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Government Wins (Again) on Compensation Based on Changes in Stock Prices

By Michael Steen, CPA, Redstone Government Consulting, Inc.

In late November 2017, the ASBCA issued its decision (ASBCA No 60086) in which it upheld a Contracting Officer (CO) final decision which disallowed compensation which was valued based upon changes in the price of corporate securities. The regulatory basis was FAR 31.205-6(i):

(1) Any compensation which is calculated or valued based upon the price of corporate securities is unallowable.

In this recent ASBCA decision, the compensation involved stock options, a contingent liability for deferred compensation which were subject to FAS No. 123r (Financial Accounting Standards). Thus, from a government contract perspective it invoked FAR 31.205-6(d) (which invokes CAS 415) and as shown above, another subsection of FAR. In this case and presumably very similar to many other cases involving deferred compensation and financial reporting, the contractor used the Black-Scholes model to compute the expense reportable for financial statement purposes. The Black-Scholes Model included five inputs including: i) option term, ii) current stock price, iii) exercise (strike) price, iv) risk-free rate of return, and (v) of particular significance in this issue, stock price variance (volatility). As asserted by the CO (and a DCAA audit) and as ultimately accepted by the ASBCA, stock price variance equates to "calculated based upon the price of corporate securities."

Regarding the DCAA audit report, it pertained to the contractor's Fiscal Year (FY) 2007 incurred cost proposal (submitted on July 1, 2009) which was the basis for the audit report dated 30 September 2014. At issue was $2,291,700 claimed for the stock options calculated in accordance with FAS No. 123r and $1,141,421 (penalties and interest for allegedly claiming expressly unallowable costs subject to FAR 52.242-3(d)(2)). The audit report cited FAR 31.205-6(i)(1) (see the opening paragraph), although the field auditor had originally believed the costs were unallowable deferred compensation (FAR 31.205-6(d) and CAS 415).

THIS ISSUE:

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In the published decision, there were extensive discussions concerning the meaning of FAR 31.205-6(i) in the context of compensation which was computed (in part) based upon stock price volatility. The ASBCA, relying in part on Webster's dictionary, determined that the plain language of the cost principle made the costs unallowable; however, due to the complexities of the issue, not "expressly" unallowable (not subject to penalties). The "complexities" were evident because i) the contractor had engaged the services of a retired DCAA auditor and ii) a number of current DCAA auditors believed the cost to be unallowable, but for different reasons than 31.205-6(i)(1). The ASBCA also noted significant differences between the current case (60086) and two earlier decisions (Raytheon and Exelis) involving unallowable compensation under 31.205-6(i); specifically, the earlier cases clearly measured compensation based upon actual changes in stock prices (in some cases compared with peer-group stock prices), but differentiated from the FAS No 123r computation which used historical volatility to project a future expense. However, the ASBCA cautioned that its interpretation that the costs were not "expressly unallowable" may not hold for other contractors claiming similar compensation using a mathematical model (i.e. Black-Scholes).

As it now stands, the government is batting "3 for 3" on compensation issues involving compensation based (in some form or fashion) on changes in the prices of corporate securities. As noted by the ASBCA and in application to compensation based upon comparison of a contractor's corporate security prices to a peer group, nothing in FAR explicitly refers to the specific "contractor's" corporate securities. Further, the three ASBCA decisions should serve notice to all contractors to re-visit outstanding indirect cost rate proposals (submitted but awaiting audit) to make certain that a contractor is not claiming compensation costs based on changes in the prices of corporate securities (using a very broad interpretation).

