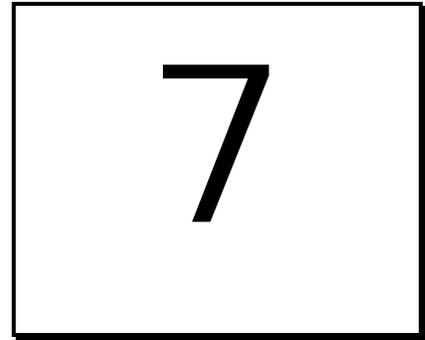


Important Note: In this 2012 edition of the guide, Chapter 7 has been updated only to reflect the issuance of the National Compensation Matrix (NCM). Other changes to this chapter may be required based on the latest rulings by the Armed Services Board of Contract Appeals (ASBCA). However, at this point, the impact of those rulings is unclear. Additional updates to Chapter 7 will appear in future editions of the guide.



Chapter 7—Compensation

7.1—General Principles

[Reference: FAR 31.205-6]

Pursuant to FAR 31.205-6—

(a) Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of [FAR 31.205-6] . . .

(1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages. . . .

(2) The total compensation for individual employees or job classes of employees must be reasonable for the work performed; however, specific restrictions on individual compensation elements apply when prescribed.

(3) The compensation must be based upon and conform 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.

(4) No presumption of allowability will exist where the contractor introduces major revisions of existing compensation plans or new plans and the contractor has not provided the cognizant state DOT, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.

(5) Costs that are unallowable under other paragraphs of . . . [FAR] Subpart 31.2 are not allowable under . . . [FAR] 31.205-6 solely on the basis that they constitute compensation for personal services.

7.2—Allowability of Compensation

[Reference: FAR 31.205-6]

Total compensation generally includes allocable and allowable wages, salaries, bonuses, deferred compensation, and employer contributions to defined contribution pension plans. Individual elements of compensation must be reviewed for allowability in compliance with the FAR.

FAR 31.205-6 distinguishes between allowability and reasonableness of compensation. It lists specific requirements for the allowability of certain elements of compensation. For an element of compensation to be allowable, it must meet the FAR requirements specific to that element. The total of all allowable compensation elements must be reasonable for the work performed. Reasonableness of compensation is discussed below in Section 7.3.

7.3—Reasonableness of Compensation

[References: FAR 31.201-3, FAR 31.205-6, DCAA CAM Sections 6-413 and 6-414]

Pursuant to FAR 31.205-6(b)(2), compensation not covered by labor-management agreements for each employee or job class of employees must be reasonable for the work performed. Furthermore,

Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition to the provisions of FAR 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms—

- (i) Of the same size;
- (ii) In the same industry;
- (iii) In the same geographic area; and
- (iv) Engaged in similar non-government work under comparable circumstances.

The engineering consultant is responsible for preparing an analysis to support the reasonableness of claimed compensation costs in accordance with FAR 31.205-6. Typically, this analysis focuses on executive positions because those positions comprise the highest compensation levels and the most significant area of audit risk.

Additionally, pursuant to FAR 31.205-6 (a)(6)(i)(A) and (B):

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.

Accordingly, in compliance with FAR 31.205-6, engineering consultants must ensure and properly document that the compensation for each employee or job class of employees is reasonable for the work performed. The auditor is responsible for reviewing/testing the engineering consultant's compensation analysis, to the extent considered necessary based on the auditor's risk assessment. Additional audit guidance appears in DCAA Contract Audit Manual (DCAA CAM) Sections 6-413 and 6-414. Much of the guidance included therein has been incorporated into this guide in the following sections.

7.4—Statutory Compensation Limit: The Benchmark Compensation Amount (BCA)

[References: FAR 31.205-6(p), Public Law 105-85 Section 808(b), DCAA CAM Section 6-413.7]

Pursuant to FAR 31.205-6, an engineering consultant is permitted to charge reasonable compensation to Government contracts as either a direct cost, indirect cost, or a combination of both. FAR 31.205-6(p) limits allowable compensation for Senior Executives^(f) to the Benchmark Compensation Amount (BCA) as determined by the Office of Federal Procurement Policy (OFPP), Section 808(b) of Public Law 105-85. The BCA is established based on the compensation of executives of publicly-owned U.S. corporations with annual sales over \$50 million for the fiscal year. The BCA applies to Senior Executives at corporate offices and business segments.

(f) Note: FAR 31.205-6(p)(2)(ii)(B) defines "Senior Executives" as "the five most highly compensated employees in management positions at each home office and each segment of the contractor, whether or not the home office or segment reports directly to the contractor's headquarters." Additionally, CAS 410 defines "segment" as "one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office, usually identified with responsibility for profit and/or producing a product or service."

