

## SELECTED AREAS OF COST

### Chapter 7 – Bonuses and Incentive Compensation

#### **Authoritative Sources**

[FAR 31.201-4](#) Determining Allocability

[FAR 31.205-6](#) Compensation for Personal Services

[DFARS 231.205-6\(f\)\(1\)](#) Bonuses or Other Payments - Restructuring Costs

[48 CFR 9904.415](#) (CAS 415) Accounting for the Costs of Deferred Compensation

Bonuses and incentive compensation can take many forms, including cash, stock, stock options, stock appreciation rights, phantom stock plans, etc., or some combination thereof and may be paid in the current period ([short-term incentives](#) (STI) or future period(s) ([long-term incentives](#) (LTI)). Bonus and incentive compensation plans differ significantly between contractors. They also vary greatly between employee levels and often are determined and awarded as a percentage of base salary.

This chapter addresses the following topics:

- 7-1 Bonuses and Incentive Compensation
- 7-2 Compensation Based on Changes in the Prices of Corporate Securities or Corporate Security Ownership
- 7-3 Compensation Paid with Securities
- 7-4 Deferred Compensation Other than Pensions
- 7-5 Owners of Closely Held Companies
- 7-6 Part of Restructuring Costs Associated with a Business Combination
- 7-7 Limitation on Allowability of Compensation for Certain Contractor Personnel, Reasonableness, and Determining Allocability

#### **General Audit Guidelines**

In situations where bonuses and incentive compensation costs are significant, auditors should review the contractor's bonus and incentive compensation plans to obtain an understanding of the unique terms and conditions of each plan. This would usually only be done in situations where the auditor considered the compensations costs related to owners, executives, and other high risk employees to be material. Once the auditor has an understanding of the unique terms and conditions of each plan they should evaluate the costs for allowability for those requirements in FAR Part 31 for which there appears to be a [high risk](#) of there being a significant amount of unallowable costs.

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After evaluating all the bonuses and incentive costs for allowability the auditor needs to include the allowable portion of those costs when determining whether the total allowable compensation costs related to applicable employee's exceed the limitations of compensation in FAR 31.205-6(p) and are reasonable in accordance with FAR 31.205-6(b). Auditors should be watchful for potential allocability issues throughout their review of the bonuses and incentive costs for allowability and reasonableness.

### **7-1 FAR 31.205-6(f)(1) Bonuses and Incentive Compensation**

Bonuses and incentive compensation are allowable provided the—

- (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.

#### **AUDIT GUIDELINES**

The auditor needs to request and review all the evidence the contractor has to substantiate that:

- [It made the award based on an agreement established before the employee performed the services or in accordance with a practice that it has consistently followed](#) and
- The basis for the award is supported.

In situations where we question costs, the auditor needs to document the evidence the contractor provided and make clear whether the contractor did not have sufficient evidence to establish: (i) there was an agreement or practice that the contractor consistently followed, or (ii) the basis of the award.

**Audit Considerations:**

The auditor should evaluate all the evidence provided and apply critical thinking when determining if the total evidence gathered is sufficient to establish that the contractor complied with the requirements in FAR 31.205-6(f)(1).

It is important to note that FAR does not require that there be an agreement and a plan or policy only one or the other. It also does not require that the agreement or plan or policy be in writing. It only requires that there be an agreement or that the practice be one that the contractor consistently follows. However, it does require that, in addition to there being an agreement or consistently followed practice, the contractor needs to have support for the basis of the award.

It is the contractor's responsibility to provide sufficient evidence to establish compliance with the requirements of FAR 31.205-6(f)(1). However, there is not a specific set of documents that the contractor needs to provide. The documentation that contractors provide will vary from contractor to contractor. The auditor should explain to the contractor that we are looking for evidence that: (1) the contractor and the employees had an agreement before the services were rendered or if not that there was a practice in place that the contractor consistently followed and (2) the basis of the award was supported. Auditor judgment is critically important in evaluating the evidence provided by the contractor to ensure the contractor has sufficient evidence to establish compliance with the requirements of FAR 31.205-6(f)(1).

The contractor may provide evidence that clearly establishes that it has complied with the requirements or other corroborating evidence to establish that it has complied with the requirements. Auditors should consider all the evidence provided by the contractor, taking care to assess the quality of the evidence. For example, in situations where the contractor:

- Claims it had an agreement with the employees before the services were rendered, but it was not in writing, the contractor may facilitate a meeting between the employees and the auditor in which the employees may provide documentation (oral/written) regarding the agreement.
- Claims it was following a practice that it consistently follows, the contractor may provide documentation to establish that it has consistently paid the awards on a cyclical basis in the past and in years after the time period under audit.
- Did not document how it arrived at the exact amount of the award, the contractor may provide documentation that establishes there is a direct relationship between amounts awarded and the employees performance (i.e. written appraisal, sales, implementation of efficiencies, etc.)

## 7-2 FAR 31.205-6(i) Compensation Based on Changes in the Prices of Corporate Securities or Corporate Security Ownership

Compensation based on changes in the prices of corporate securities or corporate security ownership, such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions.

