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Incentive Compensation: Allowable or Unallowable?

By Michael Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

There aren't many published decisions which address the allowability of incentive compensation or bonuses (FAR 31.205-6(f)); however, the relative sparsity of decisions should not be misinterpreted as a sign that incentive compensation is low risk. DCAA (Defense Contract Audit Agency) and other government auditors almost universally categorize incentive compensation as a high-risk account, thus include those costs in more in-depth after-the-fact audit testing. Some of the more frequent challenges include:

Documentation including that which supports the basis for the awards and that which evidences actual payment. Incentive compensation is allowable if the basis for the award is supported (FAR 31.205-6(f)(1)(ii)). DCAA audit policies (publicly accessible) do not provide any further insight into DCAA expectations, but experience shows that DCAA field auditors expect formula driven bonuses. For example, a specified adjectival performance rating equates to a bonus stated as a percentage of base pay. Not-so coincidentally, this criterion is derived from government personnel policies which are not incorporated into the FAR. Translated, an example of a non-contractual DCAA embellishment or expansion of the FAR. The basis for the awards only needs to be sufficient to demonstrate that the contractor followed its written or established incentive compensation plan. The basis for the awards may also have implications of un-allowability, for example if an employee is paid a bonus for securing a foreign contract which is later determined to have involved illegal bribes...no surprise, if audited, the bonus will be challenged as unallowable (directly associated with an unallowable and illegal cost). Similarly, a bonus which is tied to financial results stated in the incentive plan as increased stock prices (shareholder value) is unallowable (FAR 31.205-6(i)).

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Regarding payments, one recurring issue is with respect to bonuses accrued at year end, but paid in the following year. Although nothing in FAR precisely addresses this topic, there is an unwritten rule or DCAA interpretation that the payments must be within IRS deductibility guidelines (i.e. two and one-half months after the end of the fiscal year). Untimely payments may be challenged as deferred compensation subject to CAS 415 which introduces numerous other requirements impacting measurement and timing.

- Payments other than cash which could include stock options, stock appreciation rights, and restricted stock units. Stock options and/or appreciation rights are almost always unallowable under 31.205-6(i) because the compensation is a function of the changes in stock prices (for IRS purposes, stock options are stated at the stock price on the date of the grant; hence, the option is only exercised if the stock price subsequently increases above the price on the grant date). Restricted stock/units typically involve requirements before the RSU vests, but assuming there is a payout, the RSU's should be allowable. Outright compensation in stock, in lieu of payment in cash, is allowable as long as it can be measured. One caution for closely held corporations with few stock-holders, payment in stock may be challenged as having no measurable value if it simply dilutes the value of the existing stock held by the same individuals. In the extreme case of a CEO who owns 100% of the (issued) company stock, additional shares of stock won't have any net measurable value to the CEO (more shares, but at a proportionately diluted value per share)
- Incentive compensation plans which refer to funding based upon corporate profits (actual or projected) can be challenged as an unallowable distribution of profits (FAR 31.205-6(a)(6)(2)(B)). In one published case and other ongoing issues, the government is now using this particular FAR subsection to challenge allowability; thus, contractors should use words other than "corporate profits" and should be cautious of incentive compensation which is disproportionately more to employees who also happen to be stock-holders (closely held corporations). Similarly, contractors should avoid incentive compensation plans which include basis for award criteria stated as "to reward employees for their stock ownership or financial investment in the company". All it takes is one potentially unallowable criteria to "poison the well", resulting in cost allowability challenges to the entire incentive compensation payout.

In the world of government contracting and maximizing cost recovery, attention to details and specific wording can make the difference between allowable and unallowable incentive compensation.

Lessons from an Untimely Internal Investigation

By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

Although it happened to involve an SEC settlement action (and not a False Claims Act alleged violation), a recently published financial settlement indirectly provides some tips for government contractors in terms of what can go wrong with so-called voluntary disclosures. In the case of a government contractor, FAR 52.203-13 implicates timely mandatory disclosures (oft-times misstated as "voluntary") for specified events or situations; however, those mandatory disclosures permit internal investigations as long as the process leads to a timely mandatory disclosure. Unfortunately, this regulation does not define timely, but the SEC settlement should serve notice that the federal government will consider the facts and will hold companies and/or contractors accountable for untimely disclosures (from the perspective of the SEC or government regulator).

