

# FORVIS



## **Select Cost Principles: Compensation, Travel, Legal, and Related Costs**

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# Your instructor



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# Agenda

- Regulation Applicability
- Cost Allowability
  - FAR 31.201
  - Directly Associated Costs
- Compensation
- Travel Costs
- Professional, Consultant, & Legal Costs
- Best Practices
  - Policy & Procedures
- Case laws

# Regulation Applicability

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# FAR Cost Principles are used:

- When cost or pricing data is submitted
- When cost analysis is performed
- When cost is used to establish a price for a contract or a contract modification
  
- Contract Types
  - Cost Reimbursable
  - Flexibly Priced
  - Time & Material
  - Firm Fixed Price

# Cost Allowability

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# Cost Allowability – FAR 31.201-2

- (a) A cost is allowable only when the cost complies with all of the following requirements:
  1. Reasonableness
  2. Allocability
  3. Standards of the CASB or GAAP
  4. Terms of the Contract
  5. Cost Principle limitations

# Reasonableness – FAR 31.201-3

- Definition
  - A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a **prudent person** in the conduct of a **competitive business**.
- Factors in determining whether a cost is reasonable
  - **Ordinary and necessary** for the conduct of the contractor's business or the contract performance
  - Generally accepted **sound business practices**, arm's-length bargaining, and Federal and State laws and regulations
  - The contractor's **responsibilities** to the Government, other customers, the owner's of the business, employees, and the public at large, and
  - Any **significant deviations** from the contractor's established practices
  
- A cost is unreasonable in amount if the amount expended exceeds the benefits received



# Determining Allocability – FAR 31.201-4

- Definition
  - Is incurred specifically for the contract
  - Benefits both the contract and other work and can be reasonably distributed
  - Is necessary for overall operation of the business
  
- Often draws improper disallowances
  
- Titles such as ‘Commercial Selling’ lead to misunderstandings

# Determining Allowability – FAR 31.201-2(c)

- When contractor accounting practices are inconsistent with this subpart FAR 31.2, costs resulting from such **inconsistent practices in excess of the amount** that would have resulted from using practices consistent with this subpart are unallowable.
- “Consistency is key”
- Treatment of direct and indirect costs
  - Similar costs incurred for the same purpose must be treated the same.

# Determining Allowability – FAR 31.201-2(d)

- A contractor is responsible for accounting for costs appropriately **and for maintaining records**, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements.
- The contracting officer may disallow all or part of a claimed cost that is inadequately supported.

# Directly Associated Costs – FAR 31.201-6

- A cost which is generated solely as a result of the incurrence of another cost, and which would not have been incurred had the other cost not been incurred
- When an unallowable cost is incurred, its directly associated costs are also unallowable
- Example: Salary expenses of employees who participate in unallowable activities
- Generally, salary and travel expenses
- How do auditors find directly associated costs?

# Compensation

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# What is Compensation per the FAR 31.205-6

- Compensation means the total amount of wages, salary, bonuses, deferred compensation and employer contributions to defined contribution pension plans for the fiscal year, whether paid, earned, or otherwise accruing, as recorded in the contractor's cost accounting records for the fiscal year. ” — is generally allowable if reasonable in amount for the work performed
- Severance pay: allowable only to the extent it is required by law, employer-employee agreement, or circumstances of the particular employment
- Stock options and dividend payments: unallowable
- Pension costs: allowable dependent on many factors

# What is Compensation per the FAR 31.205-6 (Continue)

- General Criteria:
  - Must be for work performed by the employee in the **current year**
  - Must be **reasonable** for the work performed
  - Must be based upon and conform to the terms and conditions of the contractor's **established compensation plan or practice** (consistent application)
  
- **NOT be a distribution of profits**

# Bonuses and Incentive Compensation

- Allowable provided:
  - Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such payment; and
  - Basis for the award is supported.
    - + Are there any metrics used?