- (1) Any compensation which is calculated, or valued, based on changes in the price of corporate securities is unallowable.
- (2) Any compensation represented by dividend payments or which is calculated based on dividend payments is unallowable.
- (3) If a contractor pays an employee [in lieu of](#) the employee receiving or exercising a right, option, or benefit which would have been unallowable under this paragraph (i), such payments are also unallowable.

### **Audit Considerations:**

Rather than trying to cover all types of compensation that are based on stock price changes (otherwise known as stock appreciation) individually in the cost principle, in 1996 the Government streamlined FAR 31.205-6(i) and addressed general prohibitions and identified stock options, stock appreciation rights, phantom stock plans, and junior stock conversions as examples of unallowable forms of compensation that are based on stock price changes.

This would include [traditional long-term incentive plans](#), such as stock options plans, where a company grants options to purchase a fixed number of shares of stock of the corporation at a stated price during a specified period or grants rights to purchase shares of stock of the corporation at a stated price. The contractor normally grants these incentives for future services of employees.

Another example of these types of plans are Stock Appreciation Rights (SARs) where a company grants an employee the right to receive the value (in cash or stock) equal to the future appreciation in stock price. It also includes phantom stock plans which differ from stock option plans in that no stock is transferred to the employee and no cash outlays are required. Contingent stock shares are attributed to the employee. The employee's account may be increased by the equivalent dividends issued and any appreciation in the market price of the stock over the price of the stock on the measurement date.

Some corporations have replaced or supplemented traditional incentive plans that are based on stock price changes, with more complex plans which are often based on variable factors that depend on future events. For example, a corporation may award a fixed number of shares at a fixed price per share based on a stated increase in the company's earnings per share, the shares awarded are referred to as performance shares.

## **AUDIT GUIDELINES**

The examples of compensation based on stock price changes mentioned above are not an all-inclusive list and new stock scenarios are constantly emerging relative to the payment of long-term bonuses and incentives contingent on stock price appreciation (changes). Whenever an auditor identifies any scenario where bonuses or incentive compensation are based on stock price changes they should question the costs associated with them.

### **Audit Considerations:**

Bonuses and incentive compensation paid by giving the employee the actual stock of the contractor or of an affiliate, which is addressed below is not considered compensation which is based on changes in the price of corporate securities and therefore, FAR 31.205-6(i) does not make the costs associated with those type of payments unallowable. However, if deferred, the associated costs are subject to the requirements of FAR 31.205-6(k) discussed below and the associated costs should be considered when making reasonableness determinations under FAR 31.205-6(b). Additionally, ESOPs, which are qualified defined contribution employee benefit plans that are designed for the employee to invest primarily in the stock of the contractor, are addressed in FAR 31.205-6(q) and CAS 415-50(f) and are not considered unallowable compensation under FAR 31.205-6(i).

### 7-3 FAR 31.205-6(d)(2) Compensation Paid with Securities

When compensation is paid with securities of the contractor or of an affiliate, the following additional restrictions apply:

- (i) Valuation placed on the securities shall be the fair market value on the first date the number of shares awarded is known, determined upon the most objective basis available.
- (ii) Accruals for the cost of securities before issuing the securities to the employees are subject to adjustment according to the possibilities that the employees will not receive the securities and that their interest in the accruals will be forfeited.

#### **Audit Considerations:**

It is not a common business practice for a contractor to award its stock as compensation. Additionally, these type awards should not be confused with compensation based on stock price changes, such as stock options, stock appreciation rights, phantom stock plans, and junior stock conversions, which, as indicated above, are expressly unallowable under FAR 31.205-6(i). They should also not be confused with ESOPs, which, as indicated above, are qualified defined contribution employee benefit plans, and are addressed in FAR 31.205-6(q) and CAS 415-50(f). See Chapter 23 in this Guidebook for additional guidelines related to ESOP plans.

If the distribution of the stock awarded as compensation is deferred, the associated costs would also be subject to the requirements of FAR 31.205-6(k) discussed below and the associated costs should be considered when making reasonableness determinations under FAR 31.205-6(b). See CAM 8-415 for guidance related to deferred compensation.

## 7-4 FAR 31.205-6(k) Deferred Compensation Other than Pensions

The costs of deferred compensation awards are allowable subject to the following limitations:

- (1) The costs shall be measured, assigned and allocated in accordance with 48 CFR 9904.415, Accounting for the Cost of Deferred Compensation.
- (2) The costs of deferred compensation awards are unallowable if the awards are made in periods subsequent to the period when the work being remunerated was performed.

### **Audit Considerations:**

CAS 415 defines deferred compensation as an award made by an employer to compensate an employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods prior to the date of the receipt of compensation by the employee. This definition excludes the amount of year end accruals for salaries, wages, or bonuses that are to be paid within a reasonable period of time after the end of a cost accounting period. It also does not include bonuses accrued throughout the year or other short-term incentive (STI) compensation. Contractors usually pay STIs in cash; and within a short time period of the employee earning the award. However, STIs do not have to be in cash.

