

5-803.1 Audit of Executive Compensation

- a. The contractor's executive compensation system should be evaluated separately, even if the contractor does not have a separate pay structure for executives. FAR 31.205-6(b)(2) provides compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Policies and procedures for administering the compensation of executives should be evaluated using the guidance in 5-808, as appropriate to the circumstances. Some executives are also owners or in some other manner may directly influence their own compensation levels. See 6-414 for criteria to use in evaluating compensation under those circumstances.
- b. The contractor's organizational structure should identify the contractor's executive positions. Generally, the list of contractor executives would include anyone with the title of vice president or above, and normally includes all individuals responsible for managing these primary functional areas:
 - (1) executive office,
 - (2) controller-accounting,
 - (3) legal counsel,
 - (4) engineering,
 - (5) manufacturing,
 - (6) purchasing,
 - (7) contracts, and
 - (8) individuals responsible for major programs or product lines.
- c. Top executive positions are unique and must be audited individually. Position descriptions emphasize rank, function, responsibility areas, goals to be attained, impact of decisions, and number of employees directed. Divisional executives can be distinguished from corporate home office executives by their reporting level. Executives are not a class of employees. Overpayment of one cannot normally be offset against underpayment of another. However, in large organizations there may be a class of vice presidents who have similar rank, function, and responsibility. In these cases, offsets may be appropriate.
- d. Executives may be rewarded not only for their contribution to the organization, but also on the profitability of their functional unit, as well as the overall profitability of the company. Pay packages include short- and long-term incentive pay, as well as base pay, benefits, perquisites, and services. Amounts reimbursed for the executives for the payment of taxes may also be included. These are a directly associated cost (see 51009.1), which may be allowable or unallowable, that are generated solely as the result of the incurrence of another cost. For publicly traded companies, the board of directors normally sets executive pay packages based on the compensation committee's recommendations. Details of the compensation committee's meetings and research are available in the proxy statement.
- e. An audit of the contractor's executive compensation system should include:
 - (1) Evaluation of the compensation system, as appropriate, in 5-806 to 5-811.
 - (2) Determination that the policies and procedures provide a description for how executive compensation levels are established and who approves these levels; and eligibility criteria and basis for determination of how base salary, cash bonuses, long-term perquisites, benefits, services, and incentive pay bonuses are established.

- (3) **Supplemental Benefits.** In many cases, executives have available to them enhanced or supplemental benefits which are not available to the majority of the workforce. These supplemental benefits or executive benefits should be evaluated on a case by case basis. The supplemental plans should be evaluated in accordance with the applicable subparts of FAR 31.205-6 and CAS. These benefits should be evaluated for reasonableness based on market surveys or any other available data. The prevalence of such plans should also be considered in determining reasonableness. For example, if a survey states that the average Long-Term Incentive (LTI) Payment for a contractor is 10% of base salary, a 10% LTI plan would not necessarily be reasonable. The reasonable amount could be significantly different, or the payment could be unreasonable altogether if only a small percentage of the participating companies have LTI plans. A few of the supplemental or enhanced executive benefits that should be audited in detail are described below:
- (a) **Supplement Executive Retirement Plans (SERPs).** These plans are designed to provide the executive 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. It is the contractor's responsibility to demonstrate the reasonableness of a SERP by providing the auditor with comparable market data. If the contractor is unable to provide measurable market data for comparison purposes, the auditor should attempt to determine a reasonable amount or reasonable percentage of base salary for total pension expenses based on surveys or other sources. If the auditor is unable to obtain comparable market data to demonstrate the reasonableness of material SERP costs, the auditor should challenge the costs and report this as a significant deficiency.
 - (b) **Deferred Compensation.** Deferred compensation is an award given by an employer as compensation to an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods before the date of receipt by the employee. The cost of deferred awards shall be measured, allocated, and accounted for in compliance with CAS 415 in order to be allowable. There are many forms of deferred compensation, such as Split-Dollar Life Insurance and "rabbi trusts." Split Dollar Life Insurance is a plan that gives both the employer and employee an interest in a cash value life insurance policy on the employee's life. A rabbi trust is used to accumulate deferred compensation, usually to fund a SERP. The amount of the award should also be evaluated accordance with CAS 415.
 - (c) **Long-Term Incentive plans.** LTI plans are compensation plans that have an award period of two or more years. These payments are typically based on achievement of longterm business goals or as a method of retaining key executive talent. The most common LTI plans are based on stock options that are unallowable per FAR 31.205-6(i). Long Term Incentive payments should be evaluated on a case-by-case basis, including prevalence of such plans, in order to determine reasonableness.
 - (d) **Executive Severance.** 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. Contractors often argue that 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.

