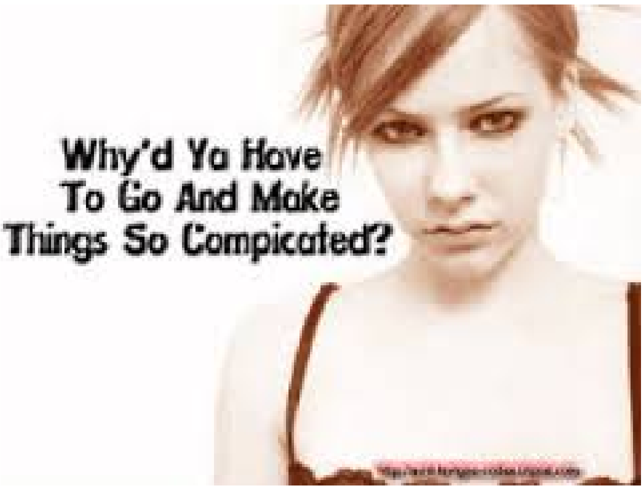

The allowability of contractor executive compensation is a complex, tricky, thing—made more tricky by recent statutory and **regulatory** changes. We have written about some of those **recent changes** before.

At this point, the average contractor must handle three separate rules that each establish separate limits on allowable compensation. Some contracts are subject to the " **old** " executive compensation ceiling of $952,308, as applied to the Top 5 most highly compensated individuals in each segment. Other contracts are subject to the "old" ceiling as applied to *all* contractor employees (not just the Top 5). Still other (newer) contracts are subject to a lower compensation ceiling of $487,000, as applied to *all* contractor employees. The ceiling on allowable compensation depends on when the contract was issued and its effective date, because it is the FAR Part 31 cost principle language *in effect on that effective date* that establishes the applicable ceiling.

Based on the foregoing, it would seem logical that each contractor must establish three different sets of billing rates, based on those three different sets of allowability rules, and then apply the appropriate set of billing rates to the appropriate contract, based on establishing each individual contract's effective date.

That seems to be a problematic approach, right? Think about it:

Three compensation allowability calculations.

Three sets of provisional billing rates.

Three sets of final billing rates.

And then you have to know which set applies to which contract. The forward pricing part might seem to be relatively easy to handle, because all new contracts will be subject to the most restrictive (lowest) compensation ceiling. Even so, the interim (provisional) billing rates for 2014 and beyond will have to account for the fact that there are several groups of contracts, each with its own allowability criteria. The same is true for the final (actual) billing rates for 2014 and beyond.

Think that's tough to implement? Maybe so. In fact, we'll assert that it *is* so. But that's what seems to be called for by the regulations.

The whole situation seems more than a little risky. You had better not make any mistakes. At a minimum, DCAA might allege that you billed expressly unallowable compensation costs, or that you included expressly unallowable compensation costs in your proposal to establish final billing rates. There are penalties and interest payments associated with expressly unallowable costs.

If you prepare your forward pricing rates (or calculate estimated indirect rates in your cost proposals) and you don't exclude the right amount of executive compensation, then you might be accused of submitting certified cost or pricing data that was not accurate – which would be a violation of what used to be called "TINA".

It's possible (though perhaps unlikely) that somebody might allege some kind of violation of the False Claims Act – *i.e.*, that the contractor intentionally or negligently overbilled the government). That would be a bad thing, very bad.

This situation cannot be what the lawmakers intended when they lowered the allowable executive compensation ceilings, can it? Is this *really* what government contractors have to do in order to comply with the regulatory requirements?

Sure, over time the issue will take care of itself, as the proportion of contracts subject to the various (higher) compensation ceilings work themselves out (*i.e.*, you burn off your backlog). But that could take years, depending on the contracts' various periods of performance. In the meantime, contractors seeking to comply with the cost principle are going to have a challenge, *to say the least*
. It's going to take additional resources and take additional time to calculate indirect cost rates. It's going to take additional resources and take additional time to support those calculations through the inevitable audit. It's going to cost contractors money at a time when budget concerns are in the forefront of the minds of the buying activities. It's going to cost contractors money at a time in which Congress and Pentagon leaders are trying to reduce the regulatory burden imposed on contractors in order to reduce unnecessary overhead costs and make doing business with the DOD more enticing.

It's the wrong thing at the wrong time, but there's nothing to be done about it … *is there*? Is there anything a contractor can do to comply with the spirit of the cost principle without having to comply with its literal compliance requirements? It would seem not.

It is what it is.

A contractor has to comply and that's going to be a pain and there's nothing that can be done about it.

Unless …

Unless DOD comes up with an acceptable approach that minimizes the bureaucratic burdens while permitting contractors to demonstrate compliance with the requirements of the cost principle.

Unless there is some mathematical means of blending all those individual compensation disallowances together, so as to create a single weighted average rate that, when applied to all active contracts, would be acceptable to both contractors and to the DOD.

Oh, wait. *There is such a methodology and DOD has endorsed it.*

Here's **a link** to the official endorsement.

Now the thing is, this DOD-approved methodology is not a panacea. It only applies to DOD contracts and it requires an advance agreement. So contractors may have to have a DOD set of blended rates and a non-DOD set of multiple rates to apply to each civilian agency contract. That still kind of sucks. But if you are a Pentagon contractor and DCAA is your audit agency, this newly approved approach provides an opportunity for you to streamline your rate calculation processes.