Other lessons for contractors:

- DCAA's initial failure to question costs (in all three cases) is meaningless if/when the ASBCA relies on the "plain language" of the cost principle (which might explain why no one has apparently tried to introduce the regulatory history and/or the public comments and regulatory responses when FAR 31.205-6(i) was implemented). It is what it is based upon the "plain language" of the regulation in spite of the fact that numerous contractors, consultants and DCAA auditors have found the language to be other than "plain."
- As cautioned in one of the footnotes within ASBCA 60086, contractors who ignore ASBCA decisions (which are purportedly based upon the plain language of the FAR) risk significant penalties; in contrast, there are no similar penalties applied to DCAA audits which ignore ASBCA decisions (reference to DCAA's compensation benchmarking which is identical to that deemed "statistically flawed" in JF Taylor and Metron, respectively).
- Financial reporting and compliance with Financial Reporting Standards will in some cases give the "wrong answer" in terms of cost allowability for government contract costing purposes. There might be a Section 809 Committee (2017 NDAA) which is implicitly addressing contractual regulations which require two (or three) sets of books; but as it stands, there are differences and there isn't any single source from which one can easily determine those differences. Just because it's compliant under Financial Reporting Standards doesn't make it allowable for government contracting.
- If one uses any compensation plan which links incentive compensation to "shareholder return," you probably have unallowable compensation costs or at the very least, if the compensation is claimed as allowable, a competent DCAA auditor will be "sniffing around" suspecting that there must be some FAR clause which makes it unallowable. Allowable compensation is for services performed and not for direct ownership (dividends) or for enhancing the value of the stock (share-holder return).
- Although compensation in the form of stock can be an allowable cost, it takes a different direction when it is in the form of a stock option for which there is a strike price which is the same as the current stock price; hence, the only value to the awardee is if the stock price increases before the expiration of the stock option, thus giving the awardee a "discount" equal to the increased stock price.
- Government contractors can reward executives and employees for financial results which will potentially increase stock prices, but it must be measured using

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some other metric(s) (e.g. revenue growth, increase in operating margin).

In a number of cases involving compensation for certain executives, FAR 31.205-6(i) may become a moot point given the relatively low compensation cap of $487,000 in FAR 31.205-6(p). For example, a CEO whose base salary in 2017 exceeds $487,000 can be paid a bonus based upon share holder return because the entire amount of the bonus is categorically unallowable (because it exceeds the cap). However, this lower cap only applies to contracts executed after June 24, 2014; hence, there may be some intervening years where FAR 31.205-6(i) will still be a allowability factor.

2018 Tax Cut and Jobs Act

By Michael E. Steen, CPA, Redstone Government Consulting, Inc.

It appears that we will soon have some significant changes to the tax code and with that a reminder that just like Financial Accounting Standards, the tax code does not necessarily define allowable or unallowable costs for government contract costing. The following are examples of existing or changes in the tax code (to be codified in the IRS Regulations) which will very likely result in different treatment ('deductibility" for IRS purposes, but "allowability" for government contract costing purposes).