# Compensation Plan

- Components of a Compensation System
  - Job Descriptions
  - Job Evaluation
  - Pay Structures
  - Salary Surveys

# Compensation Plan Components

- **Develop a program outline**
- Designate an individual to oversee designing the compensation program
- **Develop a compensation philosophy**
- **Conduct a job analysis of all positions**
- **Evaluate jobs**
- **Determine grades**
- **Establish grade pricing and salary range**
- **Determine an appropriate salary structure**
- Develop a salary administration policy
- Obtain top executives' approval of the basic salary program
- Communicate the final program to employees and managers
- Monitor the program

# Compensation – Challenges

- Reasonableness – overall
- Bonuses
- Lack of wage or salary survey to support
- Inconsistency
- T&M Contracts - Resume and Labor Category requirements

# Limitation on Allowability of Compensation

- FAR 31.205-6(p)
- Executive compensation caps
- Some compensation caps apply to “senior executives”
  - Prior to January 2, 1999: Chief Executive Officer (CEO) + Top 4 + Top 5 at intermediate home offices or segments
  - Effective January 2, 1999: five most highly compensated employees in management positions at each home office and each segment

# Compensation Caps – Before June 24, 2014

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

Source: <https://www.whitehouse.gov/wp-content/uploads/2017/11/ContractorCompensationCapContractsAwardedBeforeJune24.pdf>

# Current Compensation Caps

- Updated Annually
  - 1/1 – 12/31/24: \$646,000
  - 1/1 – 12/31/23: \$619,000
  - 1/1 – 12/31/22: \$589,000
  - 1/1 – 12/31/21: \$568,000
- Source: <https://www.whitehouse.gov/wp-content/uploads/2023/11/ContractorCompensationCapContractsAwardedafterJune24-UPDATE-NOV-2023.pdf>

# DCAA's Approach – SALARY SURVEYS

## EXECUTIVE COMPENSATION REVIEW FOR CALENDAR YEARS 2010 THROUGH 2012

Sales	Executive	Claimed Cash Comp (1)	Survey Cash Compensation Results (2)				Survey Avg. + 10% ROR Cash Comp.	Total Unreasonable
			Towers Watson	ERI	HRA	Mercer		
<b>CY 2010</b>								
\$16.0M	President	\$ 408,489	\$ 219,941	\$ 219,036	\$ 209,156	\$ 253,457	\$ 247,937	\$ 160,552
	CEO	468,140	288,378	319,724	259,374	341,566	332,487	135,653
	VP of A	325,387	ND	169,592	ND	196,272	201,225	124,162
	VP of B	325,234	ND	152,920	ND	162,728	173,606	151,628
	SR Analyst	232,316	ND	ND	ND	ND		
							<b>Subtotal:</b>	<b>\$ 571,995</b>
<b>CY 2011</b>								
\$18.0M	President	\$ 457,863	\$ 227,963	\$ 219,844	\$ 214,708	\$ 263,056	\$ 254,532	\$ 203,331
	Director	529,097	300,519	315,966	266,259	355,554	340,532	188,565
	VP of A	342,544	ND	174,930	ND	218,277	216,264	126,280
	VP of B	348,306	ND	148,117	ND	159,299	169,079	179,227
	SR Analyst	231,260	ND	ND	ND	ND		
							<b>Subtotal:</b>	<b>\$ 697,403</b>
<b>CY 2012</b>								
\$12.0M	President	\$ 429,698	\$ 218,036	\$ 201,387	\$ 220,720	ND	\$ 234,719	\$ 194,979
	Director	486,958	275,937	275,555	273,714	ND	302,576	184,382
	VP of A	316,340	ND	179,537	ND	ND	197,491	118,849
	VP of B	331,239	ND	149,948	ND	ND	164,943	166,296
	PM	173,428	ND	ND	156,423	ND	172,065	1,363
							<b>Subtotal:</b>	<b>\$ 665,869</b>
							<b>Subtotal:</b>	<b>\$ 1,935,267</b>

# DCAA's Approach (continued)

## (2) SURVEYS USED TO DETERMINE THE REASONABLENESS OF EXECUTIVE COMPENSATION:

Before performing our review, we requested information from the contractor in order to understand and evaluate the basis of the claimed compensation costs and how the company establishes executive pay levels. XXXXXXXX, Inc. indicated its claimed compensation is based on management judgement. We were provided with very limited position descriptions for the executives in the request. Had the contractor provided more detailed position descriptions, some of our position matches might have been different from the survey matches used in our analysis. As a result, our conclusions could have been impacted had we been provided more detailed position descriptions. Also, we were unable to benchmark the Sr. BP Analyst in CY 2010 and CY 2011 without a more detail position description; therefore we could not determine the reasonableness of the claimed compensation. We were not provided with any other information to support the claimed compensation for the executives. We used the executive titles and the available position descriptions in the benchmarking of the executives, using the available surveys, below.