This amount should be evaluated based on severance policies of comparable executive positions in accordance with FAR 31.205-6(b)(2). Refer to 7-2107 for additional guidance on severance payments.

- (4) The costs of "golden parachute" benefits were made expressly unallowable in FAR 31.205-6(l)(1), effective April 4, 1988. Refer to 7-2107.8 for additional guidance on the evaluation of "golden parachute" benefits.
 - (5) A comparison of executive pay (salaries, bonuses, and deferred compensation) for the current year to several past years for the purpose of establishing trends. The auditor should obtain the contractor's explanation and justification for significant increases. Also, consider the company's financial performance trends relative to the trends in executive compensation. (See 6-414)
- f. When evaluating the contractor's market comparisons of top executive pay (see 5808.8), the executive compensation components being evaluated should be consistent with that shown in executive compensation survey data. Survey data most frequently includes base pay and cash bonuses combined and long-term incentive pay as a percentage of base pay.
 - g. 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. 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 exceeds the particular industry's average.
 - (1) Examples of such financial performance measurements may include the following:
 - (a) Revenue Growth
 - (b) Net Income
 - (c) Return on Shareholder's Equity
 - (d) Return on Assets
 - (e) Return on Sales
 - (f) Earnings per Share
 - (g) Return on Capital
 - (h) Cost Savings
 - (i) 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 being a Government contractor.
 - (3) Use of a particular criterion to justify higher than average compensation should be applied consistently over a period of years, with both increases and decreases in the performance measure reflected in the changes to compensation claimed as reasonable.
- h. If the audit of the contractor's executive compensation system determines that significant system deficiencies exist or the contractor has established pay policies or procedures that appear to promote unreasonable compensation levels, conduct specific testing of the reasonableness of the executive compensation under FAR 31.205-6(a)(6), as outlined in 6414.

5-808.8 Evaluation of External Equity and the Market Comparison Process

- a. External equity or competitiveness refers to the relationship of the contractor's pay levels relative to that of its labor and product market competitors. The process is referred to as the market comparison process and focuses on the cash element of the total compensation package. It is accomplished by comparing the actual wage and salary pay levels for jobs within an entity to wage and salary pay levels established in the labor market for the same job. Data regarding pay levels existing in the relevant labor market is obtained from pay surveys. The specific jobs that are included in the market comparison process are referred to as benchmark jobs.
- b. FAR 31.205-6(b)(2) provides four factors to be considered when evaluating the reasonableness of compensation costs (refer to 5-802d.). It also provides that the appropriate factors for evaluating the reasonableness of each element of compensation depend upon the degree to which these factors are representative of the labor market for the job being evaluated. Other factors having a direct impact on the labor market for a job include (1) the supply and demand for sought after skills and abilities, and (2) the extent of competition in product and service markets. Additionally, a contractor must consider internal factors such as its ability to pay, business strategies, productivity, and the skills and abilities of its work force when evaluating particular labor markets.
- c. In administering its market comparison process, the contractor must establish control activities relating to the relevant market and the source of pay survey data.
 - (1) Relevant Market. The contractor's selected benchmark jobs are the basis for defining its relevant labor markets. The primary relevant labor market for a job generally includes companies that the contractor competes with for similarly skilled employees or the source of supply. This market consists of the geographic area(s) within which it would ordinarily expect to recruit all potential employees for a job and the geographic area(s) to which it would ordinarily expect to lose employees in that job. These geographic areas may be identical but need not be. This market can be defined within a geographic area, which consists of all or similar companies in the local, regional, national, or international market. Typically, the contractor would evaluate where it loses and finds employees to establish the initial basis of its relevant labor market.
 - (a) The relevant market will vary among each contractor and job family depending on pay objectives and the skills being evaluated. The relevant labor market will change depending on the job family being evaluated. For example, exempt jobs (administrative, professional, and managerial) tend to compete on a regional or national basis, while nonexempt (clerical) and hourly (production) jobs are most likely to compete in local and regional markets. However, generalizations of labor markets are not always correct. In large cities and metropolitan areas, high concentrations of engineers will translate into a regional labor market instead of a national market.
 - (b) Wages and benefits tend to vary according to the size of an organization. Accordingly, firms similar in size to the contractor should be included in the relevant market. The factor of size is most relevant in influencing pay for executives and to a lesser degree exempt and nonexempt.
 - (c) The factor of industry in defining the relevant market of a job relates to the company's competition in its product/service markets. This is important because of cost control and ability to pay considerations. Where possible, companies of the same industry, within the relevant geographic areas, should be included in the relevant market data for the job being evaluated. The factor of industry is most influential on the pay levels of exempt jobs. Where

