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

SUBJECT: Audit Guidance on Compensation Costs for Contractor Employees Located in Foreign Countries and Performing Work under Iraq Reconstruction Contracts

This memorandum summarizes the regional responses received to Headquarter's memorandum 03-PSP-084(NR), dated December 24, 2003, Subject: Request for Information on Compensation Costs for Contractor Employees Located in Foreign Countries and Performing Work under Iraq Reconstruction Contracts. These responses were obtained to address regional requests for assistance in determining the reasonableness of the subject compensation costs. The summary survey data presented in this guidance was compiled entirely from contractors with employees performing work in Iraq and is provided for evaluating contractor compensation costs for employees located in Iraq. However, the general audit approach and guidance can be applied when evaluating compensation costs for all contractor employees deployed overseas.

General Guidance

The cost principles that should be used in the evaluation of the contractor's base and/or special overseas pay and the various employee overseas allowances, differentials, bonuses, and miscellaneous benefits are the allowability and reasonableness criteria contained in FAR 31.201-3 (Determining Reasonableness) and FAR 31.205-6 (Compensation for Personal Services). Specifically,

FAR 31.201-3(a) states "Reasonableness of specific costs must be examined with particular care in connection with firms or their separate divisions that may not be subject to effective competitive restraints. No presumption of reasonableness shall be attached to the incurrence of costs by a contractor. If an initial review of the facts results in a challenge of a specific cost by the contracting officer or the contracting officer's representative, the **burden of proof shall be upon the contractor to establish that such cost is reasonable**" [emphasis added].

FAR 31.205-6(b)(2) states "Compensation for each employee or job class of employees must be reasonable for the work performed. Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. In determining the reasonableness of total compensation, consider only allowable individual elements of compensation. In addition

to the provisions of FAR 31.201-3, in testing the reasonableness of compensation for particular employees or job classes of employees, consider factors determined to be relevant by the contracting officer. Factors that may be relevant include, but are not limited to, conformity with compensation practices of other firms – **(i) of the same size; (ii) in the same industry; (iii) in the same geographic area**…." [emphasis added].

FAR 31.205-6(f)(1) states "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 payment, and (ii) Basis for the award is supported."

Additionally, auditors should be alert for instances in which the contractor inconsistently provides bonuses and allowances depending on the nature and type of contract (e.g., competitive vs. noncompetitive, cost vs. fixed priced contract). These instances should be further analyzed to ascertain the validity of the rationale behind the inconsistency, and the costs should be challenged in accordance with FAR 31.205-6(f)(1) if the inconsistent application effectively demonstrates the nonexistence of an established corporate plan or policy.

Individual elements of compensation need to be reviewed in order to determine total compensation reasonableness because reliable surveys of total compensation do not exist. Below is a summary of the regional responses received on the survey of 37 contractors performing work in Iraq, and related guidance to consider in evaluating the elements of special pay, bonuses, allowances, and differentials that contractors are providing to their employees for performing work in Iraq.

Survey Results and Guidance to Evaluate Special Base Salary/Pay Rates

The regional responses show that 33 of the 37 contactors performing effort in Iraq used the same base pay scale for employees working on Iraq reconstruction contracts as that used for other contractor employees performing the same job elsewhere overseas or in the United States. The remaining four contractors established a special base pay scale for their Iraq deployed employees.

Once the FAO determines that a contractor used the same base pay scale for its employees, whether they are located in Iraq, elsewhere overseas, or in the United States, and has confirmed through previous audit effort that the salaries meet the requirements of FAR 31.205-6, there is no need to perform independent tests of reasonableness of base pay for contractor employees deployed overseas and performing work under Iraq reconstruction contracts. In those instances where the contractor has established a special base pay scale for deployed employees under Iraq reconstruction contracts, and has not demonstrated that wages and salary are reasonable and thus allowable in accordance with FAR 31.205-6, an evaluation of the special base pay scale should be performed. Auditors should determine why the special pay scale was implemented, and whether it covers any of the bonuses, allowances, or differentials discussed separately below.

Survey Results and Guidance to Evaluate Specific Elements of Compensation

The 37 contractors offered varying combinations of allowances, differentials, bonuses, or miscellaneous benefits, in addition to the base pay for the work performed in Iraq. A summary of the regional responses for each specific pay element, along with related audit guidance, is discussed below. Overall, many contractors (30) offered both hardship pay differentials and danger pay allowances to their deployed U.S. employees and non-U.S. (e.g., United Kingdom, Canada, Australia) employees. Four contractors offered only one of the two; and three contractors offered neither hardship nor danger pay to the deployed employees. Rest and relaxation (R&R) allowances and assignment completion bonuses were offered in varying degrees by approximately 50 percent of the contractors to their deployed overseas employees. Additionally, approximately 33 percent of the contractors offered deployed employees a foreign service premium or allowance. Lastly, in a limited number of instances, employees were provided a sign-on bonus or other unique bonuses, benefits, and allowances. A discussion of these specific elements follows.