In the SEC settlement of $1.6 million (coincidentally involving a government contractor), the cease-and-desist order pursuant to Section 21C of the Securities Exchange Act of 1934 summarized the issue as:

- The company's failure to maintain books, records and accounts that accurately reflected the transactions….and for failing to maintain a sufficient system of internal control,
- Employees notified the company internal ethics department which undertook a prompt review; however, the review was not conducted in a sufficient and efficient manner due in part due to the failure of the ethics investigators to adequately understand the billing process involved,
- As a consequence, it was not until a later date that the company discovered the invoices which led to the improper reporting of $17.9 million in revenues

As reported by the SEC Administrative Proceeding, the overstated revenues were attributable to a company segment which created 69 invoices for cost incurred/work performed on a low-margin cost type contract. These invoices were not delivered to the government agency, but they were used to increase segment revenues which enabled this particular division to "barely satisfy the target required in order to qualify for management incentive compensation". Per GAAP and the corporate policy, revenue recognition entailed four requirements, one being "collectability is reasonably assured". The 69 invoices were not sent to the government because of issues involving collectability; hence, the revenue was not reportable per GAAP and the corporate policy.

In terms of timing, an internal (employee) ethics complaint was filed in November 2013, followed by a December 2013 investigation including several interviews; however, per the SEC, the ineffective investigation failed to timely raise the invoice issue to the Audit Committee of the Corporate Board of Directors. In the first six months of 2014, through a series of press releases and/or filings (i.e. 10-K/A or 10-Q/A) the company disclosed the overstated revenue issue including a statement that the company did not maintain an effective control environment (at the particular segment). The amended filings disclosed pre-tax charges of $169 million (of which $69 million related to the contract and the segment management and/or employees who directed the creation of 69 invoices).

In its 10K for 2015, the company reported its remedial actions to address the previously reported material weaknesses. Although it may not appear to be the case, the $1.6 million settlement was after the SEC gave consideration to the internal investigation, self-reporting, cooperation with the SEC and (the corporation) terminating a number of employees associated with the conduct in question. By implication, the issue resolution would have been more costly (than $1.6 million) but for these company actions given favorable consideration by the SEC. To a casual or even an informed observer, the company did almost everything right, but "almost" opens the door for the Government regulator (SEC) to insist on something in exchange for issue resolution.

The extrapolated lesson for government contractors (any subject to the mandatory reporting requirements of FAR 52.203-13, with or without SEC reporting); timely reporting is a highly subjective criterion which will be judged by a government agency (assuming there is a disclosure; if one fails to make a mandatory disclosure, "timely" or "untimely" won't be the issue). If you ask a government agency representative to define an untimely disclosure, the most likely answer, we don't have a definition, but we will know it when we see it. Suffice to say that internal investigations must be timely and effective; an ineffective investigation could be deemed untimely under the mere presumption that a competent investigator(s) would execute more timely. As with the corporation which had the misfortune of dealing with the SEC, to effectively and timely address any given case, the complexities may require supplemental external resources. In any case, the SEC settlement is an example of the quotation (attributed to Benjamin Franklin) that an ounce of prevention is worth a pound of cure.

There are several latent defects or potential issues embedded in this SEC settlement; in particular, the "other" implications for a government contractor (differentiated from the SEC action). First and perhaps most obvious, if there were incentive compensation payments which resulted from overstated revenues, the question of allowability (the manager(s) made their incentive compensation targets by using non-compliant tactics which overstated revenues). Additionally, a company should have safeguards in place when incentive compensation plans can drive the right behavior for the individual, but the wrong behavior for the company. The legal costs (internal or external) might be unallowable (depends upon who you ask). Arguably allowable because of explicit or implicit requirements (SEC and/or government contract) to conduct timely investigates of internal ethics' complaints. Unless it is expressly made unallowable by another clause, performing a task required by a contractual clause implicates an allowable cost. Lastly, the potential issue of compliance with DFARS Business System (252.242-7006) which includes an accounting system criteria (c)(1) for "a sound internal control environment, accounting framework and organizational structure". A government auditor may make note of the contractor's self-reported lapse in internal controls, but the specific facts simply don't equate to a business system deficiency as envisioned by DFARS. In particular, the contractor segment may have created 69 (suspect) invoices, but they never delivered any to the government. Over-reporting revenues has little or no relevance to DFARS 252.242-7006; in contrast, over-billing would have been a different story with a very different result.

Miscellaneous Compliance Issues

By Michael E. Steen, CPA, Senior Director at Redstone Government Consulting, Inc.

FAR Prohibition on Contracting with Companies with Confidentiality Agreements

Effective January 19, 2017, the rule as required by the 2015 NDAA (National Defense Authorization Act) which prohibits the Government from contracting with an entity that requires employees to sign an internal confidentiality agreement or statement prohibiting or otherwise restricting such employee or subcontractors form lawfully reporting such waste, fraud and abuse to a designated investigative or law enforcement representative of a Federal department or agency authorized to receive such information". The rule applies to contracts (including commercial) using Fiscal Year 2015 (or subsequent FY) funds.

