

Written by Nick Sanders
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Section 39 of the Office of Federal Procurement Policy (OFPP) Act requires the OFPP to issue, annually, an executive compensation “benchmark” amount that establishes an allowability ceiling on compensation of contractor executives. The benchmark amount is set at the median (50th percentile) amount of compensation over a recent 12-month period for the five most highly compensated employees in management positions at each home office and each segment of all publicly-owned companies with annual sales over \$50 million, and the determination is based on analysis of data made available by the Securities and Exchange Commission (SEC). As defined by the Cost Principles at FAR 31.205-6(p), executive compensation means the total amount of wages, salaries, bonuses, restricted stock, deferred and performance incentive compensation, and other compensation for the year, whether paid, earned, or otherwise accruing, as recorded in the contractor's cost accounting records for the year. For government contractors, executive compensation in excess of the annual OFPP benchmark/ceiling amount is unallowable. Period.

The last time the OFPP established the executive compensation benchmark was two years ago, in April, 2010. We reported it [here](#). So why was there such a delay?

One of the reasons given by OFPP for the delay was the uncertainty surrounding the allowability of executive compensation. Congress has been tinkering with the rules. As we reported in [this article](#), Section 803 of the FY 2012 National Defense Authorization Act (NDAA) extended the compensation cap beyond the “top 5” most highly compensated executives in each segment, to encompass *all* contractor employees. So (ostensibly) OFPP delayed issuing the FY 2011 benchmark amount because it was concerned that Congress would change the rules in such a fashion as to make its efforts worthless. Well, that didn’t happen and so OFPP finally—and, quite clearly, *reluctantly*—issued the 2011 benchmark amount.

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The FY 2011 ceiling amount of executive compensation is \$763,029.

The [Federal Register notice](#) provided ample evidence that the OFPP decided to comply with statutory direction only reluctantly. For instance, the ceiling amount was agreed-upon only “after consultation with the Director of the Defense Contract Audit Agency.” Further, the majority of the FR notice (at least four paragraphs’ worth of verbiage) consisted of an attack on the existing statutory formula. Included therein was an endorsement of a new formula that would tie executive compensation to Senior Executive Service compensation levels. Quite clearly, the OFPP was telling readers: “*Don’t blame us. We just follow statute.*”

Which is kind of ironic, given how OFPP has spent the past twelve months not following statutory requirements.

At this point, the majority of government contractors have already incurred FY 2011 executive compensation costs and are within about 60 days of submitting their FY 2011 Final Incurred Cost Proposals (FICPs). It’s manifestly unfair, and very nearly a retroactive application of an allowability rule, to tell them in April 2012 what their allowable 2011 costs should be. But of course, the counter argument will be: “*Fine. Feel free to use the (lower) FY 2010 executive compensation benchmark if you’d like.*”

Interestingly, the delay in issuance, coupled with the NDAA language changes, worked to create a two-tier cost allowability structure for defense contractors. As the OFPP reports in its FR notice—

... this broader application of the Section 39 cap does not apply to FY 2011. That is because Section 803 of the NDAA provides that its amendments ‘shall apply with respect to costs of compensation incurred after January 1, 2012.’ Accordingly, the benchmark compensation amount in this notice, for FY 2011, applies only to the same limited number of contractor executives as did the Section 39 caps for FY 2010 and prior years. The broader application called for in Section 803 of the NDAA will be implemented through regulation and addressed in future notices.

What that means is that the OFPP benchmark amount applies to all contractors’ executive compensation costs incurred effective January 1, 2011. For non-defense contractors, the

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ceiling applies only to the top five most highly compensated executives in the company (and in each segment). However, for defense contractors, the ceiling applies to the “Top 5” for FY 2011 only; in FY 2012 it applies to *all employees*. That bifurcated approach will take some work to figure out.

With rules like this one, is it any wonder why defense contractors’ overhead rates continue to increase?