

Labor and Fringe Benefit Costs FAR 31.205-6

And small business labor cost concerns

Wayne Owens, CPA, CGMA, CDA
Tony Machi, CPA, MBA, CDA
Kellianne Mayer, CPA, CPCM, CDA, MACC

1

Meet Today's Presenters



Wayne Owens
CPA, CGMA, CDA
*Managing Director,
Government Contracting*



Tony Machi
CPA, MBA, CDA
*Manager, Government
Contracting*



Kellianne Mayer
CPA, CPCM, CDA, MACC
*Manager, Government
Contracting*

2

**Stambaugh
Ness**

AGENDA

- Background on Compensation and Fringe Benefits, per 31.205-6
- FAR Part 31 – Specific Elements of Labor Related to Compensation
- Small Business Concerns - Compensation

3

3

**Stambaugh
Ness**

Compensation-31.205-6

Background and Regulation

4

4

Definition

FAR 31.001 defines the term compensation as

“all remuneration paid currently or accrued in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor.”

Compensation includes payment:

- made or to be made in the future
- in the form of cash, corporate securities such as stocks, bonds and other instruments or other assets, products or services.

5

5

WHAT THE FAR SAYS....

FAR 31.205-6 Compensation for Personal Services

- Must be for work (services): (31.205-6(a))
- Performed by employee in current year
- Cannot be a retroactive adjustment of prior year salary
 - That is reasonable for work performed
 - Based upon and conforming to terms and conditions of compensation plan or practice
 - No presumption of allowability exists to major revisions
- Cannot be unallowable based on other cost principles

6

6

The FAR Requires “Reasonable” Compensation for Each Labor Category

Junior Professional Staff



Based Mostly on New Graduate Salaries

Admin & Tech Support Staff



Based Mostly on Local Market Wage Levels

Managers & Executives



Based Mostly on Firm Size (Nationally)

7

7



The sum of allowable compensation elements needs to be reasonable in total.
(AUAAG § 7.2)

8

8

Reasonableness

Reasonableness – in TOTAL!!

- ❖ The sum of allowable compensation elements needs to be reasonable in total.

HOW THE FAR IS TRANSLATED...

- ❖ Normal for a comparable business
 - Same size, Industry, Geographic area and amount of non-governmental business
- ❖ What the IRS allows as a deduction

Reasonable overall compensation for overhead audit purposes is generally evaluated at the executive compensation level based on compensation surveys or the National Compensation Matrix published by AASHTO

9

9

Overview of Executive Compensation

- Compensation analysis only required for top five executives with firm wide responsibility plus 10% owners, and family members of these five.
- Evaluated on total compensation, which comprises:
 - Salary
 - Bonus
 - Company payments to qualified retirement plan
 - Other company paid, and allowable, benefits included in W-2s
- Executive comp is subject to strict allowability criteria

10

10

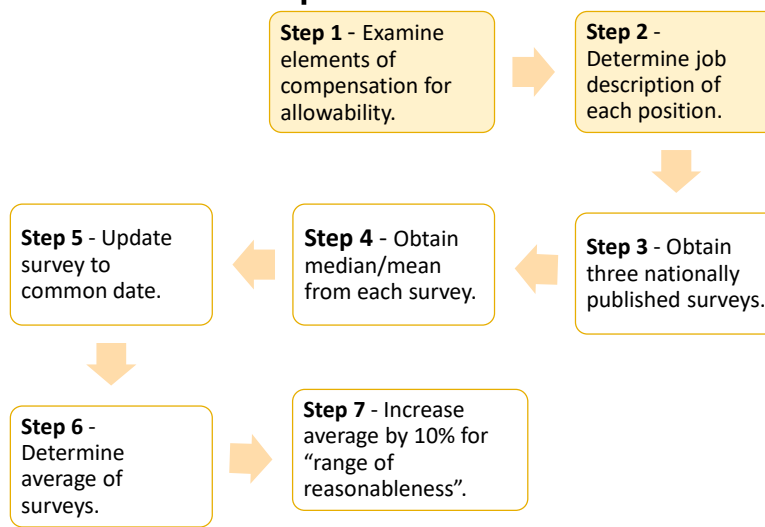
Compensation Got Easier

National Compensation Matrix

11

11

Determining "Reasonable Compensation"