Towers Watson: 2010/2011 Top Management Comp Calculator by Towers Watson Data Services. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Officer and Chief Executive Office in the Engineering Services Industry.

ERI: Economic Research Institute Executive Compensation Assessor: July 1, 2010, July 1, 2011 and July 1, 2012 Databases. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Officer, Chief Executive Officer and Vice President using the North American Industry Classification System (NAICS) Code 541330, Engineering Services.

HRA: 2010 Compensation Survey Report, by Human Resource Association of The National Capital Area. We used the median total cash compensation based on companies with Gross Revenue Less Than \$25 Million for the Chief Operating Officer, Chief Executive Officer and Program/Project Senior Director.

Mercer: 2008 Mercer Benchmark Database Executive Survey Report by Mercer LLC. We used regression analysis for median total cash compensation based on annual sales for the Chief Operating Office, Chief Executive Officer and Top Division Executive from Professional Services.

**SUMMARY:** We have determined that a total of \$1,935,267 of the claimed cash compensation for the executives is unreasonable in accordance with FAR 31.205- 6(b)(2). The audit position is based on comparisons with the same or similar executive positions from organizations of similar size and industry as XXXXXXXX, Inc. All survey data was aged to the contractor's Calendar Year midpoints of June 30, 2010, June 30, 2011 and June 30, 2012 using Salary Budget Trend Data as published by WorldatWork. We were unable to benchmark the Sr. BP Analyst in CY 2010 and CY 2011 without a more detail position description; therefore we could not determine the reasonableness of the claimed compensation.



# DCAA Methodology

- Evaluate all contractor labor categories
  - DCAA often does not consider:
  - Survey Match of Labor Category
    - + Additional responsibilities, education, experience, ownership role
  - Industry
  - Profitability
  - Geographical Location (National Pool of Executives)
  - Bonus
  - Question entire amount if not documented according expectations
  - Exceptions to spot bonuses
- Rather than considering REASONABLENESS as defined in the cost principles, DCAA uses the output generated by flawed surveys as input to a mathematical formula. All compensation over the formula amount is “unreasonable”.
- Unfortunately, DCMA may rubber stamp such findings.

# Travel Costs

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# Travel Costs – FAR 31.205-46

- Travel Costs:
  - Airfare
  - Transportation
  - Lodging
  - Meals
  - Incidental expenses
  
- Related to travel costs:
  - FAR 31.205-6, Compensation
  - FAR 31.205-14, Entertainment Costs
  - FAR 31.205-34, Recruitment Costs
  - FAR 31.205-35, Relocation Costs
  - FAR 31.205-43, Trade, Business, Technical, and Professional Activity Costs
  - FAR 31.205-51, Alcohol Costs

# Travel Costs (Continued)

- Travel costs typically follows the type of labor effort
  - Direct travel if effort is for direct labor
  - Indirect travel if effort is for indirect labor
  
- Maximum daily amounts apply – **per diem rates**
  - Factors in fiscal year, month, state, city or zip code.
  - <https://www.gsa.gov/travel/plan-book/per-diem-rates>
  
- Company's Policy and Procedures apply

# Travel Costs (Continued)

- Airfare
  - Lowest priced airfare available
  - Few exceptions: during normal business hours, circuitous routing, excessively prolong travel, medical needs, or not reasonably available to meet mission requirements.
  
- Per Diem - reasonableness
  - Transportation – Type of car (luxury, SUV), need basis
  - Lodging – Per diem is based on the location of the work activities
  - Meals – Different per diem rates for breakfast, lunch, and dinner
  - Incidental expenses – Once a day with same per diem rate
  - First and Last day of travel – 75% of per diem
  - Receipt is not required for each expenditure less than \$75

# Related Travel Cost Principles

- Alcohol (FAR 31.205-51) – Meals
- Compensation (FAR 31.205-6) – Hazard pay
- Entertainment (FAR 31.205-14) – Local events
- Trade, business, technical, and professional activity costs (FAR 31.205-43) – travel for trade shows / conferences
  
- Document the purpose of the trip.
  - Allocability: Unallowable purpose = unallowable travel costs.

