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Is Your Executive Compensation Package Fully Allowable?

Most contractors think that as long as their executives' compensation is less than the statutory cap (currently set at $693,951) they're in the clear. Sadly, that's not the case.

The compensation cap represents a limit on the amount of compensation for any individual employee that can be charged to Government contracts, either directly or indirectly. Amounts in excess of the cap are unallowable by statute, but amounts less than the cap are still subject to a "reasonableness test."

Some readers are asking "don't you mean the top five most highly compensated employees?" No, that changed with the passage of the 2012 National Defense Authorization Act (NDAA). The Senate version of the NDAA included a provision to drop the cap to $400,000, an amount equal to the President's salary. The House included a provision in its version that left the current benchmark of $693,951 in place, but extended it to all contractor employees instead of just the top five.

In the end, the NDAA bill the President signed on December 31st, 2011, included the House language. So, the cap remains at the benchmark set each year by OMB, but is now effective for all contractor employees. By the way, when the OMB finally gets around to the long overdue update of the benchmark, it will likely rise to more than $750,000.

If that were not enough, the White House is once again calling for a dramatically lower cap. On January 31st, the acting head of the Office of Federal Procurement Policy (OFPP) posted an entry to the OMB Blog entitled "Ending the Overpayment of Federal Contractor Executives." In it, he called the current executive compensation benchmark "far in excess of what can be justified" and called on Congress to "abolish the outdated statutory formula" and tie the cap to the top salary of the Government executive pay schedule - $200,000.

Legislators from Senator Charles Grassley (R-IO) to Senator Barbara Boxer (D-CA) have echoed this call and in the current Congressional environment, it could actually happen!

But, in the mean time, we are left with the two-part test consisting of the statutory limit set by Congress and the OMB and the reasonableness test administered by Government auditors – usually by the Defense Contract Audit Agency (DCAA).

So, how does that reasonableness test work, anyway?

The Defense Contract Audit Manual (DCAM) 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 refers auditors to Section 6-413 which instructs auditors to compare each element of compensation (salary, bonuses, stock grants or options, etc.) 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.

Now, on the surface, this all seems very logical. The problem is, they just don't do a very good job of it.

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 since the DCAM

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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 18th, 2012, the 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% 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 DCAA, but it was a very good day for the rest of us.

More often than not, DCAA treats questioned executive compensation as matter of fact rather than simply a question. Unfortunately, many contracting officers are reluctant to challenge DCAA on anything; much less an issue as politically charged as executive compensation. As a result, many of these issues end up before the ASBCA just as the Taylor case. At Watkins Meegan, we often assist clients and work closely with their attorneys to resolve questioned costs in cases like this.

Has DCAA questioned compensation of your employees, executive or otherwise? We can help with analysis to support your response or refer you to counsel with experience in the area.

Update (8/15/2012): This morning, the government request for reconsideration of the J.F. Taylor decision was denied. The government offered four different reasons for reconsideration of the decision and ALL were rejected by the ASBCA.

J. F. Taylor, Inc. was represented before the ASBCA by Nicole J. Owren-Wiest and Richard B. O'Keeffe, Jr. of Wiley Rein LLP.

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