12

12

National Compensation Matrix

National Compensation Matrix Tool - 2019
Automated Tool for Compensation Allowability

Enter Gross Revenues for Target Firm:

Position	Formulaic Result	%aR	Computed Compensation
Chairman (non-CEO)	739,198	37.15%	276,333
CEO/President	493,684	60.82%	525,000
Executive Vice President / Chief Operating Officer	312,878	32.51%	345,489
Senior Vice President	282,320	28.49%	310,812
Vice President	241,734	27.29%	269,031
Chief Financial Officer	269,583	34.21%	303,797
Top Engineering Executive	245,140	7.04%	252,344
Human Resources Director	136,905	12.10%	149,011

NOTE: CEO/President may only be applied to a single executive. (1)

** All positions are subject to a statutory compensation cap of \$525,000 for costs incurred between 1/1/2018 and 12/31/2018.

Statutory Compensation Cap for Calendar Year 2018:	Value
NCM Revenue Floor	\$500,000
NCM Revenue Ceiling	\$500,000,000

(1) The NCM was developed using a compilation of published surveys involving companies with a single CEO; accordingly, the CEO position should be matched only to a single executive. Engineering consultants with unique ownership and compensation structures that do not fit the NCM model should prepare their own executive compensation studies in accordance with the procedures recommended in Chapter 7 of the AASHTO Uniform Audit & Accounting Guide.

13

13

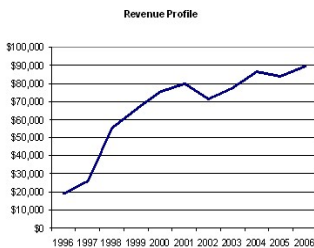
Key Matrix Components

- Match executive job description and duties to position description in Matrix
- Only one CEO/President is allowed
- Multiple Senior Vice Presidents and Vice Presidents are allowed
- Small firms must pay close attention to “duties” as opposed to title
- Related parties must be evaluated

14

14

Consultants Can Justify 75th Percentile Compensation if They Are Above Average in:



Growth



Client Satisfaction



Performance

15

15

Achieving Above Average Compensation

- Firm must document “above average”
 - Performance
 - Growth
 - Customer satisfaction
- Above Average entitles above average executives, based on performance criteria, the 75th percentile total compensation
- Court cases Techplan and Information Systems

16

16

There is an Absolute Max

- Depending on contract date:
 - Pre-6/24/14 - Benchmark Compensation Amount (BCA)
 - \$1,144,888
 - 6/24/14 - Contractor Employee Compensation Cap per BBA (Bipartisan Budget Act of 2013)
 - 2021-\$568,000 subject to inflation adjustment
 - 2022-\$589,000
- BCA limit is typically only for Senior Executives
- BBA limit is for ALL employees (FAR 31.205-6(p)(3))

17

17

Contract Compensation Limit

- Section 702 of the Bipartisan Budget Act of 2013 established a \$487,000 cap on the reimbursement of compensation costs for contractor employees.

• 1/1/2022 - 12/31/2022	\$589,000
• 1/1/2021 - 12/31/2021	\$568,000
• 1/1/2020 - 12/31/2020	\$555,000
• 1/1/2019 - 12/31/2019	\$540,000
• 1/1/2018 - 12/31/2018	\$525,000
• 1/1/2017 - 12/31/2017	\$512,000

18

18

Fringe Benefits

Fringe Benefits: 31.205-6(m)(1)

- The cost of vacations, sick leave, holidays, military leave, employee insurance, and supplemental unemployment benefit plans. Except as provided otherwise in subpart 31.2, the **costs of fringe benefits are allowable to the extent that they are reasonable and are required by law, employer-employee agreement, or an established policy of the contractor.**

19

19

FAR Part 31

Specific
Elements of
Labor Related
to
Compensation

20

20

Specific Elements of Labor Related to Compensation

Stambaugh
Ness

“Services” can be broken down to differing types of work performed that are then considered allowable or unallowable depending on the nature of the work performed.