# Professional, Consultant, & Legal Costs

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# FAR 31.205-33, Professional and consultant service costs

- “Services rendered by persons who are members of a particular profession or possess a special skill and **who are not officers or employees of the contractor.**”
- Examples include **legal, economic, financial, or technical** consultants
- Professional and consultant service costs cannot be contingent upon recovery of the costs from the government
  
- Allowability factors:
  - Nature and scope of the service rendered in relation to the service required
  - Necessity of contracting service (considering contractor’s capability)
  - Whether the services can be performed more economically by employment rather than by contracting
  - Qualifications of the consultant
  - Adequacy of the contractual agreement for the service (description of the service, estimate of time required, rate of compensation)



# FAR 31.205-33, Professional and consultant service costs (Continued)

- Must be supported by:
  - Details of agreement and actual services
  - Invoices with sufficient detail to allow an evaluation of what was done
  - Work product or memorandum of meetings

# DCAA Guidebook – Professional and Consultant Services

- FAQ Scenarios provided in DCAA guidebook
- Scenario 1: A contractor uses a temporary **accounting service** to perform bookkeeping activities. The accounting service provided several individuals to input vendor invoices into the contractor's accounts payable system after the buyers approved them for payment. Are these costs professional and consultant services?
- Answer: No. Accounting, by any reasonable interpretation, is a profession under the FAR 31.205-33(a) definition. However, the type and nature of the work performed in this example represents clerical effort that is not a professional and consultant service. Accordingly, it would not be appropriate to evaluate these costs using FAR 31.205-33 criteria.

# DCAA Guidebook – Professional and Consultant Services (Continue)

- FAQ Scenarios provided in DCAA guidebook
- Scenario 2: The contractor enters into an agreement with an individual to perform program management activities for one of its contracts. **In this capacity, the individual worked directly with contractor employees and contractor management to track and monitor progress on contract performance.** Is this a consultant and should the audit team require documentation consistent with the FAR 31.205-33(f) criteria?
- Answer: No. In this circumstance, **the individual is equivalent to a contractor employee.** The contractor integrated the individual as an inherent part of operations and no single work product exists to demonstrate the effort expended. The individual's contribution was to the overall management of contract performance. Accordingly, it would not be appropriate to evaluate these costs using FAR 31.205-33 criteria.

# Costs Related to Legal and Other Proceedings – FAR 31.205-47

- Costs include:
  - Administrative and clerical expenses
  - The costs of legal services
  - The costs of the services of accountants, consultants, or others retained by the contractor or subcontractor to assist it
  
- Unallowable cost when in connection with:
  - Criminal proceedings
  - Fraud
  - Debarment or suspension by an executive agency
  - Void a contract or termination of a contract due to violations.
  - Suits amongst contractors
  - Claims against the Government

# Best Practices

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# Best Practices

- Establish policies and procedures
  - Purpose is to set good internal controls and to establish a consistent practice
  - Add elements of Cost Allowability FAR 31.201 – Reasonableness, Allocability, Standards of CASB or GAAP, Terms of the contract, and Selected Costs FAR 31.205
  - Make policy based off FAR – Compensation, Travel, Legal, etc.
  - Add elements of Directly Associated costs
  - Require the necessary documents and the specific requirements
  - Do not add additional requirements unless the company will follow it
- Reinforce Policy and Procedures with internal controls, employee training and P&P updates
- Policy and Procedures sets the standard of good practices

# Contractor Compensation Best Practices

- Be proactive and demonstrate reasonableness according to the case law and DCAM guidance.
- DCAA may not follow these steps but you can!
  - Develop a compensation plan
  - Perform and document your market research with relevant surveys (ERI, BLS etc.) and retain the documentation!
  - If compensation is later questioned, **request the basis of the questioned costs including survey results and calculations and evaluate the findings based on the case law and audit guidance.**

# Contractor Compensation Best Practices (Continue)

- Do not accept precedent setting questioned costs.
- Remember that the DCAA is not your customer!
- Ensure your point of view is documented in the audit report.
- If DCAA is not reasonable present your case to the ACO.
- Fight back and urge the ACO not to rubber stamp DCAA findings.



