



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
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IN REPLY REFER TO

PAC 730.3.B.01/2008-02

March 4, 2008
08-PAC-010(R)

MEMORANDUM FOR REGIONAL DIRECTORS, DCAA
DIRECTOR, FIELD DETACHMENT, DCAA

SUBJECT: Audit Guidance on the Application of FAR 31.205-6(p), Limitation on Allowability of Compensation for Certain Contractor Personnel

SUMMARY

This memorandum provides audit guidance on the proper application of the FAR compensation cap for the top five executives. In summary, the FAR 31.205-6(p) limitation for the top five (5) executives imposes a ceiling on allowable compensation costs paid or accrued in the contractor fiscal year. Consequently, auditors should verify that the contractor determined the otherwise allowable compensation costs for each executive before applying the compensation cap. The ceiling is applied to year-end allowable compensation costs.

GUIDANCE

Executives subject to the compensation cap sometimes perform unallowable activities, such as lobbying, advertising, and organization or reorganization activities. In addition, the executive's compensation may include unallowable elements of cost under the FAR, such as stock appreciation rights and bonuses calculated based on changes in the price of corporate securities. To properly apply the FAR 31.205-6(p) compensation cap, auditors should verify that contractors determined the allowable portion of compensation costs for each executive by identifying the amount of unreasonable compensation, the amount of unallowable compensation elements and the amount attributable to unallowable activities, and deducting those amounts from the executive's total compensation costs subject to the cap. After verifying that the contractors' adjustments for unallowable compensation costs are appropriate, the auditor should then compare the allowable portion of the executive's compensation cost to the benchmark compensation limitation imposed by FAR 31.205-6(p).

Further, auditors are reminded that not all compensation cost elements are subject to the compensation cap. FAR 31.205-6(p)(2)(i) defines compensation subject to the cap to be wages, salary, bonuses, deferred compensation, and employer contributions to defined contribution pension plans. Auditors should evaluate all other compensation cost elements using the applicable FAR cost principle provisions.

To help auditors better understand the application of the executive compensation cap, the Enclosure includes an example application.

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Auditors are reminded that when performing a compensation system internal control audit, they should verify that the contractor's policies and procedures provide for the identification of the executives subject to the compensation cap (FAR 31.205-6(p)), and the proper application of the cap in preparing submissions to the Government.

CLOSING REMARKS

Field audit office personnel should direct questions regarding this memorandum to their regional offices. Regional offices should direct their questions to Accounting and Cost Principles Division, at (703) 767-3250 or by e-mail at DCAA-PAC@dcaa.mil.

/Signed/
Kenneth J. Saccoccia
Assistant Director
Policy and Plans

Enclosure:
a/s

DISTRIBUTION: C

EXAMPLE

Application of the FAR 31.205-6(p) Compensation Cap

The following example demonstrates the proper application of the compensation cap for two executives. All the amounts noted below are for the contractor fiscal year 2007.

Assumptions:

<i>Cost Elements</i>	<i>Executive A</i> (Note 1)	<i>Executive B</i> (Note 1)	<i>Reference</i>
<u>Compensation</u>			
Salary	\$1,000,000	500,000	
Cash Bonus	200,000	100,000	Note 2
Defined Benefit Pension Plan	50,000	30,000	Note 3
Contributions to 401(k) Plan.	5,000	5,000	Note 4
Stock Appreciation Rights	200,000	100,000	Note 5
Medical Insurance	4,000	4,000	Note 6
Company-Furnished Automobile	<u>11,000</u>	<u>11,000</u>	Note 7
Total	<u>\$1,470,000</u>	<u>\$750,000</u>	
FAR Benchmark Compensation Cap for CFY 2007	<u>\$597,912</u>	<u>\$597,912</u>	

- Note 1 The contractor agrees that both Executives A and B spent fifty percent of their effort performing unallowable lobbying activities (see FAR 31.205-22). The total compensation paid to each executive is considered reasonable in amount.
- Note 2 The cash bonus is paid in accordance with a plan that makes awards based on the executive's performance during the year. The cost is allowable per FAR 31.205-6(f)).
- Note 3 Costs for defined benefit pension benefits are not included in the definition of compensation (FAR 31.205-6(p)(2)(i)) subject to the cap.
- Note 4 The contractor contributes to the 401(k) retirement plan in accordance with the plan provision. The cost is considered allowable per FAR 31.206-6(j)(4).
- Note 5 Stock appreciation rights (SAR) represent deferred compensation that is calculated based on changes in the prices of corporate securities, which is unallowable per FAR 31.205-6(i).
- Note 6 The contractor provides group medical insurance to all of its employees. The cost is considered allowable per FAR 31.205-6(m)(1).
- Note 7 The contractor provides a company automobile for the executive's personal use. The cost is unallowable per FAR 31.205-6(m)(2).

EXAMPLE

Application of the FAR 31.205-6(p) Compensation Cap:

Calculate Allowable Compensation in accordance with FAR 31.205-6(p):

<i>Cost Elements</i>	<i>FAR</i>	<i>Executive A</i>	<i>Executive B</i>
1. <u>Comp Elements Subject to Limitation</u>			
Salary	31.205-6(p)(2)(i)	\$1,000,000	\$500,000
Cash Bonus	31.205-6(p)(2)(i)	200,000	100,000
Employer Contributions to 401(k) Plan.	31.205-6(p)(2)(i)	5,000	5,000
Stock Appreciation Rights	31.205-6(p)(2)(i)	<u>200,000</u>	<u>100,000</u>
Subtotal		\$1,405,000	\$705,000
2. Subtract Unallowable Costs			
a. Stock Appreciation Rights	31.205-6(i)	<u>(200,000)</u>	<u>(100,000)</u>
Subtotal		\$1,205,000	\$605,000
b. Lobbying Activity (50%)	31.205-22	<u>(602,500)</u>	<u>(302,500)</u>
3. Allowable Comp Subject to the Limitation at FAR 31.205-6(p)		<u>\$602,500</u>	<u>\$302,500</u>
FAR Benchmark Compensation Cap, CFY 2007		\$597,912	\$597,912
4. Net Allowable Compensation in Accordance with FAR 31.205-6(p)	31.205-6(p)(1)	<u>\$597,912</u>	<u>\$302,500</u>