But it requires an advance agreement.

We were tempted to opine that the advance agreement is unnecessary, because why would you need an advance agreement to follow the methodology that DOD has already approved? But then we did some research, and we noticed that DCAA does not approve of the "blended rate" approach to excluding unallowable executive compensation. In point of fact, the DCAA CAM (October 2014 edition) states:

Under the blended rate method, the blended rate is applied to both cap-covered and noncovered contract work. This is in violation of Title 31 of the United States Code, section 1301(a), herein referred to as the Purpose Statute, and section 1341(a)(1), herein referred to as the Anti-Deficiency Act. Section 1301(a) (Purpose Statute) requires that appropriations shall be applied to the objects for which the appropriations were made. Section 1341(a)(1) (Anti-Deficiency Act) places limitations on officers or employees of the United States Government expending and obligating amounts exceeding amounts available in the appropriation. Both sections would be violated at most contractor locations since use of a blended rate would result in a predominant misallocation of the unallowable compensation credit to the contract work that is not subject to the cap or authorized by the appropriation.

If contractors do not carry out or expand their blended rate calculation to an appropriate number of decimal places, the impact of the unallowable compensation may not be significant enough to lower the G&A rate. As a result, unallowable compensation costs will not be recovered by the Government.

[CAM Ref. 6-414.9]

Based on the foregoing – and unless DCAA changes its position in response to the official Pentagon policy change – your DCAA auditors are going to question your use of the blended rate methodology and they are going to assert those costs are expressly unallowable. Your executed advance agreement should act to ensure that those questioned costs are not sustained by your cognizant ACO. Consequently, it seems very prudent indeed to execute that advance agreement called-for by the DOD guidance.

Assuming you are going to go forward with the approved blended rate methodology, it is going to be a complicated calculation. As we see it, here are the key steps inherent in the process endorsed by DOD:

1. Establish a list of all employees whose total compensation, as defined by 31.205-6(p), exceeds the compensation cap of $487,000. Determine the aggregate total amount of unallowable compensation in accordance with the cost principle. Hopefully the unallowable compensation will be limited to the G&A expense pool. If not, apportion the unallowable compensation between all affected indirect cost pools.

2. Establish a list of all employees whose total compensation, as defined by 31.205-6(p), exceeds $952.308. Determine the aggregate total amount of unallowable compensation for those individuals. Hopefully you will have less than five such individuals. If not, you will have to develop two pools of unallowable compensation costs: one pool for the “Top 5” individuals and another pool for the total population. Hopefully the unallowable compensation will be limited to the G&A expense pool. If not, see Step 1.

3.

Identify all cost-reimbursement contracts that were (or will be) awarded after June 24, 2014, It is expected that the vast majority of those contracts affecting 2014 have already been bid (*i.e.*, they are near-firm backlog). These contracts are subject to the compensation limits you identified in Step 1.

4.

Identify all cost-reimbursement contracts awarded prior to June 24, 2014. (These are firm backlog contracts as of that date.) Those contracts are subject to the compensation limits you identified in Step 2. (Remember you may have two groups based on those contracts that are subject to “Top 5” limits and those for which all employees’ compensation must be evaluated.)

5.

For all contracts, estimate G&A expense allocation base dollars to be incurred for those contracts. (If another indirect cost pool is affected, you may need to identify the allocation base dollars (*e.g.*, direct labor dollars) of all affected indirect cost pools.) Extend those values out, year-by-year, for the length of those contracts’ periods of performance, as backlog is burned to zero. Adjust for expected contract modifications (*e.g.*, authorized but currently unpriced work). Where necessary, use out-year Business Development forecasts to estimate the G&A allocation base dollars by contract. As before, if other indirect cost pools are affected, then you will have to identify the affected allocation bases of those pools, year-by-year.

6.

Aggregate the G&A base dollars by contract groups. Do a check to make sure that, when you add the G&A allocation base dollars together and then look at the G&A allocation base dollars from all other contract types (*e.g.*, FFP or T&M), you get your total forecasted G&A allocation base. If you don’t, then figure out where you went wrong and do the math again. Note that if you have a high percentage of T&M contract work, you may want to add that type to the cost-reimbursable contracts, because the “M” part of the T&M contract may be absorbing a material amount of your allocated G&A expense dollars.)

7.

Calculate a ratio of each contract group’s G&A allocation base dollars to the total G&A allocation base dollars. (Do the same for other affected indirect cost pools, if you have any.) Assuming the G&A expense pool is the only pool where you have unallowable executive compensation, you should have three ratios.

1.

Ratio of cost-type contracts subject to the high limit, Top 5 population.

2.

Ratio of cost-type contracts subject to the high limit, total employee population.

3.

Ratio of cost-type contracts subject to the low limit, total employee population.

4.

Multiply the ratios you calculated in Step 7 to the appropriate pool of unallowable costs you identified Steps 1 and 2. The results of that multiplication will be your unallowable executive compensation costs.

5.

Add the three results together and credit your G&A expense pool.

6.

Calculate your DOD G&A expense rate (total claimed G&A expense pool over total G&A allocation base).

Or you can just have three sets of rates and apply them to the appropriate contracts, based on each contract's effective date. It's your choice.

But if you are one of those contractors whose ERP system does not easily support multiple billing rate tables, you may have less of a choice than you think.