Although the BCA is the statutory maximum for Senior Executive compensation costs that may be charged to Government contracts, the BCA must not be construed as an entitlement or a guaranteed amount of cost recovery. Instead, compensation is subject to the FAR allowability criteria discussed in FAR 31.201-2, including the allocability and reasonableness provisions of FAR 31.201-4 and FAR 31.205-6, respectively.¹⁵ Owners of closely-held firms are subject to an additional restriction—no payment that represents a distribution of profits may be submitted as a cost against a Government contract.

7.5—Determining the Reasonableness of Executive Compensation

[References: FAR 31.205-6, DCAA CAM Section 6-414, Techplan Corporation, Information Systems (ASBCA cases)]

A. Generally

Pursuant to DCAA CAM Section 6-414.4c:

Executive positions within a company are usually unique positions within that company. Only the largest of firms have the potential for a class of employees performing vice-presidential level duties, which can be described as having similar rank, function, and responsibility. Normally, executives are not part of a class of employees and must be evaluated individually.

The engineering consultant's policies and procedures should provide descriptions of how executive compensation levels are established and who approves these levels, as well as the eligibility criteria and basis for establishing base salary, cash bonuses, long-term perquisites, benefits, services, and incentive pay bonuses.

In developing FAR-allowable overhead rates, engineering consultants should evaluate the reasonableness of executive compensation costs in accordance with FAR 31.205-6 and should prepare documentation to support this evaluation. Additional guidance on the evaluation of executive compensation costs appears in DCAA CAM Sections 6-413 and 6-414, which should be consulted for more details prior to performing the analysis.

¹⁵ This was reinforced by the Federal Office of Management and Budget: "While the benchmark executive compensation amount is the maximum allowable amount of compensation costs for certain executives of Government contractors, the benchmark amount as applied to a particular executive is not necessarily a safe harbor. Without regard to the benchmark compensation amount, the allowable compensation costs for each affected executive are still subject to the Federal Acquisition Regulation and the Cost Accounting Standards as applicable and appropriate to the circumstances, e.g., reasonableness and allocability. The Executive Compensation Cap is implemented at FAR 31.205-6(p)." (See http://www.whitehouse.gov/omb/procurement_index_exec_comp.)

B. Procedures for Determining Reasonableness

The engineering consultant must determine the reasonableness of executive compensation in a manner compliant with the criteria established in FAR 31.205-6 and the two major Armed Services Board of Contract Appeals (ASBCA) decisions dealing with compensation: *Techplan Corporation*,¹⁶ and *Information Systems and Networks Corporation*.¹⁷

The engineering consultant should prepare a compensation analysis in accordance with the procedure described below in Section 7.5.C. In compliance with FAR 31.205-6, the consultant must disallow costs in excess of the amount deemed reasonable as determined by the compensation study.

Note: In cases where a consultant does not perform an acceptable compensation analysis, State DOTs may use the National Compensation Matrix (NCM) as a benchmark for determining the reasonableness of executive compensation. See Section 7.7 for specifics regarding the NCM.

C. Performing a Compensation Analysis in Compliance with FAR 31.205-6, *Techplan*, and *Information Systems*

The approach that engineering consultants should use to evaluate compensation reasonableness should include the following steps:

Step 1. Examine all elements of compensation and eliminate from FAR-allowable overhead those elements which are defined as unallowable under FAR 31.205-6 or other applicable FAR cost principles. For example, compensation calculated based on changes in corporate securities (such as stock options) is expressly unallowable, and should be excluded from overhead and from the compensation evaluated.

Step 2. For the individual executives or classes of employees to be examined, prepare a schedule listing all allowable components of compensation and the amount paid for each. Compensation includes wages, salary, bonuses, incentive compensation, deferred compensation, and employer contributions to defined contribution pension plans.

Step 3. Obtain nationally-published compensation surveys to match the engineering consultant in terms of revenue, industry, geographic location, and other relevant factors. Engineering consultants and auditors should ensure survey data used to support reasonableness determinations is based on reliable and unbiased surveys that are representative of the engineering consultant's relevant market or industry. In most cases, no one survey is sufficient to determine the market rate of pay for all the engineering consultant's positions. A primary survey may be selected with secondary surveys used to corroborate the results of the primary survey. Typically, industry best practices include the use of three surveys. DCAA CAM Section 5-808.8c(2) provides guidance on evaluating compensation survey data. Some types of surveys that should generally not be used include magazine or newspaper surveys, free internet surveys, and GSA schedules.

Nationally-published surveys typically identify the mean, median or percentile amounts of salary, bonus and other elements of compensation by revenue ranges, number of firm employees, or discipline. Geographical regions, position title, job descriptions, and additional data analysis typically are standard topics.

The engineering consultant must match the job description and duties of each of its executives to the survey data. However, matching positions based solely on job titles may result in an inaccurate comparison. For instance, in a small business an executive will perform certain duties that are performed by multiple people in a larger company.