- **Depreciation (and/or expensing for capitalizing certain long term-assets).** The Act modified the Sec 168(k) "bonus" depreciation, allowing a business to deduct 100% of the cost of qualifying property. The bonus depreciation is effectively 100%, but subject to phasing down beginning in 2023 (80% for property acquired in 2023 followed by 60/40/20 in the subsequent years). In contrast, government contractors subject to CAS 404 and 409 are still expected to depreciate assets over their useful lives, based upon records maintained by the contractor in which case a contractor might have different asset lives for similar types of assets than another contractor. For contractors not subject to CAS, FAR 31.205-11(c) permits those contractors to claim depreciation which does not exceed the amount used for financial reporting. Noting the FAR invokes financial reporting and not tax reporting, if financial reporting permits a contractor to fully depreciate assets in the year acquired, then contractors which are only subject to FAR can effectively expense qualifying assets. One clarification, FAR 31.205-11(c) limits depreciation to the amount used for financial reporting; however, it would not prohibit a contractor from claiming depreciation based upon traditional measures (i.e. computed based upon the useful lives of the asserts versus 100% expensing in the acquisition year…if the tax code is also compliant with financial reporting standards).
- **Compensation for publicly traded companies** (in 2018 including those with publicly traded debt) is limited to $1 million for specified company executives (four positions, which will the CFO). In contrast, government contractors are capped at $487,000 for allowable compensation for any given employee (not limited to executives). Further the IRS and the FAR differ in terms of defining the types of compensation subject to the limitations on deductibility or allowability (i.e. FAR 31.205-6(p) defines the type of compensation included in the "cap"). Although the IRS has the much higher cap, unlike FAR 31.205-6(p), this IRS limitation also applies to compensation which continues after the executive leaves the company (e.g. severance).
- **Moving expenses.** The Act basically eliminated moving expenses as a deductible expense for individuals (other than those in the Armed Services) and similarly, moving expense reimbursements are not excluded from the taxable income of the individuals (again excluding those in the Armed Services). Although FAR does not address moving (or relocation) expenses as allowable or unallowable by the employee, FAR 31.205-35 does address cost allowability for the company (contractor) and FAR does permit the contractor to reimburse the employee for increased FICA and income taxes incident to allowable reimbursed relocation costs. The changes in the 2018 Tax code will not change FAR 31.205-35, but it's quite possible that contractor's might be incurring more allowable costs to cover the "tax gross-up" payments. As an aside, from time to time, contractors (clients) inquire about adjusting an employee salary to offset the (unfavorable) impact of a change in the tax code and our most common response is to "proceed with caution". Unless it involves a foreign assignment (tax differential) or tax reimbursement related to a relocation, compensation which is or looks like a tax gross-up is unallowable per FAR 31.205-6(e).

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Key Personnel – A Peril of Becoming Ineligible for Award

By Guest Author: Jerry Gabig, Attorney, Wilmer & Lee.

For best value procurements for services, often key personnel are the discriminating factor in the source selection decision. However, proposals that offer key personnel also face a potential peril of being eliminated from the competition. A peril to offering top caliber key personnel is that they are much in demand and may elect to pursue other opportunities. A GAO decision issued last summer highlights this potential peril.

In *YWCA of Greater Los Angeles*, B-414596.3, July 24, 2017, DOL issued an RFP seeking a contractor to operate the Los Angeles Job Corps center. The RFP designated the center director as a key personnel position. The solicitation required offerors to submit a resume and letter of commitment for the proposed center director. YMCA was the 52-year incumbent on this effort. YMCA submitted a proposal for $98,999,975.

During discussions, the awardee was informed that its proposed center director (candidate A) did not meet the minimum qualifications. The awardee then proposed candidate B. Discussions closed. Later the awardee notified DOL that candidate B had become unavailable and substituted candidate C. YMCA protested that DOL engaged in unequal discussions. Observing that "submission of key personnel resumes after receipt of final proposals constitutes discussions, not clarifications," the GAO sustained the protest.

A common ground for protest to procurements for services is that the apparent winner has engaged in "bait and switch." Bait and switch means the offeror submitted names of individuals without expecting those individuals to actually perform the work. Bait and switch implies an intentional misrepresentation. For example, in *ACS Government Services, Inc*., B-293014, January 20, 2004, a protest was sustained because the awardee misrepresented that three proposed key personnel had agreed to work for the firm, but the record showed that the three individuals never agreed to work for the offeror. Bait and switching can also be grounds for a False Claims Act violation. See *U.S. ex rel American Systems Consulting v. ManTech Advanced Systems Int'l*, 600 Fed. Appx. 969 (6th Cir. 2015).

Succinctly put, the peril consists of vendors who, after submitting their proposals, learn that a proposed key person is no longer available to perform the work. This peril is more likely to occur when an agency unreasonably prolongs awarding the contract. In those situations, the vendor has a duty to notify the contracting officer. The reason is that without the proposed key person the offer may either not be eligible for award or may no longer represent the best value to the government. From the government's perspective, the integrity of the procurement system is at stake. Withholding such information is likely to be regarded by the government as a violation of FAR § 3.1002(a) which states "Government contractors must conduct themselves with the highest degree of integrity and honesty." Hence, the painful reality of the contractor's peril is that if the contracting officer is unwilling to re-open discussions, the offeror is probably ineligible for award. One technique that might protect an offeror is to include in the initial proposal resumes of alternate key personnel.

