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The Cost Corner
Government Contracts Cost and Pricing: Compensation for Personal Services—Part I

By Keith Szeliga and Emily Theriault*

Welcome back to the Cost Corner, where we provide practical insight into the complex cost and pricing requirements that apply to government contractors. The current topic is Federal Acquisition Regulation (FAR) Cost Principles applicable to contracts with commercial organizations. Previous columns addressed the Cost Principles pertaining to the general criteria for determining the allowability of costs, direct and indirect costs, accounting for unallowable costs, and penalties for unallowable costs. This column begins coverage of FAR 31.205, Selected Costs, which includes forty-seven Cost Principles, each of which governs the allowability of a particular type of cost. The Cost Corner will not address all of the Cost Principles in FAR 31.205 but instead will focus on those that have, in our experience, generated the most significant questioned and disallowed costs.

FAR 31.205-6, Compensation for Personal Services (the Compensation Cost Principle), is the lengthiest and arguably most complex Cost Principle. The Compensation Cost Principle establishes: (1) six general criteria, including reasonableness, for determining the allowability of compensation costs, and (2) additional limitations on the allowability of more than a dozen elements of compensation.

This column analyzes the six general criteria for allowability of compensation costs, with a particular emphasis on reasonableness, including relevant guidance from the Defense Contract Audit Agency (DCAA) Contract Audit Manual (DCAM). The next Cost Corner will address some of the most commonly encountered "additional limitations" on specific compensation costs.

DEFINITION OF COMPENSATION

The FAR defines compensation for personal services to mean "all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor."[1] This definition is quite broad. It includes compensation in the form of cash,

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[1] FAR 31.001.

corporate securities (e.g., stocks, bonds, and other financial instruments), and any other assets, products, or services provided in exchange for services rendered by employees.[2]

Examples of compensation include salaries and wages, bonuses and incentive compensation, fringe benefits, income tax differential pay, "golden parachute" and "golden handcuff" payments, backpay, severance pay, pension costs and other postretirement benefits, deferred compensation other than pensions, and employee stock ownership plans (ESOPs).[3]

GENERAL CRITERIA FOR ALLOWABILITY

The Compensation Cost Principle establishes six general criteria for the allowability of compensation costs and specific requirements for reasonableness of compensation.[4]

First, subject to certain exceptions, 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.[5] The exceptions to this rule include certain severance pay, allowable backpay, pension costs, other deferred compensation, fringe benefits, and post-retirement benefits other than pensions.[6] The exceptions are subject to additional limitations on allowability that will be addressed in the next Cost Corner column.

The primary effect of the first criterion for the allowability of compensation is to render unallowable most types of backpay and retroactive adjustments for work performed in prior years.[7] It does not impact the allowability of backpay and retroactive adjustments for work performed in the current year.[8]

Second, the total compensation for individual employees or job classes of employees must be reasonable for the work performed.[9] The government typically analyzes reasonableness by individual employee for owners, executives, and other "high risk compensation categories" and by job class for other employees. The standard for reasonableness depends on whether the compen-

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[2] FAR 31.205-6(d)(1).

[3] FAR 31.205-6(d)–(q).

[4] FAR 31.205-6(a), (b).

[5] FAR 31.205-6(a)(1).

[6] Id.; FAR 31.205-6(g), (h), (j), (k), (m), (o).

[7] FAR 31.205-6(a)(2).

[8] Id.

[9] FAR 31.205-6(a)(2).

sation is paid in accordance with an "arm's length" labor-management agreement negotiated pursuant to the Federal Labor Relations Act or similar state statutes.[10]

Costs of compensation established under covered labor-management agreements are deemed reasonable unless the costs are "unwarranted" by the character and circumstances of the work or "discriminatory" against the government.[11] The application of a labor-management agreement intended to apply to a given set of circumstances and terms and conditions of employment, such as work involving extremely hazardous activities or work not requiring recurrent use of overtime, would be considered "unwarranted" when applied to a government contract involving significantly different circumstances and terms and conditions of employment, such as work involving less hazardous activities or work continually requiring the use of overtime.[12]

The application of a labor management agreement is "discriminatory" against the government if it results in employee compensation in excess of that being paid for similar non-government work under comparable circumstances.[13] For example, a union agreement that provided for higher wage rates for construction work on a government installation than for rates applicable to commercial construction in the same area under similar circumstances would be discriminatory.[14]

On the other hand, the application of a labor-management agreement is not "discriminatory" against the government simply because the government pays more than commercial customers if the circumstances are different. For example, a union agreement that provided for higher wage rates for construction work on hazardous sites would not be discriminatory against the government if the government paid higher rates for work performed on a hazardous government site.

