Executive compensation, the gift that keeps on giving.


Congress has no trouble with the free market, until and unless that same free market dictates that corporate executives should earn as much as movie stars. Then legislation is drafted and becomes law, and the FAR Councils draft regulatory revisions and they become final rules … and then contractors have to figure out how to comply. At which point, everybody realizes how flawed the original statutory language was, which led to a flawed regulatory regime, which led to a compliance conundrum—wherein it costs contractors more to comply with the flawed requirements than the Federal government saves in price reductions.

What are we talking about?

For background, please start with **this article**, published more than two years ago, in January, 2014. Or maybe start with **this one**, an article written about six months prior to the other one. They are but two of several articles we've devoted to the topic of calculating allowable executive compensation in accordance with the complex – and flawed – rules.

Those articles formed the backdrop for our **November 2014 article** on use of "blended rates" to calculate allowable executive compensation. As we wrote in that article—

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.

The solution to that problem, as we discussed, was the use of "blended rates" to calculate a weighted average allowable executive compensation amount.

But as we noted, at that time DCAA was not on board with the use of blended rates, even though DOD as an agency approved of that methodology. DCAA was going to question the resulting indirect cost rates and questioned costs were going to be found to be expressly unallowable. Thus, the need for an Advance Agreement to create the situation where the contractor and the cognizant ACO agreed in advance that the resulting rates were going to be allowable. The Advance Agreement acted to protect the contractor; any DCAA questioned compensation costs stemming from use of blended rates would not be sustained by the ACO.

(Never mind that Advance Agreements are extremely difficult to obtain these days, as we discussed in yet **another article** .)

So, anyway. That's where things stood until recently.

What changed?

Well, one thing that changed was that the OFPP **published** another executive compensation benchmark and ceiling in March, 2016. The new ceiling, which applies to compensation costs incurred after January 1, 2014 is $1,144,888. We think that ceiling applies to compensation costs incurred by non-DOD contractors (and to compensation costs incurred by DOD contractors prior to June 24, 2014) but, quite honestly, at this point we're not sure of anything regarding executive compensation. It's a big confusing mess. The OFPP has a **webpage** that tries to help people make sense of it all, but we got lost trying to figure it all out.

Another thing that changed was that DCAA issued MRD **16-PSP-005** on February 19, 2016. That MRD transmitted a guidance memo from OUSD (AT&L) signed by Shay Assad, Director of Pricing. The DOD memo noted that the FAR had been revised (via interim rule) to implement some of the legislative interference in the free market we noted above. The DOD memo acknowledges that DOD contractors "may elect, but are not required, to use the blended rate approach." The DOD memo states –

If a contactor proposes to use the blended rate method to cost and propose, the contractor will initially calculate and use a blended rate for interim billing. Subsequently, for the purpose of establishing final overhead rates, contractors will calculate blended rates reflecting actual proportion of contract costs for the current year for contractors prior to and after June 24, 2014. The contractors' final overhead submission for the completed fiscal year must include auditable substantiation of the calculation of the actual blended rates.

The DOD memo also stated –

Contract administration office contracting officers and contractors will execute an advance agreement … with each contractor that chooses to employ the blended rate method. The advance agreement will outline the agree-to process, auditable data submission and expiration for the application of the blended rates. Additionally, DCMA will issue implementation guidance in coordination with DCAA on this subject.

The implementing guidance noted in the preceding quoted paragraph was issued January 29, 2016; it was also included in the DCAA MRD. It started by reciting some of the history of the compensation ceiling and how that ceiling applies to contractors. (*I.e.*, it is a summary of the hairball of compliance rules with which contractors must comply.) The implementing guidance memo made it crystal clear that DCAA was to audit the contractor's calculation of the blended rate ceiling. In other words, DCAA was not to question compensation costs solely from the use of a weighted average compensation ceiling. (Thus the prior DCAA audit guidance was changed by executive fiat.)

There is lots of good guidance in the memo regarding exactly *how* a contractor is to calculate its weighted average compensation ceilings. If you have questions in this area, please see the memo.

But that's not all that changed.

On June 30, 2016, DCAA published MRD **16-PSP-007** , which was an "audit alert" regarding treatment of proposals to establish final billing rates (aka "incurred cost proposals") when a contractor used blended rates to determine allowable executive compensation. It establishes the novel and utterly unsupportable position that a final billing rate proposal shall not be considered to be adequate for audit until and unless the contractor and government have executed an Advance Agreement.

Now, we've already written that such Advance Agreements are good things to have, and we agree that one should be in place. On the other hand, we've also written that it's very difficult to actually obtain an Advance Agreement these days. It may be the case that the contractor and the government cannot come to a meeting of the minds regarding how the contractor will implement the blended rate methodology. It may be the case that the Contracting Officer is waiting for legal review, or the results of a Review Board, or maybe everybody is really busy. The point is, an Advance Agreement may not be in place.

The DCAA audit guidance states: "When the proposal is determined adequate and there is no executed advance agreement, the audit team should return the proposal and require the contractor to resubmit the proposal only after executing an advance agreement with the ACO." That is insane.

Contract clause 52.216-7 establishes the format of a contractor's proposal to establish final indirect rates. DCAA rammed through its ICE model approach into the FAR a couple of years ago, and right now that's what the FAR requires. Nowhere does the language of 52.216-7 require an Advance Agreement to be in place in order for the contractor's proposal to be audited.

Nowhere in the FAR language of 31.109 does it condition cost allowability on the existence of an Advance Agreement. In fact, the word “should” is found in the regulatory language, which is a far cry form the word “shall” (which denotes the imperative).

In our admittedly biased view, if DCAA refuses to audit a contractor’s incurred cost proposal simply because an Advance Agreement is missing, that decision would be tantamount to a contract breach. If the conditions established in 52.216-7 have been met, then the government must meet its duty of performing an audit and entering into negotiations to establish final billing rates.

We hope somebody, somewhere, takes DCAA to task for this bizarre and unsupportable position.

So there you have it. Executive compensation. Cost allowability. Blended rates. Legislative interference and DCAA interference. A hairball of regulatory complexity that may actually cost more to comply with than any savings generated thereby.

Your government at work.