¹⁶ *Techplan Corporation*, ASBCA Nos. 41470, 45387, and 45388, 1996 ASBCA LEXIS 141. *Techplan* is the seminal case that established a methodology for applying the reasonableness provisions of FAR 31.205-6 to compensation issues.

¹⁷ *Information Systems and Networks Corporation*, ASBCA No. 47849, 1997 WL 381263 (A.S.B.C.A.), 97-2 BCA P 29132.

Step 4. From these surveys, develop an estimated reasonable compensation amount for each executive position. First, determine the survey median compensation amounts for each comparable position, selecting survey data for firms of comparable size and geographic area. Some surveys will classify firms by size based on number of staff, while others will use total revenues. Use the category that best matches the survey data to the subject firm.

For example, assume the subject firm has 45 employees and revenues of \$9 million. Survey data, such as the sample shown below in Table 7-1, should be analyzed as described in the following steps.

TABLE 7-1. SAMPLE SURVEY DATA FOR DETERMINING REASONABLENESS OF COMPENSATION

Position: President/CEO					
<i>Survey 1</i>	Number of Employees	Salary (median)	Bonus/ Incentive (median)	Other Compensation (median)	Total Compensation (median)
	1-20	\$101,000	\$15,000	\$8,000	\$124,000
	21-50	145,000	32,000	11,000	188,000
	51-100	210,000	47,000	18,000	275,000
	101-200	241,000	82,000	24,000	347,000

Step 5. Apply appropriate escalation factors to adjust survey data to a common date of July 1 of the same year or the mid-point of the Consultant’s Fiscal Year. The escalation factor used should be supported by survey data on trends in compensation for the years examined. Often, surveys will include an executive summary section that will present data on such trends.

Step 6. Develop a composite median amount by averaging the median total compensation amounts, after application of any necessary escalation factors.

Step 7. Next, increase the composite median by 10 percent, based on DCAA guidance (see DCAA CAM Section 6-414.4) which allows for a 10 percent range of reasonableness to be applied in developing estimated reasonable compensation.

Disclaimer: The following data in Table 7-2 are presented for illustration purposes only and must not be relied upon or applied to an analysis of actual compensation costs.

TABLE 7-2. ESTIMATED REASONABLE COMPENSATION

Position: President / CEO		Salary (median)	Bonus/ Incentive (median)	Other Compensation (median)	Total Compensation (median)
<i>Survey 1</i>	Staff size 21-50	\$145,000	\$32,000	\$11,000	\$188,000
<i>Survey 2</i>	Revenue \$5-10M	127,000	35,000	15,000	177,000
<i>Survey 3</i>	Revenue \$5-15M	146,000	42,000	14,000	202,000
Average					189,000
Range of reasonableness (ROR) factor					* 10%
Adjusted for 10% ROR					207,900
President/CEO estimated reasonable compensation					207,900

(M = million)

Note: If survey data from prior years is used, then adjust to the current year using an

appropriate escalation factor. In this example, only one year of data is presented.

Note: Only allowable elements of compensation should be included in the analysis. Survey and actual data should be reviewed for allowability prior to inclusion. Allowability of specific compensation elements is discussed in FAR 31.205-6 and elsewhere in this chapter. The term “Other Compensation” as used here includes all FAR-allowable compensation other than salary and bonus or incentive compensation.

Step 8. Compare total actual compensation for each executive to the estimated reasonable compensation developed in Step 7 for that position.

Disclaimer: The following data in Table 7-3 are presented for illustration purposes only and must not be relied upon or applied to an analysis of actual compensation costs.

TABLE 7-3. COMPARISON TO ACTUAL EXECUTIVE COMPENSATION:

	Actual Salary	Actual Bonus/ Incentive	Actual Other Comp.	Actual Total Comp.	Estimated Reasonable Total Comp.(†)	Potential Unreasonable Comp.
President / CEO	\$144,000	\$52,000	\$18,000	\$214,000	\$207,900	\$6,100
Perform this analysis for each executive as defined in this chapter, and accumulate total potential unreasonable compensation.						

(†)**Note:** No compensation claimed for any Senior Executive may exceed the benchmark compensation amount (BCA) discussed previously in Section 7.4.

Step 9. In the cases where total compensation exceeds the estimated reasonable amount, FAR-allowable compensation for that executive should generally be limited to the estimated reasonable compensation, with one notable exception, as explained in Section 7.6.