Where compensation is not covered by a labor-management agreement, compensation for each employee or job class of employees must be reasonable

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[10] FAR 31.205-6(b). The FAR does not define what constitutes an "arm's length" labor-management agreement. The DCAA interprets the term to mean "agreements between independently organized labor groups, such as labor unions, and contractor management for the purpose of establishing wage increases, hours, benefits, and working conditions." DCAA, DCAM ¶ 6-413.1.c.

[11] FAR 31.205-6(b)(1).

[12] Id.

[13] Id.

[14] DCAA, DCAM ¶ 6-413.1(e).

for the work performed—there is no assumption of reasonableness.[15] Compensation is reasonable if the total of each measurable and allowable element sums to a reasonable total.[16] In determining the reasonableness of total compensation, only allowable individual elements of compensation are considered, since the government does not pay for the unallowable elements.[17]

In addition to the general criteria for reasonableness set forth in FAR 31.201-3, Determining Reasonableness, the Compensation Cost Principle requires consideration of factors the contracting officer determines to be relevant which may include the consistency of the contractor's compensation practices with other companies:

(1) Of the same size;

(2) In the same industry;

(3) In the same geographic area; and

(4) Engaged in similar non-government work under comparable circumstances.[18]

Reasonableness is a necessary condition, but not a sufficient condition, for the allowability of compensation costs. The additional limitations on specific elements of compensation apply and can render a cost unallowable even if the total compensation is reasonable.[19]

Third, the compensation must be based upon and consistent with "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."[20] The best practice for meeting this requirement is to implement and consistently follow a written compensation plan that is clearly communicated to employees. A contractor may, however, meet the requirement based on a course of dealing or oral promises to employees.[21]

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[15] FAR 31.205-6(b)(2).

[16] Id.

[17] Id.

[18] Id.

[19] See FAR 31.205-6.

[20] FAR 31.205-6(a)(3).

[21] See, e.g., Boeing Aerospace Operations, ASBCA No. 46274, 94-2 BCA ¶ 26,802 ("The past practice, even on a single occasion, was sufficient to inform the employees of the potential that the payments would be made and give rise to an expectation they would be made."), aff'd on recons., ASBCA No. 46274, 94-3 BCA ¶ 27,281; Petroleum Operations and Support Servs., EBCA No. 291-6-83, 85-2 BCA ¶ 18,037 (bonuses were unallowable where 61% of employees surveyed believed there was no agreement that the bonuses would be paid and most were "surprised" to receive them); Appeal of Symetrics Eng'g Corp., NASABCA No. 1270-20, 74-1

Fourth, the Compensation Cost Principle provides that:

> 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 ACO, either before implementation or within a reasonable period after it, an opportunity to review the allowability of the changes.[22]

The FAR contains neither a general presumption of allowability nor a presumption of reasonableness.[23] The quoted language, however, arguably creates a presumption of allowability, by negative implication, if the contractor provides the contracting officer with a reasonable opportunity to review major revisions or new compensation plans and the contracting officer does not object to the changes.[24]

Fifth, costs that are unallowable under other provisions of FAR Subpart 31.2 do not become allowable under the Compensation Cost Principle solely because they constitute compensation for personal services.[25] For example, most lobbying costs are unallowable pursuant to FAR 31.205-22, Lobbying and Political Activity Costs, and such costs would not become allowable if the contractor paid its own employees to engage in lobbying services rather than hiring an outside lobbyist.

Sixth, the Compensation Cost Principle requires "special consideration" of compensation costs for certain individuals.[26] Such individuals include owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families, and persons who are contractually committed to acquire a substantial financial interest in the contractor's business.[27] Compensation for those individuals must be reasonable for the personal services rendered and not be a distribution of profits, which is an unallowable cost.[28] Further, for owners of closely held companies, compen-

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BCA 10,553 (bonuses were allowable based on president's oral promise to pay a bonus if company had a profitable year).

[22] FAR 31.205-6(a)(4).

[23] FAR 31.201-3.

[24] See FAR 31.205-6(a)(4); Karen L. Manos, Government Contract Cost & Pricing § 13:3 (2023).

[25] FAR 31.205-6(a)(5).

[26] FAR 31.205-6(a)(6)(i).

[27] Id.

[28] FAR 31.205-6(a)(6)(ii).

sation in excess of the costs that are deductible as compensation under the IRS Code and implementing regulations are unallowable.[29]

DCAA AUDIT GUIDANCE

Chapter 6 of the DCAM, Incurred Cost Audit Procedures, includes detailed guidance for evaluating the reasonableness of compensation costs. This guidance is useful not because it is necessarily uniformly correct but because it provides insight into what contractors can expect from audits and how they can reduce audit risk.

The DCAM instructs auditors that compensation established under covered labor-management agreements is reasonable and is not to be tested against detailed criteria for reasonableness unless the agreement provisions are unwarranted or discriminatory against the government.[30] As a result, such compensation has a lower the audit risk.