# Caselaw

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# Caselaw RAYTHEON COMPANY, RAYTHEON MISSILE SYSTEMS – Appeal from ASBCA Nos. 59435-59438, 60056-60061

- First Issue - lobbying hours were not recorded
  - Salaried employees worked after-hours (past 5 pm) and did not record their time.
  - Total Time Accounting - effective hourly rates were impacted as a result.
  
- Second Issue - M&A hours were not recorded
  - M&A occurs before there is any official agreement (e.g. time spent to research).
  - Contractors should review their policy and procedures in regard to economic planning or market planning to properly record unallowable time for any effort related to potential future merger or acquisition.
  
- This puts to question how to properly account for M&A time.

## Techplan, ASBCA No. 41470, 7/2/1996

- Government's Position:
  - Challenged the allegedly above-average salary paid to Techplan's CEO and major shareholder
- Techplan's Position:
  - Techplan presented evidence showing its CEO's involvement in the company's high growth rate, sustained profitability, and reputation for quality
- ASBCA Decision:
  - Salaries were allowable in part because the FAR cost principles “allow the flexibility necessary to determine reasonableness based upon generally accepted practices in the compensation field.” Techplan “could reasonably elect to set the CEO's compensation at an above average level, i.e., at the 75th percentile”

## Techplan, ASBCA No. 41470, 7/2/1996 (Continue)

- Within the decision, the ASBCA outlined steps that compensation experts would “generally accept” to evaluate the reasonableness of compensation using survey data as follows:
  - **(1) Determine the position to be evaluated;**
  - **(2) Identify survey(s) of compensation for the position to be evaluated which match the company in terms of revenue, industry, geographic location and/or other relevant factors;**
  - (3) Update the surveys to a common data point for each year through the use of escalation factors;
  - (4) Array the data from the surveys for the relevant compensation elements at various levels of compensation such as the average (mean) or selected percentiles and develop a composite number for each;
  - (5) Determine which of the numbers to use for comparative purposes;
  - **(6) Apply a range of reasonableness such as 10 percent to the number or numbers selected;**
  - (7) Adjust the actual total cash compensation for lower than normal fringe benefits; and
  - (8) Compare the adjusted compensation to the range of reasonableness.

## J.F. Taylor, No. ASBCA 56105, 4/22/2013

- Facts:
  - **Gov't disputed the reasonableness of compensation J.F. Taylor ("JFT") paid to four of its executives.** Government relied on a discredited compensation expert and made no effort to rebut JFT's statistical arguments
  - JFT's statistical expert undermined DCAA's executive compensation review methodology stating "there is no substance behind the scientific veneer" of DCAA's mathematical model for determining unallowable executive compensation
  - DCAA's erroneously used an **arbitrary 10% range of reasonableness** that did not take into consider the actual dispersion among the survey data
- Decision:
  - "[M]ethodology used by DCAA was fatally flawed statistically and therefore unreasonable." DCAA's 10% range of reasonableness ignores actual amount of dispersion among survey data

# Metron, ASBCA No. 56751, 6/4/2012

- Government's Position:
  - Issued a final decision denying and demanding repayment of Metron's executive compensation costs for two fiscal years based on a DCAA audit
  - In determining reasonableness, DCAA compared several compensation surveys and disagreed with Metron's classification of senior engineers as executives
- ASBCA Decision:
  - Metron met burden of proving questioned costs were reasonable and allowable
  - Found a single survey of high technology companies provided the best match when determining compensation amounts
  - 75th percentile was reasonable based on both financial and nonfinancial measures **(e.g., PhDs and TS/SCI clearances)**
  - DCAA's extrapolations & adjustments of survey data lacked any factual basis:
    - + **Additional survey data relied upon by DCAA “were not sufficiently comprehensive, reliable, relevant to Metron's industry, and/or the job matches were not sufficiently similar and representative to warrant material reduction of the results obtained from use of the Radford Survey data alone for the disputed positions”**
  - Rejects DCAA's use of “division” revenues and concludes total revenue is appropriate benchmark

## Metron, ASBCA No. 56751, 6/4/2012 (Continue)

- Metron Repercussion
- **Contract Audit Manual - 5-803.1 Executive Compensation**
  - “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.”

# Questions?



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