

## Executive Compensation – What Exactly is Reasonable?

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The Defense Contract Audit Manual states in Section 6-413 that the compensation costs of owners, some executives, and certain other [highly compensated] employees have a higher risk of unreasonable compensation and will not be accepted on the basis of a compensation system audit without *specific testing to substantiate the reasonableness* of the compensation. It then instructs auditors to compare each element of compensation to those 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.

The DCAM provides very specific guidance to the effect that “A compensation element is considered unreasonable if the contractor's compensation for that element exceeds the survey data weighted average (or median) rates by 10 percent.” This permissible variance is often referred to as the “Range of Reasonableness.” The 10 percent allowable variance is both fixed and arbitrary and because the DCAM permits the auditor to measure the variance from either the Mean (average) or the Median, the auditors usually pick whichever one allows the least variation (disallows the most cost). To put it bluntly, this is NOT good analytical practice. Means and Medians are very different. Both have their uses, but they are not interchangeable.

In a recent case before the Armed Services Board of Contract Appeals (ASBCA), case [Nos. 56105 and 56322, J. F. Taylor, Inc.](#), January 18<sup>th</sup>, 2012, the Board concluded that “there are statistical flaws in the government methodology for determining reasonable compensation...” and upheld all but \$42,000 of the \$590,000 disallowed by DCAA.

The Board identified eight (8) specific flaws in the methodology, including:

1. The 10 percent range of reasonableness
2. The use of different surveys with significantly different population sizes
3. Lack of consideration of financial performance
4. Lack of consideration of any factors other than financial (such as security clearances or customer satisfaction)
5. Use of different industry classifications for the same contractor in different years
6. Use of different titles for the same positions and same people across years
7. Use of different salary survey data in different years
8. Mixing and matching of means and medians from different surveys

It was bad day for the DCAA, but it was a very good day for the rest of us.

More often than not, the DCAA treats questioned executive compensation as a matter of fact rather than simply a question. At Watkins Meegan, we often assist clients in defense of their positions when executive compensation costs are questioned and when issues are elevated, work closely with their attorneys to resolve questioned costs. Above all, we promote a proactive approach to defending the reasonableness of executive compensation; waiting until costs are questioned to decide how to defend your position puts you behind the curve.