- M&A Costs
- Promotional/Advertising/Entertainment
- Bid and Proposal
- Bonus payments
- What about unbillable labor?
- Other allowable/unallowable labor costs

21

21

Specific Elements of Labor Related to Compensation

Stambaugh
Ness

- **M&A Costs**
- Promotional/Advertising/Entertainment
- Bid and Proposal
- Bonus payments
- What about unbillable labor?
- Other allowable/unallowable labor costs

22

22




M&A Labor

Is it all unallowable?

23

23



M&A Labor Costs

Allowable Labor Cost

- 31.205-12 Economic Planning Costs - long range economic planning concerning future overall development of the contractor's business are allowable. Includes planning an organizational change and evaluating potential markets or firms for M&A. Once a specific target is identified costs are unallowable.
- 31.205-38 Selling Costs - Defines "Market Planning" as market research and analysis and general management planning concerned with development of the contractor's business.
 - Indicates that long-range planning is subject to the allowability provisions of FAR 31.205-12, but other market planning costs are allowable.

24

24

Stambaugh
Ness

M&A

Unallowable Labor Cost

- *31.205-27 Organization Costs*
Costs incurred related to (1) planning or executing organization or reorganization of the corporate structure of a business, including M&A (2) resisting reorganization or change in controlling interest in ownership and (3) raising capital are unallowable. Incentive related compensation for employees who participate in organizational activities is excluded from this principle and subject to 31.205-6.
- *31.205-47(f)(2) Legal Costs*
Unallowable legal costs resulting from organizations, reorganizations, mergers, and acquisitions, or resisting mergers and acquisitions.
This would include in-house legal departments working on these types of effort
Rationale: No relationship to the work of the existing entity, therefore, it provides no benefit to the Government.

25

This Photo by Unknown Author is licensed under CC BY-NC-ND

25

Stambaugh
Ness

Specific Elements of Labor Related to Compensation

- M&A Costs
- **Promotional/Advertising/Entertainment**
- Bid and Proposal
- Bonus payments
- What about unbillable labor?
- Other allowable/unallowable labor costs

26

26

Advertising & Marketing Labor Cost

FAR 31.205-1

- Disallows general public relations and advertising costs to promote the company and the sale of products and services.

Intent

- The Government announces its needs for goods and services. Since advertising is not necessary to attract Government business, it's not a cost that is allowable or allocable to government work.

Reality

- Some advertising costs are allowable if they are specifically required by contract performance, necessary to do business with the Government or community service related.
- Market planning and administration is allowable.

27

27

It May Be a Question of Language

The FAR Disallows

- Advertising
- Promotion
- Marketing

The FAR Allows

- Bid and proposal costs (31.205-18 (c))
- Dissemination of Technical Information (31.205-43(c))
- Marketing planning and administration (31.205-38(b)(4))

28

28

Advertising & Marketing – Allowable Labor Cost

Marketing Planning and Administration is Allowable

- Maintenance of client/project databases
- Research on prospective or current markets
- Planning/managing marketing efforts
- Client specific research
- Development of marketing support materials used for government sales
- Marketing training
- Recruiting

29

29

Advertising & Marketing – Unallowable Labor Cost

Just a few examples.....

- Manning a booth at a trade show
- Preparing information brochures, newsletters, or handouts
- Attending public events handing out corporate trinkets
- Costs of attending ceremonies, corporate celebrations and new product launches

30

30

Entertainment Labor Cost

FAR 31.205-14

If you are having fun during work hours, the government will not pay for it

- Sporting events
- Chili cookoff and beer drinking contest (you will never convince the government this is employee morale)
- Golfing
- Parties on company time
- NASCAR races
- Time spent driving to refill your empty kitchen office beer kegs

31

31

Specific Elements of Labor Related to Compensation

- M&A Costs
- Promotional/Advertising/Entertainment
- **Bid and Proposal**
- Bonus payments
- What about unbillable labor?
- Other allowable/unallowable labor costs

32

32

Bid and Proposal Labor Cost

Allowable indirect cost effort

FAR 31.205-18 (c) makes the cost of IRD and B&P allowable as an indirect cost

Definition: The costs incurred in preparing, submitting, and supporting bids and proposals (whether or not solicited) on potential Government or non-Government contracts. The term does not include the costs of effort sponsored by a grant or cooperative agreement or required in the performance of a contract.