Similarly, when evaluating wage increases, if the contractor's compensation system is adequate and the contractor's established practice is to provide wage increases to certain non-bargaining unit employees comparable to those provided under covered labor-management agreements, the DCAM advises auditors that they do not need to test reasonableness.[31]

With regard to compensation not established under a covered labor-management agreement, the DCAM instructs auditors to tests for reasonableness where: (1) the auditor has determined that the contractor's internal control system cannot be relied upon to demonstrate reasonable levels of compensation, and (2) the auditor has identified the potential for unreasonable levels of compensation.[32] Thus, implementing and documenting adequate internal controls for determining compensation can significantly reduce audit risk.

The DCAM provides the following additional guidance for auditors applying the enumerated factors that may be relevant when using the compensation practices and data of other firms for determining reasonableness:

- The DCAM states that size pertains to comparisons with firms of "relatively the same size in terms of number of employees or sales volume."[33] The FAR does not, however, preclude consideration of other potentially relevant measures of size including but not limited to

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[29] FAR 31.205-6(a)(6)(iii).

[30] DCAM ¶ 6-413.1.a.

[31] DCAM ¶ 6-413.2.c.

[32] DCAM ¶ 6-413.2.a.

[33] DCAM ¶ 6-413.3.a(2).

total revenue, cost of goods sold, market capitalization, or number and geographic dispersion of facilities. These measures of size may be more relevant than the number of employees or sales volume for certain types of businesses as well as businesses in certain stages of growth.

- The DCAM states that the same industry means firms "producing similar products or providing similar services."[34] For example, the compensation levels for a contractor whose principal product is shipbuilding should be compared to other shipbuilders.[35] Other examples of industries include aerospace, electrical/electronics, office equipment and computers, and research and development.[36]
- The DCAM states that "geographic area" refers to comparisons made with firms in the "same *local or regional* areas" as the contractor.[37] This guidance affords contractors considerable leeway to try to influence the appropriate level at which to define the relevant geographic area. For example, a contractor located in Albany or Buffalo might take the position that it is appropriate to consider the higher salaries paid in Manhattan because it is arguably a part of the same broad geographical region. A contractor in Manhattan, however, might argue that it would be manifestly unfair to consider the lower salaries paid in Albany or Buffalo because salaries differ significantly between the localities.
- The DCAM explains that contractors "engaged in similar non-Government work under comparable circumstances" refers to "comparable services from sources outside the contractor."[38]

DCAA acknowledges that the factors identified above may not be relevant to the same extent in every case and advises auditors that the relevance depends upon the "degree to which each of the factors is representative of the labor market for the job being evaluated."[39] This guidance gives contractors broad latitude to argue that the factors supporting a higher level of compensation are more relevant than those that might cause an auditor to question the reasonableness of compensation costs.

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[34] DCAM ¶ 6-413.3.a(3).

[35] Id.

[36] Id.

[37] DCAM ¶ 6-413.3.a(1) (emphasis added).

[38] DCAM ¶ 6-413.3.a(4).

[39] DCAM ¶ 6-413.3.b.

Salary surveys are DCAA's primary tool for testing the reasonableness of compensation.[40] The DCAM advises auditors that more than one salary survey may be required to consider the significance of the relevant factors in a particular circumstance.[41] When DCAA challenges reasonableness, the contractor can contend that a salary survey that supports a higher level of compensation is more relevant. The DCAM also directs auditors not to use "free internet salary surveys" to evaluate compensation because "there is no way to check the statistical accuracy of the data and most practicing compensation specialists regard the free surveys as non-credible sources for determining reasonableness."[42]

The DCAM instructs auditors to test reasonableness by comparing the weighted average or median wage or salary of a contractor job class with those provided in an acceptable salary survey.[43] Evaluation at the job class level reduces the risk that the DCAA will challenge the compensation paid to individual outliers. However, the DCAM advises auditors that "top executive positions" are unique and must be audited individually regardless of the individual's assignment to a job class, grade, or pay structure.[44]

The DCAM directs auditors to challenge compensation that falls outside of a 10% range of reasonableness (ROR): "Compensation is considered unreasonable if the aggregate of each allowable and measurable element of compensation exceeds the survey data weighted average (or median) rates by 10 percent."[45] DCAA has retained this guidance notwithstanding Armed Services Board of Contract Appeals (ASBCA) decisions finding the 10% threshold was arbitrary and did not justify questioning the contractor's costs.[46] Thus, contractors may have a compelling argument against the disallowance of costs that DCAA questions solely because they fall outside the ROR.

The DCAM includes additional guidance for determining the reasonableness and allowability of compensation for owners, executives, and other high risk

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[40] DCAM ¶¶ 6-413.3.c-e, 6-414.3.g(1).