7.6—Criteria for Demonstrating Superior Performance

[References: DCAA CAM Section 6-414.4h]

A. Generally

Pursuant to DCAA CAM Section 6-414.4h (entire text reproduced below)—

Often contractors will propose that their executives should be paid more than 110 percent of the reasonable compensation based on the average compensation paid by comparable firms for executives with similar duties. Above average levels of compensation are usually identified by percentiles, such as the 75th percentile. For an executive with responsibility for overall management of a segment or firm, such a proposal may be justified by clearly superior performance as documented by financial performance that significantly exceeds the particular industry’s average. The ASBCA, in its decision on Information Systems and Networks Corporation ASBCA No. 47849, “capped” executive compensation at the 75th percentile when justified by performance.

(1) Examples of financial performance measures may include the following:

- Revenue Growth
- Net Income
- Return on Shareholder's [sic] Equity
- Return on Assets
- Return on Sales
- Earnings per Share
- Return on Capital
- Cost Savings
- Market Share

(2) The contractor must show that the measure chosen is representative of the executive's performance. Consideration should be given to the competitive environment in which the contractor operates. There should be no extra compensation awarded because of high performance measured by a standard which is not affected by the executive's performance, and certainly there should be no extra compensation due to performance which results primarily from the contractor's status as a Government contractor. Performance is typically measured using more than one criterion of performance. For example, a contractor may have significant sales growth through acquisitions and mergers while operating at a loss. In this situation, the contractor would not be considered to have superior performance based on the lone measure of sales growth.

(3) Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measures reflected in the changes to compensation claimed as reasonable.

B. Procedure for Establishing Compensation Amounts in Excess of Survey Medians

To justify the superior performance necessary to evaluate an engineering consultant's executive compensation at higher than the median (up to but not exceeding the 75th percentile), the consultant must prepare and document an analysis of the firm's performance in comparison to selected performance measures from the list above (as excerpted from DCAA CAM 6-414.4h(1)). Typically, superior performance may not be based on only one performance measure; instead, superior performance in comparison to three or more measures must be established to present a compelling case for the allowability of higher than median executive compensation.

The analysis methodology steps include the following—

Step 1. Calculate a minimum of three financial performance measures stated above using the engineering consultant's actual financial data for the same time period.

Step 2. Calculate the firm's composite financial performance measure. This is done by calculating the simple average of the financial performance measures calculated in the previous step.

Step 3. Using proxy data available from SEC filings and the following criteria, identify the same financial performance measures used in the engineering consultant's analysis:

- in SIC code 87;
- in the same revenue range; and
- for the same time period as the engineering consultant's data.

Note: If no SEC proxy data are available commensurate with the engineering consultant's revenue amount, it may be appropriate to consider financial data from other sources, such as Dun and Bradstreet or Standard & Poor's.

Step 4. Calculate the proxy composite financial performance measure. This is done by calculating the simple average of the financial performance measures calculated in the previous step.

Step 5. Compare the engineering consultant’s composite financial performance measure to the proxy composite financial performance measure to identify the consultant’s applicable percentile.

Step 6. Provide a copy of each executive’s position description, job duties, and the relationship between executives’ performance and the firm’s performance.

If the engineering consultant can successfully demonstrate superior performance, then the analysis performed in compliance with this Section (7.6) should be performed using survey data at the applicable percentile. For example, if the firm’s financial performance is at the 75th percentile, then the compensation analysis should use compensation survey data at the 75th percentile as well. Some surveys are robust enough to provide data at any percentile ranking; however, it may be necessary to extrapolate survey data if the applicable percentile is not presented. Additionally, pursuant to DCAA CAM Section 6-414.4h(3):

Use of a particular measure to justify higher than average compensation should be applied consistently over a period of years, with both increase and decreases in the performance measures reflective in the changes to compensation claimed as reasonable.

Note: Regardless of firm performance, executive compensation costs in excess of the Benchmark Compensation Amount¹⁸ are unallowable.

7.7—State DOT Oversight: Review of Executive Compensation

[References: FAR 31.205-6, *Techplan Corporation, Information Systems Corporation* (ASBCA cases)]

A. Reviewing the Engineering Consultant’s Compensation Analysis

As discussed previously in Section 7.5.B, engineering consultants are responsible for preparing a compensation analysis to demonstrate that claimed compensation costs are reasonable, and otherwise allowable,¹⁹ in compliance with FAR 31.205-6, as interpreted and clarified by the ASBCA in *Techplan* and *Information Systems*. State DOTs and/or independent CPA auditors should review the consultant’s analysis to validate compliance with the procedures described in Section 7.5.B.

Note: If the engineering consultant’s compensation analysis is fully compliant with the *Techplan* and *Information Systems* criteria discussed previously in Section 7.5.B, then State DOTs will be required to accept the consultant’s analysis.

