

## Executive Compensation: Aiming at the Wrong Target

Written by Nick Sanders

Friday, 23 November 2012 00:00

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We've recently reported on several misfires by the Defense Contract Audit Agency (DCAA), as its auditors have tried to question the allowability of contractors' executive compensation costs using a "fatally flawed" statistical methodology. While nobody has expressed any specific concerns with DCAA's general methodology, the devil (as they say) is in the details.

DCAA's general approach recognizes the current OMB-issued [executive compensation ceiling](#) as the upper limit on allowable compensation, but then puts the burden on contractors to justify the reasonableness of their compensation levels—even when the compensation is below the OMB ceiling. (We [noted](#)

that the executive compensation ceiling was extended to *all*

contractor employees in the FY 2012 National Defense Authorization Act. However, implementing regulations have not yet been issued by the FAR Councils as this article is written.) Consequently, contractors must not only disallow compensation in excess of the OMB ceiling, but they must also support and justify the reasonableness of *all*

employee compensation. Compensation found to be insufficiently supported and justified is likely to be questioned by DCAA as being unreasonable, and likely to be disallowed by the cognizant Contracting Officer.

The fact of the matter is that only a very few top executives get paid in excess of the current OMB ceiling of \$763,029; the vast majority of contractor employees get paid amounts that are far lower. Accordingly, DCAA's focus on the reasonableness of compensation costs at levels below the OMB ceiling implicates essentially *all* your compensation costs, and puts those costs at risk from DCAA's judicially disfavored methodology. (It is in the application of the audit methodology to the compensation costs of the executives that has generated the litigation and ensuing condemnation of DCAA's audit findings, but much of that methodology is also used to evaluate the compensation levels of rank-and-file employees as well.)

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Meanwhile, the Obama Administration [has proposed](#) lowering the OMB compensation ceiling amount from its current level to \$230,700—the ES Level I level. There's both good and bad news associated with that initiative. The good news is that it will significantly—perhaps drastically—limit the impact of DCAA's flawed methodology on your compensation costs. The bad news is that it will result in a *humongous* amount of compensation costs being automatically disallowed. Any compensation in excess of the lowered ceiling amount will not only be unallowable, it will likely be viewed as being *expressly unallowable*.

The justification for lowering the compensation ceiling is simple. The ceiling is driven by a statutory formula; as a result of the formula the amount of the ceiling tripled between 1995 and 2011. The feeling is that it has simply grown too large, and that defense employees shouldn't be permitted to claim that much allowable compensation.

But as we all know, the current compensation ceiling really only affects the top one percent of contractor employees. Whether you set the ceiling at \$500,000 or \$700,000, you are only effectively disallowing a small portion of contractor costs. But if you set the ceiling at just about \$230,000—and then apply that ceiling to all contractor employees—you cut an extremely broad swath through what used to be allowable (and reasonable) compensation.

Or, to put it another way, you may have a zillion independent compensation surveys that justify and support your compensation levels as being right within peer industry norms, but this initiative would moot those findings and arbitrarily define “reasonable” compensation as being less than \$230,700.

Is this the wrong approach to defining allowable employee compensation? *You bet it is.*

First of all, as previously noted many contractor employees are compensated at the \$230,700 (or higher) level. And deservedly so. If you are a world class Program Manager or Systems Engineer, then you absolutely deserve that level of compensation. And if Contractor A doesn't pay you that comp level, then it's highly likely that Contractors B, C, and D will be very happy to offer it. At the right mix of skill set and experience, \$230K is essentially the minimum level of

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expectations.

Let's talk fairness and equity. It's relative. If you live in Mississippi, then perhaps \$230K may seem like a lot of money; but if you live in San Francisco, Los Angeles, New York, Chicago, then \$230K barely achieves a middle-class lifestyle. Folks inside The Beltway perhaps do not understand that the cost of living is variable and dependent on geographic location ... and that there is a correlation between many urban environments and many centers of research and innovation. Think Silicon Valley. You think it's cheap to live in Silicon Valley? [Think again](#).

Let's discuss comparative stats. There's a strong vocal opinion out there—nominally championed by the [Project on Government Oversight](#) (POGO)—that contractors make too much money; or, at least, that they make too much more than their Federal civil service peers. We've [discussed](#) this issue before. The fact is that there's as much evidence that Federal employees make more than their contractor counterparts as there is that they make less. The case on either side is far from convincing.

The conclusion that we've reached is that this initiative is a bad idea. Cutting allowable compensation down to \$230,000 will tend to impact the positions of Program Manager, System Engineer, and Scientist—the very critical positions that contractors (and DOD) rely upon to execute complex develop contracts and Major Defense Acquisition Programs (MDAPs). The defense industry already has too much trouble competing with the private sector for such talent; this initiative is going to make that bad situation worse.

Thinking more long term, the aerospace/defense industry has championed science, technology, engineering, and math (STEM) education. The reason for this is because not enough students are choosing these career paths. Now we are going to be telling those students that these careers, if they are part of the defense industrial base, will be paying even less. And we expect this to make those careers more attractive? We don't think so.

At the end of the day, we suspect that contractors will continue to pay the going market rate for their personnel. If they don't, it's going to be difficult for them to retain employees. Employers will pay the going rate, but they won't be able to recover the "excess" salary costs over \$230K. So the end result of this initiative, if implemented, will be to reduce contractors' profits. We find this result counter-intuitive, given that it is the [official DOD position](#) that they are not targeting contractors' profits when seeking to reduce costs.

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But maybe it's not a DOD initiative. Perhaps it is truly an Obama Administration initiative, as it's been postured to be. Maybe the DOD is receiving marching orders from the Commander-in-Chief, and like a good soldier is doing what it's being told to do.

Look, we don't want to go off a rant here. We work fairly hard to keep political rhetoric off this blog. But we think Mitt Romney missed an opportunity to take the President to task on this, and related, initiatives.

It's a fact that the U.S. manned spaceflight program ended under the Obama Administration's watch. Sure, you can argue that it really ended under the Bush Administration, for failure to plan and fund, but it actually came to an end under the Obama Administration. We reported the death throes [here](#).

We believe that Mr. Romney could have argued, with some justification, that while Mr. Obama was busy [bailing out](#) the predominantly blue-collar auto industry, he was allowing the predominantly white-collar aerospace/defense industry to stagnate, or perhaps to decline. One need only look at the [recent history](#) of NASA budget appropriations to see support from this point of view.

And from that point of view, the initiative to limit allowable employee compensation to roughly \$230,000 is simply another prong of the attack on the white-collar aerospace/industry. Indeed, almost by definition, the compensation limits will *only* affect white-collar workers in management positions. We're not saying it's the correct point of view, but we believe it could have been raised with some justification in the recent election.

So we think that the Obama Administration, the Department of Defense, and the legislators of Congress need to evaluate the impact(s) of this proposed initiative on the defense industry. We hope they evaluate both the near-term impacts, as well as the likely long-term impacts. And we also hope they evaluate the impact of this initiative on the perception of how the Obama Administration views those citizens who are white-collar workers: the Program Managers, System Engineers, and Chief Scientists who form the backbone of the defense industrial base.

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