[41] DCAM ¶ 6-413.3.e.

[42] DCAM ¶ 6-414.3.g(1).

[43] DCAM ¶ 6-413.3.d.

[44] Id.

[45] DCAM ¶ 6-413.4.a.

[46] See J.F. Taylor, Inc., ASBCA No. 56105, 12-1 BCA ¶ 34,920; Metron, Inc., ASBCA No. 56624, 12-2 BCA ¶ 35,066. But see Information Systems & Networks Corp., ASBCA No. 47849, 97-2 BCA ¶ 29,132.

compensation categories.[47] According to DCAA, this additional guidance is necessary because an individual's ability to influence his or her own compensation (either directly or indirectly) creates a higher risk that such employees could pay themselves unreasonable compensation.[48] If the compensation costs are considered material, the DCAM instructs auditors to evaluate the reasonableness and allowability of compensation for individual owners, executives, and other high risk employees in incurred cost audits.[49] DCAA considers all sole owners, partners, and persons owning more than 10% of the voting stock of a company to have influence over their own compensation.[50] Auditors also consider the combination of corporate voting power held by family members in determining whether an employee has the power to influence his or her compensation.[51]

The DCAM directs auditors to evaluate executive compensation based on the following process to the extent practical:

- Determine the position to be evaluated.
- Identify surveys of compensation for the position to be evaluated that match the company in terms of revenues, industry, geographic location and/or other relevant factors.
- Update the surveys to a common data point for each year through the use of escalation factors.
- 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.
- Determine which of the numbers to use for comparative purposes, defaulting to the average or median as an initial position.
- Apply a 10% range of reasonableness.
- Adjust the actual total cash compensation for lower than normal fringe benefits.
- Compare the adjusted compensation to the range of reasonableness and question differences as unreasonable.[52]

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[47] DCAM ¶ 6-414.

[48] DCAM ¶ 6-414.1.a.

[49] DCAM ¶ 6-414.1.c.

[50] DCAM ¶ 6-414.2.

[51] Id.

[52] DCAM ¶ 6-414.3.h.

The DCAM notes that executives with responsibility for overall management of a segment or firm may justify higher compensation based on superior performance as documented by financial performance that significantly exceeds the particular industry's average.[53] The contractor must show the measure of financial performance chosen to justify higher than average compensation is representative of the executive's performance.[54] High performance measured by a standard that is not affected by the executive's performance should not be considered (such as high performance resulting primarily from the contractor's status as a government contractor).[55]

The DCAM further suggests that performance is typically measured using more than one criterion such that an executive would not, for example, be considered to have superior performance based on the lone measure of sales growth, achieved through acquisitions and mergers, while the contractor is operating at a loss.[56] This guidance is questionable as applied to companies, such as startups, that focus on growth over immediate profitability.

RESPONDING TO CHALLENGES TO THE REASONABLENESS OF COMPENSATION

Government challenges to the reasonableness of compensation have not fared well before the ASBCA. Two cases, in particular, should be considered mandatory reading for any contractor that receives a challenge to compensation for personal services based on reasonableness.[57]

Collectively, those cases identified the following flaws (among others) in the DCAA's analyses:

- DCAA relied on surveys that were not sufficiently comprehensive, reliable, and specific to the contractor's industry.
- DCAA did not adequately consider the sample sizes for salary surveys.
- DCAA's labor mapping was based on titles rather than actual job responsibilities.
- DCAA arbitrarily assumed a linear relationship between size, specifically revenue, and reasonable compensation.

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[53] DCAM ¶ 6-414.3.i.

[54] DCAM ¶ 6-414.3.i(2).

[55] Id.

[56] Id.

[57] J.F. Taylor, Inc., ASBCA No. 56105, 12-1 BCA ¶ 34,920; Metron, Inc., ASBCA No. 56624, 12-2 BCA ¶ 35,066.

- DCAA's arbitrary 10% range of reasonableness ignored the high degree of data dispersion in the survey data.
- DCAA's arbitrary use of the 50th percentile ignored the contractor's financial performance.
- DCAA failed to consider subjective discriminators such as level of education, security clearances, customer satisfaction, and product quality.
- DCAA's selection of publicly-traded companies as the peer group for a small, private, closely-held company was misleading and unfair.
- DCAA used compensation surveys for different industries in different years.
- DCAA inconsistently used the median versus the mean of the survey data.

These cases provide a roadmap for responding to audit findings regarding the reasonableness of compensation. In fact, the government frequently concedes when presented with these and other rational challenges to DCAA's methodology for evaluating reasonableness.

CONCLUSION

This Cost Corner focuses on the general criteria for the allowability of compensation for personal services with a particular focus on reasonableness. The next Cost Corner will address some of the additional limitations on the allowability of specific elements of compensation.