B. Using the National Compensation Matrix (NCM) to Evaluate Executive Compensation

In cases where engineering consultants do not prepare an acceptable compensation analysis, State DOTs must use other tools and techniques to obtain reasonable assurance that executive compensation costs are reasonable and otherwise allowable. To promote consistency in this process, a group²⁰ was formed to prepare a “National Compensation Matrix” (NCM or Matrix) for use in determining reasonable levels of executive compensation for engineering consultants in compliance with the criteria established in Section 7.5.B. The NCM Team began its deliberations on October 24, 2011, and the NCM was issued on May 8, 2012. The NCM is available at <http://audit.transportation.org/Pages/default.aspx>.

In future periods, the NCM will be updated as deemed appropriate by the NCM Team. In the event that the NCM is not updated in any given year, the amounts stated in the most recent NCM should be adjusted (escalated or de-escalated, as appropriate) based on instructions issued with the NCM.

¹⁸ See prior discussion in Section 7.4.

¹⁹ Only the net amount of total compensation attributable to allowable business activities is subject to the reasonableness test. Accordingly, before performing a review for reasonableness, the engineering consultant must first disallow all unallowable forms of compensation and compensation associated with unallowable activities.

²⁰ The group (NCM Team or Team) includes representatives from AASHTO, various State DOTs, the FHWA, ACEC, independent CPAs, and an independent Certified Compensation Professional (CCP).

Note Regarding State DOT Contracting Terms:

Engineering consultants should be aware that, if a State DOT imposes a direct hourly rate limitation pursuant to contractual agreement (and consistent with the FAR cost principles), then the difference between compensation paid versus compensation billed is still direct labor and must be allocated to projects accordingly. The amount not reimbursed by the State DOT must not be moved to another project or transferred to an indirect labor account. Accordingly, the unrecovered/unbilled amount represents a reduction to the profitability of a specific contract.

7.8—Executive Compensation—Required Supporting Documentation

Engineering consultants are required to prepare a schedule to demonstrate the application of, and compliance with, either:

- A complete compensation analysis prepared in accordance with all the criteria discussed in Section 7.5, or
- The NCM.^(†)

(†) Note: Regardless of whether the engineering consultant prepares its own compensation study using published compensation surveys or instead uses the NCM, the consultant must perform the procedures described in Section 7.5.C, Steps 1, 2, 8, and 9. (Consultants that use the NCM are not required to complete Steps 3 through 7 from Section 7.5.C.)

Each year, the schedule must be submitted to the engineering consultant's home State DOT and the consultant's CPA along with an updated indirect cost rate schedule. For engineering consultants working in multiple states, the non-home State DOT should contact the home State DOT to ensure that the schedule has been submitted by the consultant and accepted by the home State DOT. If the engineering consultant receives a cognizant audit, the schedule would only be submitted to the State DOT that performs the cognizant agency review.

For each executive, the engineering consultant must voluntarily disallow all compensation that exceeds the maximum amounts established by the consultant's analysis, or alternatively, the amount in excess of the applicable NCM threshold. The following information must be provided on the schedule and must be disclosed separately for each applicable position:

1. Employee/owner/officer first and last name or employee identification (ID) number.
2. Position title.
3. Total wages/salaries paid including taxable fringe benefits.
4. Total bonuses paid.
5. Total employer contributions to defined contribution pension plans (whether paid, earned, or otherwise accrued).
6. Total of items 3 through 5 above.
7. The applicable amount from the consultant's analysis or the NCM.
8. The excess compensation required to be disallowed from the indirect labor or bonus line item.

Note: The reviewing State DOT must be able to verify and reconcile the schedule to the engineering consultant's financial records.

7.9—Additional Procedures—Related Parties

An important aspect of a FAR-compliant audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under GAAP to disclose material related-party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an

undisclosed related party.

Potential related-party indicators²¹ that may impact audit risk include, but are not limited to, the following:

- Agreements under which one party pays expenses on behalf of another party.
- Circular business arrangements and transactions between related parties.
- Engaging in business deals (such as leases) at greater or less than market value.
- Discovery of an undisclosed related party.
- Inadequate disclosure.
- Payments for services at inflated prices.
- Revenue recognition based on sales that lack economic substance.
- Sale of land with arranged seller financing.
- Sale of securities.
- Services or goods purchased from a party at nominal cost or no cost.
- Unusual, high-value transactions, particularly close to quarter- or year-end.
- Use of a related party to mitigate market risks.

The consultant must provide a list of all employees who are related to company executives as reported above. For each related party, the list should include the following six items:

1. Employees' first and last names or employee IDs.
2. Name or employee ID of related executive, and nature of relationship.
3. Position title or job classification.
4. Brief description of the employee's job duties.
5. Total wages or salaries paid, including taxable fringe benefits.
6. Total bonuses paid.

Auditors should review this information to evaluate whether there is a risk that compensation paid to a related party is unreasonable given the nature of their position or job responsibilities. Based on auditor judgment and risk assessment, the auditor should determine if additional audit procedures are necessary.