jobs are tied to a specific industry, as aerospace engineers are to the aerospace industry, the market for those jobs should be defined on an industry basis.

(2) External Pay Surveys. External pay surveys provide detailed data regarding market pay levels for specific jobs and are the primary tools used by the contractor to ensure compliance with its external equity pay policy and demonstrate compliance with FAR 31.205-6(b). The pay survey data identifies rate ranges and a central tendency figure such as a mean, median, or mode salary/wage level for each job. Pay surveys also provide a standard job description for each job along with career level progression charts that identify the knowledge, education, level of supervision required and work experience for each job within a particular job family. Do not use free internet surveys. They are not considered independent or objective.

(a) Three sources of pay surveys are available to a contractor making market comparisons:

- Published surveys that are available for the general public to purchase regardless of participation in the survey.
- Private surveys based upon data from survey company clientele and which only participants may purchase.
- Contractor self-conducted surveys.

(b) Contractors generally use private surveys and self-conducted surveys. The contractor can tailor these surveys to represent its relevant market by including specific companies representing its perceived product and labor market competitors. If a contractor uses free internet surveys to support proposed or incurred compensation costs, request assistance from the field or regional compensation technical specialist to perform an independent market analysis.

(c) In most cases, no one survey is sufficient to determine the market rate of pay for all jobs. Most companies use several surveys. A primary survey may be selected with secondary surveys used to corroborate the results of the primary survey.

(d) Consider the basis for the contractor's reliance on a source of pay survey data, including internal sources. Minimal information should include:

- The company name, society, or group that collected the data.
- The expertise in job evaluation and job analysis possessed by the individuals collecting the data.
- The names of the companies contributing data and the geographical location of the source data. The relation to and influence of these companies in the contractor's labor markets.
- The size of the sample of companies reporting data and the size of the companies reporting data for each job.
- The extent that the data is based on job titles and job descriptions.
- The number of years that the survey has existed.

(e) If the contractor uses internally developed pay surveys, determine if the contractor independently ensures that they are unbiased and reliable.

(f) Evaluation of the contractor's selected pay surveys should consider if:

- The survey provides specific job classifications with corresponding job content survey descriptions that identify duties, responsibilities, and experience. An acceptable

alternative would be a maturity-curve survey because of difficulties encountered in evaluating professional, scientific, or engineering jobs.

- Well-defined written policies and procedures are established detailing what criteria are used to select the pay surveys in evaluating its wages (i.e., geographical location, company size, and type of industry).
- The pay surveys provide the weighted average rates (or median) by job. Also, the survey should provide sufficient range values, minimum and maximum rates, and/or percentile and quartile data to validate the average rate and changes to pay structures.

(g) Deficiencies in the contractor's selection and use of pay surveys include:

- Lack of job descriptions in pay surveys that cause the contractor to benchmark jobs based on position titles only. The use of job titles only in benchmarking does not ensure proper comparability of jobs.
- Lack of weighted average rate (or median) in the pay survey. Pay surveys may provide only the minimum, midpoint, and maximum pay ranges for each job classification. The midpoint of the range would not be reflective of the market rate because survey participants actually pay employees under the minimum and over the maximum.
- The contractor is unable to rationally support its basis for relying on the survey data used to make market comparisons.
- The pay survey the contractor uses is not representative of its labor market and there is no supporting data for the selection criteria.
- The contractor's compensation data were not excluded from the pay survey weighted average.
- The contractor does not remove identifiable and measurable unallowable compensation elements from market survey data prior to benchmarking.

d. Management is responsible for determining the extent to which external market considerations are used to monitor and influence its pay levels for the purposes of:

- (1) ensuring that pay rates are sufficient to attract and retain employees
- (2) controlling labor costs so that the organization's product and service prices are competitive, and
- (3) ensuring that compensation paid for services rendered on Government contracts is reasonable in accordance with FAR 31.205-6(b).