Fun fact – this is a FAR cost principle that incorporates the requirements of CAS(420) in its entirety.

BID AND PROPOSAL IS NOT UNALLOWABLE MARKETING OR ADVERTISING!

33

33

Specific Elements of Labor Related to Compensation

- M&A Costs
- Promotional/Advertising/Entertainment
- Bid and Proposal
- **Bonus payments**
- What about unbillable labor?
- Other allowable/unallowable labor costs

34

34

Bonus Costs

BONUS - FAR 31.205-6(f)

Bonus payments are generally allowable subject to the following:

- (i) Awards are paid or accrued under an agreement entered into in good faith between the contractor and the employees before the services are rendered, or pursuant to an established plan or policy followed by the contractor so consistently as to imply, in effect, an agreement to make such a payment; and
- (ii) Basis for the award is supported

35

35

Bonus Costs

THERE IS NO REQUIREMENT UNDER THE FAR THAT A BONUS PLAN HAS TO BE WRITTEN

But

Suggested best practices:

- a. Have an explicit agreement in place OR have a history of bonus payments that is consistently followed, so it functions similarly to an explicit agreement.
- b. Have in place either the agreement or the established plan or policy and ensure it is understood before the work is performed.
- c. Support the basis of bonus calculation according to policy with measurable and verifiable evidence.

36

36

Specific Elements of Labor Related to Compensation

- M&A Costs
- Promotional/Advertising/Entertainment
- Bid and Proposal
- Bonus payments
- **What about unbillable labor?**
- Other allowable/unallowable labor costs

37

37

Unbillable labor

What is unbillable labor?

Types – generally direct:

- Warranty work
- De-obligated funds
- Not deliverable
- Work not funded by contract
- Costs expressly not allowed by contract

So - what happens?

The labor needs to follow the project where it was incurred, it stays in direct labor to bear its pro-rata share of costs. It should NOT be moved to indirect labor!

38

38

Specific Elements of Labor Related to Compensation

- M&A Costs
- Promotional/Advertising/Entertainment
- Bid and Proposal
- Bonus payments
- What about unbillable labor?
- **Other allowable/unallowable labor costs**

39

39

Other labor in 31.205-6

ALLOWABLE:

- ❖ Income tax differential – foreign (31.205-6(e)(1))
- ❖ Severance – involuntary termination, when required by law, agreement, policy, circumstances of particular employment (31.205-6(g)(2))
- ❖ Backpay – prior year work that was underpaid, union working without a contract, required by settlement (31.205-6(h)(1))
- ❖ Pensions, measured and assigned in accordance with CAS413 allowable with few exceptions (31.205-6(j))
- ❖ Deferred compensation, measured and assigned in accordance with CAS 415
- ❖ Post retirement benefits other than pensions (31.205-6(o))
- ❖ ESOPs measured and assigned in accordance with CAS 415 (31.205-6(q))

UNALLOWABLE:

- ❖ *Income tax differential – domestic (31.205-6(e)(2))*
- ❖ *Severance pay-retention payment/bonus, "golden parachute" (31.205-6(g)(3))*
- ❖ *Backpay – retroactive adjustment of prior year salaries (31.205-6(h))*
- ❖ *Comp based on change in corp. securities, dividend payments, in lieu of stock rights payments (31.205-6(i))*
- ❖ *Employee rebates and purchase discounts on products or services produced by the contractor (31.205-6(n))*

40

40

Other labor in FAR part 31

ALLOWABLE:

- ❖ Training during company hours, at straight time (31.205-44)
- ❖ Labor relations effort – maintaining satisfactory relations(31.205-21(a))
- ❖ Lobbying – attending contract hearings, presenting contract performance information (31.205-22(b))
- ❖ Manufacturing and production engineering (31.205-25(a))
- ❖ Travel – time spent for allowable labor activities (directly associated costs)