Although most regulations apply to future contracts and future contract awards, this particular regulation has retroactive implications to the extent it requires offerors to represent that it will not require its employees or subcontractors to sign **or comply** with internal confidentiality agreements or statements which prohibit or restrict…from lawfully reporting. Hence, existing internal confidentiality agreements cannot be enforced and per the Federal Register Discussion and Analysis, there is an expectation that employers will issue a "blanket notice of nonenforcement" (FAR 52.203-19(b)).

Coincidentally this new rule puts to rest an issue of cost allowability for contractors who offered incremental severance payments to employees who would sign a similar non-disclosure agreement when separating from the company (inappropriately challenged as unallowable by DCAA in the mid-1990s). Actually, a contractor can still have and enforce these broadly worded employee non-disclosure agreements, but only if the contractor has no interest in future federal contract awards and if the company is willing to expose its personnel policy to challenges from the Department of Labor.

Privacy Training.

Effective January 19, 2017, a requirement for initial and annual training requirements for employees who have access to a system of records on individuals or handle personally identifiable information (PII). There are very few exceptions to the requirement; the final rule clarified that it applies to commercial items/services and contracts and subcontracts below the simplified acquisition threshold. Contractors can use their in-house training (if it meets certain requirements) or the training provided by a government agency. As with other invasive government regulations, the regulation has a specific record-keeping requirement as well as a requirement that no employee shall be permitted to have or retain access (to PII data or systems) unless the employee has completed privacy training.

This requirement will be incorporated into solicitation and contracts through FAR 52.203-18 and 52.203-19.

As a side-note, any time "a" contract introduces new requirements, a contractor can consider tracking these costs (at least those associated with initial compliance) and direct charging (and pricing) those costs to the specific contract. There may be coincidental benefits to the company as a whole, but the nexus to a particular contractual requirement (stated in finite detail) supports direct charging to that contract. This may not be worth the costs to track (for a cost type contract) and even more difficult to estimate as a cost included in a proposed fixed price contract. Unfortunately for many, merely one more additive cost of doing business with the federal government…and it may not be recoverable other than as an embedded cost within contractor overhead or G&A.

Training Opportunities

2017 Redstone Government Consulting Sponsored Seminar Schedule

February 23, 2017 – Prime Contractor Challenges in Managing Subcontracts
WEBINAR – Register Here

February 28, 2017 – Fundamentals of Cost Accounting Standards (CAS) Part 1*
WEBINAR – Register Here

The 2017 Redstone Edge Conference

September 21, 2017 –
CONFERENCE UPDATES & NEWS – Sign Up Here

2017 Federal Publications Sponsored Seminar Schedule

MORE EVENTS COMING SOON

Go to http://www.fedpubseminars.com/ and click on the Government Contracts tab.

Blog Articles to our Website

ASBCA Repudiates DCAA Legal Theory for Prime Contractor Management of Subcontracts
Posted by Michael Steen on Wed, Jan 18, 2017 – Read More

Details Matter in Preparing Responsive Bids (Part 2)
Posted by Charlie Hamm on Mon, Jan 16, 2017 – Read More

Details Matter in Preparing Responsive Bids (Part 1)
Posted by Charlie Hamm on Wed, Jan 3, 2017 – Read More

2016 Yes, Virginia, there is a Santa Clause
Posted by Michael Steen on Fri, Dec 23, 2016 – Read More

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Posted by Wayne Murdock on Wed, Dec 21, 2016 – Read More

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Posted by Michael Steen on Thu, Dec 15, 2016 – Read More

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Heart Problems with the Incurred Cost Proposal
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Posted by Asa Gilliland on Tue, Sep 6, 2016 – Read More

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A Whitepaper by Asa Gilliland – Read More

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A Whitepaper by Wayne Murdock – Read More

Government Contracting and Uncompensated Overtime
A Whitepaper by Wayne Murdock - Read More

DCAA Rejection of Incurred Cost Proposals
A Whitepaper by Michael Steen – Read More

For More Whitepapers:
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CFO Roundtable

Redstone Government Consulting, Inc., Radiance Technologies, Inc., & Warren Averett will be sponsoring a CFO/Controller roundtable for Government Contractors.

All Government contractor CFO's or Controllers are invited to participate. The meetings will be held quarterly and will include lunch and networking from 11:30am – 1:00pm. The next meeting is TBA. 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

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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