7.10—Special Consideration for Closely-Held Firms

[Reference: FAR 31.205-6(a)(6)(i)(A)]

Pursuant to FAR 31.205-6(a)(6)(i)(A), compensation for certain individuals in closely-held firms requires special review and consideration. This is required because small firms typically do not have compensation committees, and the owners and officers of these firms may exercise considerable influence over their own levels of compensation.

Additionally, small firms typically have principals who are responsible for a variety of job duties. For example, it is common for a principal in a small firm to perform some overlapping job duties of CEO, CFO, Division Manager, and/or Project Manager. Many of these duties involve material amounts of direct labor that must be tracked to the appropriate projects. However, the following practices may cause a disproportionate distribution/allocation of principals' labor to the direct and indirect labor pools—

- Principals take infrequent draws in lieu of taking regular salaries.
- Principals take low salaries coupled with high bonuses.
- Principals wait until the firm's profitability is known at year end and treat any remaining cash surplus as compensation.

²¹ As discussed in the AICPA Publication, *Accounting and Auditing for Related Parties and Related Party Transactions, A Toolkit for Accountants and Auditors*. December 2001.

Note: For additional guidance regarding labor distribution, see Chapter 5 (Cost Accounting) and Chapter 6 (Labor Charging Systems and Other Considerations).

To address the issue stated above, consultants must review executive compensation to ensure that labor is appropriately distributed to the direct and indirect labor pools. Absent other guidance, compensation costs should be distributed based on the ratio of each principal's direct and indirect labor hours. If material, an adjustment should be made to correct distortions of the labor pools.

7.11—Bonus and Incentive Pay Plans

[Reference: FAR 31.205-6(f)(1), FAR 31.205-6(a)(6)(ii)(B)]

Payments made under bonus and incentive-pay plans frequently represent a large portion of the total compensation costs claimed by consultants. To be allowable charges against Government contracts, bonus payments must be allocable to Government contracts, reasonable in amount, and must not represent a distribution of profits to owners.²² FAR 31.205-6(f)(1) further specifies that bonus payments are allowable, provided the:

Awards are paid or accrued under an agreement entered into in good faith between the contractor [consultant] and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor [consultant] so consistently as to imply, in effect, an agreement to make such payment; and . . . [b]asis for the award is supported.

FAR 31.205-6(a)(6)(ii)(B) states that for owners of closely-held firms, allowable bonus amounts may not represent a distribution of profits. Accordingly, there must be clear distinctions of the various portions of total compensation; specifically, which portion is a true bonus based on stated objectives and which portion is a profit distribution.

A. Bonus Plans

Typically, bonus plans are applicable to a broad class of employees. Some plans include eligibility for all employees, while others limit eligibility to professional and management staff. Individual participation may be based on the productivity of an individual, team, overall company, or some combination of these factors. Bonuses may be based on a percentage of an employee's base salary, or alternatively may be issued as lump sum distributions, based on the available pool of money to be distributed.

B. Profit-Distribution Plans

By contrast, profit-distribution plans involve a distribution of net earnings to owners. Individual distributions are based on partners' capital account balances, level of partnership (e.g., junior versus senior partner), number of owned shares, or some other factor linked to ownership.

C. Documentation of Bonus and Profit-Distribution Plans

Some companies have both bonus plans *and* profit-distribution plans. However, only the portion that is a valid bonus is allowable as a recoverable overhead expense. Consultants should prepare and maintain written bonus plans that identify eligibility requirements and provide details regarding how bonus payments are determined. Profit-distribution agreements also should be in writing. This will serve to reduce confusion as to what is a bonus and what is a profit distribution. An acceptable bonus policy should include an adequate description of the performance measures used to determine bonus amounts, such as employee performance evaluation ratings, contributions toward the firm's revenue growth, and responsibilities for cost containment.

Written bonus plans should include, at a minimum, the following components—

- Eligibility criteria.
- Period of bonus plan.

²² See FAR 31.201-3, FAR 31.201-4 and FAR 31.205-6(a)(6)(ii)(B), respectively.

- Performance criteria (e.g., individual expectations—must be measurable and verifiable criteria).
- Incentives awards/spot bonuses must be related to performance, as measured by quantitative and qualitative factors.
- Form of payment to be received.
- Distribution timeline.

7.12—Fringe Benefits

[Reference: FAR 31.205-6(m)]

Fringe benefits are defined at FAR 31.205-6(m) as the cost of “vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans.” Fringe benefit costs are allowable to the extent that they are reasonable and are required by law, an employer-employee agreement, or an established policy of the consultant.

Frequently, additional fringe benefits are available to all employees. The more common elements are discussed in the following sections.

A. Deferred Compensation, Generally

[References: FAR 31.001, CAS 415]

FAR 31.001 defines *deferred compensation* as:

[A]n award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of the receipt of compensation by the employee. This definition shall not include the amount of year end accruals for salaries, wages, or bonuses that are to be paid within a reasonable period of time after the end of a cost accounting period.