UNALLOWABLE:

- ❖ Training incurred in overtime – the premium portion (31.205-44(a))
- ❖ Training salaries to attend grad level classes during working hours (31.205-44(b))
- ❖ Labor relations effort – collective bargaining (31.205-21(b))
- ❖ Lobbying – effort to influence Federal, State or local legislation (31.205-22(a))
- ❖ Manufacturing and production engineering that should be capitalized under consultant policy or IRS regulation –the amortizable cost is allowable(31.205-25(c))
- ❖ Travel – time spent traveling for unallowable labor activities (direct associated cost)

41

41

Small Business Compensation Issues

Labor Costing for Small Business

42

42

Small Business Compensation Issues

The Who

FAR 31.205-6(a)(6)(i)

(A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of their immediate families; and

(B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.

The What

FAR 31.205-6(a)(6)(ii)

(A) Be reasonable for the personal services rendered; and,

(B) Not be a distribution of profits (which is not an allowable contract cost).

43

43




A Word About Owners

- Shareholders should have some reward
- Reward does not need to be cash
- Portion of profits or share appreciation attributable to owners should be documented in compensation plan.

44

44




Partnerships

But we don't get a salary!!!

45

45



How....

Partnership compensation must be structured as guaranteed payments

- Must be accrued as a calculated wage
- Must be for services anticipated to be paid within a reasonable timeframe

DRAWS ARE NOT COMPENSATION!

46

46

**Stambaugh
Ness**

Accounting Treatment

- Establish a reasonable annual compensation amount for all partners and treat as guaranteed payments.
- Record this in job cost system just like regular employee.
- Prepare timesheets like all employees recording all hours.
- Labor will be costed according to labor costing policy in appropriate G/L income statement accounts.
- Include all partners in performance bonus pool.

47

47

**Stambaugh
Ness**

LLC

LLC Taxed as Partnership

Same as Partnership

48

48

Stambaugh
Ness

Sole Proprietors

There's no line for this on our Schedule C!

49

49

Stambaugh
Ness

Just Like a Partnership

- Set up accounting system just like a partnership with the same accounts.
- Record and cost like a partnership.
- If financial statements are prepared include all owner labor accounts in the income statement.
- Owner labor must be eliminated for the preparation of Schedule C.

50

50

Stambaugh
Ness

Single Member LLC

Same as Sole Proprietor

51

51

Stambaugh
Ness

Audit challenges in determining what is allowable/reasonable

CHALLENGES TO AUDIT:

1. Lack of supporting documentation
2. Ambiguous consultant policies
3. Interpreting the FAR meanings/definitions appropriately
4. Making determinations on costs not specifically mentioned in the FAR
5. Assessing reasonableness of costs that may be allowable

52

52



**Stambaugh
Ness**

Questions?

53

53



**Stambaugh
Ness**

It's our belief that an extraordinary client experience shouldn't be limited to a physical office, a city or even a state. So, we redefined what that experience looks and feels like for the clients we serve in 40+ states.

By fully utilizing and investing in innovative tools and practices, we offer direct access to high-level industry expertise that's anticipatory, collaborative, and personal.

And a geographically diverse employee model allows us to hire the best talent for our clients, focusing on the knowledge and skills they bring instead of where they reside.

No boundaries. No limitations. Just endless opportunities.

SN

**Stambaugh
Ness**

stambaughness.com | Collaborative. Forward Thinking. Future-Ready.

54

54



Let's Connect

T. Wayne Owens, CPA, CGMA, CDA
Managing Director, Government Contracting

P: 717.757.6999
E: wowens@stambaughness.com

**Stambaugh
Ness**

55



Let's Connect

Tony Machi, CPA, MBA
Manager, Government Contract Services Practice Area

P: 717.757.6999
E: tmachi@stambaughness.com

**Stambaugh
Ness**

56



Let's Connect

Kellianne Mayer, CPA, CPCM, CDA, MACC
Manager, Government Contracting

P: 717.757.6999

E: kmayer@stambaughness.com

Stambaugh
Ness