

## 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.

### **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.

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.

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

## **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.

## **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 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.

### **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.

### **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.

### **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).

## **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.

## **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](#))

**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](#))