Conversely, employees typically earn deferred compensation or long-term (bonus) incentive compensation (LTI) for current performance or performance over several future years and contractors pay them in future periods. LTI can take many forms, including cash, stock, stock options, stock appreciation rights, phantom stock plans, restricted stock, etc. It is common for contractors to utilize multiple LTI plans in tandem.

## 7-5 FAR 31.205-6(a)(6)(iii) Owners of Closely Held Companies

For owners of [closely held companies](#), compensation in excess of the costs that are deductible as compensation under the Internal Revenue Code (26 U.S.C.) and regulations under it is unallowable.

**AUDIT GUIDELINES:**

In situations where [related party](#) taxpayers, which would include a contractor and an individual that owns 50% of its stock use different accounting methods, IRC Section 267(a)(2) prevents the related party taxpayer making the payment (contractor) from taking a deduction for the payment until the year the other related party taxpayer (stockholder) has to include it in income. Therefore, a contractor cannot claim the cost associated with a bonus awarded to an individual that owns more than 50% of its stock in the year the award was made unless it is paid by the end of that year. If a contractor claims such costs the auditor should question the costs based on FAR 31.205-6(a)(6)(iii).

**Audit Considerations:**

See CAM 6-414.3f for additional information regarding limitations of compensation of owners of closely held companies to that deductible under the Internal Revenue Code.

**7-6 DFARS 231.205-6(f)(1) Part of Restructuring Costs Associated with a Business Combination**

In accordance with Section 8122 of Pub. L. 104-61, and similar sections in subsequent Defense appropriations acts, costs for bonuses or other payments in excess of the normal salary paid by the contractor to an employee, that are part of restructuring costs associated with a business combination, are unallowable under DoD contracts funded by fiscal year 1996 or subsequent appropriations. This limitation does not apply to severance payments or early retirement incentive payments. (See DFARS 231.205-70(b) for the definitions of “business combination” and “restructuring costs.”)

**AUDIT GUIDELINES:**

Auditors should question bonus costs that exceed the employee's normal salary that are paid as restructure costs related to a business combination unless they are severance and early retirement incentive payments.

**Audit Considerations:**

As indicated in CAM 6-414.6b, reasonable payments for severance are allowable subject to the provisions in FAR 31.205-6(g), “Severance pay,” and for retirement incentive payments subject to the provisions in FAR 31.205-6(j)(6), “Early retirement incentive plans.”

## **7-7 FAR 31.205-6(p) Limitation on Allowability of Compensation for Certain Contractor Personnel, FAR 31.205-6(b) Reasonableness, and FAR 31.201-4 Determining Allocability**

### **AUDIT GUIDELINES:**

After evaluating bonuses and incentive costs for allowability the auditor will need to include the allowable bonuses and incentive costs along with the allowable portion of the other appropriate components of the contractor's compensation when verifying that the total allowable compensation costs for applicable employees do not exceed the limitation imposed by FAR 31.205-6(p). The allowable bonuses and incentive costs should also be included with the allowable portion of the other components of the contractor's compensation when determining whether the total allowable compensation costs for high risk employees are reasonable in accordance with FAR 31.205-6(b). See CAM 6-414.7 Compensation Ceilings - General Policy and CAM 6-414.8 Compensation Ceilings - General Audit Considerations for guidance related to the audit of compensation costs in regard to the compensation ceilings and CAM 6-413 Reasonableness of Compensation Costs for guidance regarding the audit of compensation costs for reasonableness. Auditors should be watchful for potential allocability issues based on FAR 31.201-4 Determining allocability throughout their review of the bonuses and incentive costs for allowability and reasonableness.

### **Callout**

**Short Term Incentive** - Contractors usually pay STIs in cash; and within a short time period of the employee earning the award. However STIs do not have to be in cash. ([Return](#))

**Long Term Incentive** - LTI can take many forms, including cash, stock, stock options, stock appreciation rights, phantom stock plans, restricted stock, etc. It is common for contractors to utilize multiple LTI plans in tandem. ([Return](#))

**High Risk** - Risk Considerations: Company Size, Number of Employees, Contract Mix, Business Structure, Materiality of Award. ([Return](#))

**Agreement Established** - The contractor and the employees had an agreement before the services were rendered or if not that there was a practice in place that the contractor consistently followed. ([Return](#))

**In lieu of** - Examples of lieu of payments are cash or the contractor's stock given to an employee instead of previously awarded stock options. However, it is not a common business practice to make such payments in place of awards of rights, options, or other benefits. ([Return](#))

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**Traditional LTIP** - Examples of traditional incentive plans include stock options, stock appreciation rights, and phantom stock plans. However, contractors very rarely use phantom stock plans anymore. ([Return](#))

**Closely Held Companies** - Although FAR does not define closely held companies, it is reasonable to assume that in situations where an individual owns more than 50% of the contractor stocks that the contractor would be considered a closely held company. ([Return](#))

**Related Party** - IRC Section 267(b)(2) identifies individuals that own more than 50% of the stock of a corporation and that corporation as persons to which this restriction applies. ([Return](#))