To be allowable as charges against Government contracts, the cost of deferred awards must be measured, allocated, and accounted for in compliance with CAS 415.

B. Pension Plans

[References: FAR 31.001, FAR 31.205-6(j), ERISA, I.R.C., CAS 412, CAS 413]

Defined. FAR 31.001 defines a *pension plan* as a “deferred compensation plan established and maintained by one or more employers to provide systematically for the payment of benefits to plan participants after their retirements, provided that the benefits are paid for life or are payable for life at the option of the employees.” Pension plan accounting is complex and is subject to various laws, regulations, and policies including FAR Part 31, the Internal Revenue Code (I.R.C.) and related regulations, the Employee Retirement Income Security Act (ERISA), CAS 412 (cost accounting standard for composition and measurement of pension cost), and CAS 413 (adjustment and allocation of pension cost). Accordingly, costs associated with pension plans must be reviewed carefully to determine the allowability of claimed costs.

Funding Requirements. “Qualified pension plans” are definite, written programs that meet the eligibility criteria set forth in the Internal Revenue Code. All other pension plans are considered unqualified pension plans. Costs for either type of plan may be allowable, depending on the specific circumstances. Except for nonqualified pension plans using the pay-as-you-go method, one of the critical FAR requirements is that, for pension costs to be allowable in the current year, they must be funded by the due date for filing the Federal income tax return, including extensions. Pension costs assigned to the current year but not funded timely are unallowable in any subsequent year.

Allowable Contributions. The amount contributed to qualified pension- or profit-sharing plans on behalf of principals and other employees is allowable. However, the payments must be reasonable in amount and be paid pursuant to an agreement entered into in good faith between the consultant and employees, before the work or services are performed and pursuant to the terms and conditions of the established plan. Contributions for pension costs must comply with FAR 31.205-6(j), which incorporates CAS 412 and 413.

Changes in Pensions Plans. As noted in FAR 31.205-6(j)(1), the cost of changes in pension plans are not allowable if the changes are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future. Additionally, one-time-only pension supplements not available to all plan participants are generally unallowable, unless the supplemental benefits represent a separate pension plan, and the benefits are payable for life at the option of the employee. Finally, increased payments to retired participants for cost-of-living adjustments are allowable if paid in accordance with a consistent policy or practice.

C. Employee Stock Ownership Plans (ESOPs)

[References: FAR 31.205-6(q), CAS 412, CAS 415]

Defined. An ESOP is a stock bonus plan designed to invest primarily in the stock of the employer corporation. The consultant’s contributions to an Employee Stock Ownership Trust (ESOT) may be in the form of cash, stock, or property. An ESOP may be designed as a deferred compensation plan or as a supplementary pension plan; each would be covered by different regulations. To determine whether certain ESOP costs are allowable, FAR 31.205-6(q) should be referenced along with applicable CAS provisions (see note below). Private companies must have an annual outside valuation performed to determine the market value of their ESOP shares.

Note: On May 1, 2008, the Cost Accounting Standards Board, Office of Federal Procurement Policy, issued a final rule amending Cost Accounting Standard 412, “Cost Accounting Standard for composition and measurement of pension cost,” and CAS 415, “Accounting for the cost of deferred compensation.” These changes to the CAS direct that costs of all Employee Stock Ownership Plans, regardless of type, be accounted for in accordance with CAS 415, and provide criteria in CAS 415 for measuring ESOP costs and assigning those costs to cost accounting periods. The amendments specify that the provisions of CAS 415, and not any other standard, govern accounting for ESOP costs. Pursuant to CASB 9904.415-20, CAS 415 applies to the cost of all deferred compensation except the cost for compensated personal absence, and the cost for pension plans that do not fit the description of an ESOP, as defined in CASB 9904.415-30. The final rule also revises CASB 9904.415-40 to specify the requirements for measurement and assignment of ESOP costs.

* The FAR has not been revised to reflect the changes in CAS 412 and 415.

General Considerations. FAR 31.205-6(q)(2) provides that the costs of ESOPs are allowable subject to the following conditions:

- (i) For ESOPs that meet the definition of a pension plan at [FAR] 31.001, the contractor—
 - A. Measures, assigns, and allocates the costs in accordance with 48 CFR 9904.412;
 - B. Funds the pension costs by the time set for filing of the Federal income tax return or any extension. Pension costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year; and
 - C. Any amount funded in excess of the pension cost assigned to a cost accounting period is not allowable in that period and shall be accounted for as set forth at 48 CFR 9904.412-50(a)(4). The excess amount is allowable in the future period to which it is assigned, to the extent it is not otherwise unallowable.
- (ii) For ESOPs that do not meet the definition of a pension plan at [FAR] 31.001, the contractor measures, assigns, and allocates costs in accordance with 48 CFR 9904.415.
- (iii) Contributions by the contractor in any one year that exceed the deductibility limits of the Internal Revenue Code for that year are unallowable.
- (iv) When the contribution is in the form of stock, the value of the stock contribution is limited to the fair market value of the stock on the date that title is effectively transferred to the trust.
- (v) When the contribution is in the form of cash—
 - (A) Stock purchases by the ESOT in excess of fair market value are unallowable; and
 - (B) when stock purchases are in excess of fair market value, the contractor shall credit the amount of the excess to the same indirect cost pools that were charged for the ESOP contributions in the year in which the stock purchase occurs. However, when the trust purchases the stock with borrowed funds which will be repaid over a period of years by cash contributions from the contract to the trust, the contractor shall credit the excess price over fair market value to the indirect cost pools pro rata over the period of years during which the contractor contributes the cash used by the trust to repay the loan.
- (vi) When the fair market value of unissued stock or stock of a closely held corporation is not readily determinable, the valuation will be made on a case-by-case basis taking into consideration the guidelines for valuation used by the IRS.

Note: Given the complexity of ESOPs, specific guidance should be consulted for the proper cost accounting treatment relating to ESOP costs, including stock forfeitures and similar items.

D. Severance Pay

[Reference: FAR 31.205-6(g)]

The FAR defines severance pay as “a payment in addition to regular salaries and wages by contractors to workers whose employment is being involuntarily terminated.” Severance pay does not include payments under early-retirement incentive plans.

FAR 31.205-6(g)(2) provides that severance pay is allowable only when payment is required either by: (1) law, (2) an employer-employee agreement, (3) an established policy that is, in effect, an implied agreement on the consultant’s part, or (4) the circumstances of the particular employment.

Normal severance pay relates to recurring, partial layoffs, cutbacks, and involuntary separations. These costs are allowable when they are properly allocated. By contrast, *abnormal severance* refers to any mass termination of employees, which is usually unpredictable. Actual costs of normal severance pay must be allocated to all work performed at the consultant’s facility. Accruals of normal severance pay are acceptable if the amount is both (1) reasonable in light of prior experience, and (2) is allocated to both Government and non-government work. For accruals, FAR 31.205-6(g)(5) notes that “Abnormal or mass severance pay is of such a conjectural nature that accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, the Government will consider allowability on a case-by-case basis.” Special

compensation paid to terminated employees after a change in management control is unallowable to the extent that it exceeds normal severance pay.

7.13—Supplemental Benefits

In many cases, executives have available to them enhanced or supplemental benefits that are not available to the majority of the workforce. These supplemental benefits or executive benefits should be evaluated on a case-by-case basis to determine their levels of compliance with applicable subparts of FAR 31.205-6 and the Cost Accounting Standards. The reasonableness of these benefits should be evaluated based on market surveys or other available data. The prevalence of such plans within the industry should also be considered in determining reasonableness.

A. Supplemental Executive Retirement Plans (SERPs)

[References: FAR 31.205-6, CAS 412, ERISA]

These plans are designed to provide executives with earned benefits in excess of amounts payable under qualified retirement plans. These plans are often referred to as “ERISA Excess Plans.” These plans should be evaluated in accordance with FAR 31.205-6(j) and CAS 412.

B. Long-Term Incentive (LTI) Plans

[Reference: FAR 31.205-6(i)]

LTI plans are compensation plans that have an award period of two or more years. These payments typically are based on the achievement of long-term business goals or as a method of retaining key executives. The most common LTI plans for publicly-traded companies are based on stock options, which are unallowable per FAR 31.205-6(i).

C. Executive Severance

[Reference: FAR 31.205-6(g)]

Severance payments should be evaluated in accordance with FAR 31.205-6(g). Most severance policies are based on a formula that relies on length of service/employment as the determining criterion in the calculation of the severance amount. In many cases, executives are awarded severance in excess of the normal or established policy. In many instances, severance payments are based on executive employment contracts; however, the fact that a severance payment is based on an executive employment contract does not necessarily support the amount as reasonable.

D. Golden Parachutes

[Reference: FAR 31.205-6(l)(1)]

“Golden parachutes” are payments made under a contract entered into by a consultant and key personnel under which the consultant agrees to pay certain amounts to its key personnel in the event of a change in ownership or control of the consultant. The costs of golden parachute benefits are expressly unallowable per FAR 31.205-6(l)(1).

E. Golden Handcuffs

[Reference: FAR 31.205-6(l)(2)]

FAR 31.205-6(l)(2) provides that special compensation paid to an employee is unallowable if the compensation is contingent on an employee remaining with the organization after an actual or prospective change in management control. These costs are frequently referred to as “golden handcuffs.”