e. Evaluate and test the contractor's control activity over the market comparison process to determine that:

- (1) A valid match is obtained when comparing the job descriptions and career levels for the contractor's job(s) included in the market comparison process and the job descriptions and career levels for the job(s) included in the market pay survey(s).
- (2) The relevant labor market selected for those jobs included in the market comparison process takes into consideration the factors identified in FAR 31.205-6(b)(2) that are representative of the labor market for the job being evaluated.
- (3) The actual wages and salaries paid by the contractor to its employees for services rendered in the performance of Government contracts remains reasonable in accordance with FAR

- 31.205-6(b)(2) and FAR 31.201-3 for particular employees, job classes of employees, and/or between the compensation packages of employees in jobs included in the same pay grade.
- (4) Corrective action is taken when necessary to bring into line the actual wages and salaries for those jobs found to have unreasonable levels of compensation. Unreasonable levels of compensation occur when the contractor's actual average (or median) rate of pay for a job class or grade exceeds by 10 percent the weighted average (or median) market rate reported in the pay survey. See 6-413.4a for a discussion of DCAA policy regarding the use of the 10 percent range of reasonableness when evaluating compensation costs.

5-802 Background Information

- a. Compensation for personal services is one of the largest components of cost incurred under Government contracts. It includes all remuneration paid currently or accrued, in whatever form, and whether paid immediately or deferred, for services rendered by employees to contractors during contract performance. The objective of a compensation system is to provide the level of pay and benefits necessary to attract, retain, and motivate employees to direct their efforts toward achieving the goals of the organization. To be considered adequate, a contractor's compensation system must be reliable, be subject to applicable management control objectives and activities, and result in allowable, allocable and reasonable compensation costs charged to Government contracts in accordance with FAR provisions.
- b. The regulatory foundation for audits of contractor compensation systems resides in FAR 42.302, FAR 31.201-3, and FAR 31.205-6. FAR 42.302(a)(1) provides that the contract administration office will review a contractor's compensation structure. FAR 31.201-3, Determining reasonableness, provides general criteria for determining whether a cost is reasonable in its nature and amount, and FAR 31.205-6, Compensation for personal services, provides both general criteria and additional requirements for evaluating the allowability, allocability, and reasonableness of the different elements of compensation.
- c. As provided in FAR 31.205-6(a), to be allowable, total compensation:
 - (1) 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) for individual employees or job classes of employees, must be reasonable for the work performed,
 - (3) 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) is not presumed to be allowable where the contractor introduces major revisions of existing compensation plans or new plans and the contractor has not provided the cognizant ACO, either before implementation or within a reasonable period after implementation, an opportunity to review the allowability of the changes,
 - (5) costs that are unallowable under other paragraphs of FAR 31.2 are not allowable under FAR 31.205-6 solely on the basis that they constitute compensation for personal services, and
 - (6) costs for certain individuals (e.g., owners of closely held corporations, immediate family members, and others with a substantial financial interest) require special consideration. For these individuals, compensation must be reasonable for the personal services rendered; and not be a distribution of profits (which is not an allowable contract cost). Refer to 6-414 for guidance on evaluating the reasonableness and allowability of compensation costs to individuals who pose a higher risk of unreasonable compensation.
- d. As provided in FAR 31.205-6(b)(2), Compensation not covered by labor management agreements, compensation for each employee or job class of employees is considered 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. The reasonableness of compensation is directly influenced by the compensation practices of other firms and by the supply and demand for a job as measured in the labor market for the job being evaluated. 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, as well as those factors identified at subparagraph (b)(2) of the cost principle. Examples of factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms:

- of the same size,
 - in the same industry,
 - in the same geographic area; and
 - engaged in similar non-Government work under comparable circumstances.
- e. Certain elements of compensation are made expressly unallowable by FAR 31.205-6. These include compensation based upon changes in the prices of corporate securities (31.205-6(i)) and compensation in excess of specific limitations on the allowability of compensation for certain contractor personnel (31.205-6(p)).
- f. As provided in FAR 31.205-6(b)(1), special provisions exist for determining the reasonableness of compensation amounts established under “arms length” labor management agreements. Refer to the guidance at 6-413.1 for evaluating compensation costs set by the provisions of a labor-management agreement.