If, after contract award, the offeror learns for the first time of the unavailability of a proposed key personnel, the peril greatly diminishes (although there is a possible risk of being terminated for failure to comply with the contract). Post award, the GAO regards the unavailability of key personnel to be a matter of contract administration. In *Development Alternatives, Inc*., B-217010, February 12, 1985, the awardee submitted the names of key personnel in good faith and with the consent of the named persons. A competitor objected to the award because one of the key persons had informed the awardee just after the contract was signed that she had decided to stay with her present employer. Another proposed key person, after contract award, imposed new conditions of employment on the awardee which the awardee deeded unacceptable. The GAO denied the protest.

In summary, proposing key personnel can be fraught with peril. If a vendor learns prior to contract award that its proposed key personnel will not be available to perform the work, the downside can be worse than merely not being eligible for award. If no disclosure is made and the matter is brought to the government's attention such as through a protest, it is unlikely the contractor will retain the contract. Moreover, the vendor's reputation for honesty is likely to be imputed which can have dire consequences. Worst case, albeit rare, the matter could result in a termination for default, a False Claims Act accusation, or possible suspension and/or

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debarment. Stated differently, when an offeror learns prior to award that a proposed key person is no longer available, it would be wise to follow an admonishment of the Supreme Court (*i.e.,* "Men must turn square corners when they deal with the government") and disclose the unavailability to the contracting officer.

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CFO Roundtable

Redstone Government Consulting, Inc., Radiance Technologies, Inc., and Warren Averett are sponsoring a CFO/Controller roundtable for Government Contractors.

All Government contractor CFO's or Controllers are invited to participate. The meetings are held quarterly and will include lunch and networking from 11:30am – 1:00pm. The next meeting is TBD. Participants will be notified via email announcements for all future locations and seminar topics.

The CFO Roundtable is **free** to attend. All participants will be invited to share topics of interest and the group will be interactive. Redstone GCI, Radiance Technologies, and Warren Averett will strive to provide speakers on topics that are of interest to the group each quarter. Please provide us your email address and we will notify you 30 days in advance of each meeting. RSVP's are required.

Sign up for CFO Roundtable updates here.

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About Redstone Government Consulting, Inc.

Our Company's Mission Statement: RGCI enables contractors doing business with the U.S. government to comply with the complex and challenging procurement regulatory provisions and contract requirements by providing superior cost, pricing, accounting, and contracts administration consulting expertise to clients expeditiously, efficiently, and within customer expectations. Our consulting expertise and experience is unparalleled in understanding unique challenges of government contractors, our operating procedures are crafted and monitored to ensure rock-solid compliance, and our company's charter and implementing policies are designed to continuously meet needs of clients while fostering a long-term partnership with each client through pro-active communication with our clients

In achieving government contractor goals, all consulting services are planned and executed utilizing a quality control system to ensure client objectives and goals are fully understood; the right mix of experts with the proper experience are assigned to the requested task; clients are kept abreast of work progress; continuous communication is maintained during the engagement; work is managed and reviewed during the engagement; deliverables are consistent with and tailored to the original agreed-to scope of work, and; follow-up communication to determine the effectiveness of solutions and guidance provided by our experts.

Specialized Training

Redstone Government Consulting, Inc. will develop and provide specialized Government contracts compliance training for client / contractor audiences. Topics on which we can provide training include estimating systems, FAR Part 31 Cost Principles, TINA and defective pricing, cost accounting system requirements, and basics of Cost Accounting Standards, just to name a few. If you have an interest in training, with educational needs specific to your company, please contact Ms. Lori Beth Moses at lmoses@redstonegci.com, or at 256-704-9811.

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