1. Hardship Pay Differential. Most contractors justified providing the deployed employees with hardship pay differential due to the known difficult living conditions they would be working under. The Department of State Standardized Regulations (DSSR) (http://www.state.gov/m/a/als/c1843.htm), which provides guidance on Government employee overseas differentials and allowances, was cited by 12 of the contractors as the basis for justifying these costs. However, the statistics that follow demonstrate that contractors did not adopt the DSSR specific percentage allowance or the salary base to which the percentage allowance was applied. The DSSR hardship pay differential for Iraq is 25 percent of an employee's base pay, calculated on a 40 hour work week. In addition to the 12 contractors mentioned above, the survey results noted that 10 contractors with U.S. Agency for International Development (USAID) contracts are required to follow the DSSR. This is in accordance with the USAID Acquisition Regulations (AIDAR) (http://www.usaid.gov/business/regulations/) that specifies the use of the DSSR allowance provisions in all USAID cost reimbursement contracts performed in whole or in part overseas.

Shown below is a summary of the 37 contractors and the basis they use to calculate employee hardship pay.

# of Contractor(s)	Calculation of Hardship Pay
14	25% times base pay (where the base is a 40 hour week)
6	20% times base pay (where the base is a 40 hour week)
3	25% times base pay (where the base is a 60 hour, 48 hour, or 6 day week)
5	Use varying percentages ranging from 20% to 35% using either total pay, in-country pay, base pay plus overtime, or base pay plus weekend pay
5	Do not offer hardship pay
4	Use varying combinations of the above depending on the contract

As shown by the statistics above, 25 of the 37 contractors offer hardship pay equal to or less than the DSSR. For those contractors with USAID cost reimbursement contracts, verify that the contractor is following the hardship pay provisions of the DSSR for those employees located in Iraq. Since the predominant industry practice for the deployed contractor employees working on non-USAID contracts is to cite the DSSR as the basis for the hardship pay differential, auditors should evaluate contractors offering a hardship pay differential in excess of the DSSR hardship pay differential of 25 percent of base pay, calculated on a 40 hour work week. Review the contractor's hardship pay policy and practices, the basis to calculate hardship pay, the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. In cases where there is inadequate contractor support to justify hardship payments beyond the DSSR allowances, challenges to these costs should be made in accordance with FAR 31.205-6(b) because the costs exceed compensation practices of other firms in the same geographic area (i.e., Iraq). In accordance with FAR 31.201-3(a), the burden of proof is then upon the contractor to establish that such a cost is reasonable.

2. Danger Pay Allowance. Most contractors justify providing the deployed employees with danger pay due to known dangerous conditions. As with the hardship pay differential, the DSSR was cited by 12 contractors as the basis for justifying the payment of danger pay. The DSSR danger pay allowance for Iraq is 25 percent of an employee's base pay, calculated on a 40 hour work week. In addition to the above 12 mentioned contractors, the survey results noted that 10 contractors with USAID contracts are required to follow the DSSR. Contractors offer danger pay allowances to their U.S. and non-U.S. employees. Shown below is a summary of responses for the 37 contractors and the basis used to calculate employee danger pay.

# of Contractor(s)	Calculation of Danger Pay
18	25% times base pay (where the base is a 40 hour week)
3	25% times base pay (where the base is a 60 hour, 48 hour, or 6 day week)
8	Use varying percentages ranging from 15% to 25% using either total pay, base pay plus overtime, base pay plus overtime and G&A, or base pay plus weekend pay
4	Do not offer danger pay
4	Use varying combinations of the above depending on the contract

As shown above, 22 of the 37 contractors offer danger pay equal to or less than the DSSR. For those contractors with USAID cost reimbursement contracts performed in whole or in part overseas, verify that they are following the danger pay provisions of the DSSR. For those non-USAID contracts, auditors should perform an evaluation of contractors offering their deployed employees a danger pay allowance in excess of the DSSR danger pay allowance of 25 percent of base pay, calculated on a 40 hour work week. Review the contractor's danger pay policy and practices, the basis to calculate the danger pay, the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. In cases where there is inadequate contractor support to justify danger pay allowances beyond the DSSR allowances, challenges to these costs should be made in accordance with FAR 31.205-6(b) because the costs exceed compensation practices of other firms in the same

geographic area (i.e., Iraq). In accordance with FAR 31.201-3(a), the burden of proof is then upon the contractor to establish that such a cost is reasonable.

3. Sign-On Bonus. Most contractors (33) did not offer a sign-on bonus. In the four instances where it was offered, it was based on special circumstances (e.g., the need to have employees and/or essential positions deployed to Iraq in a very limited timeframe).

In those instances when sign-on bonuses are offered to deployed contractor employees, auditors should review the contractor's sign-on bonus policy and practices, the basis to calculate the sign-on bonus, the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. Verify that reasons for providing a sign-on bonus are justified and based on special circumstances. Challenges to contractor sign-on bonuses should also be made if contractor provided justification and documentary support are deemed inadequate. In accordance with FAR 31.201-3(a), the burden of proof shall then be upon the contractor to establish that such a cost is reasonable.

4. Rest and Relaxation (R&R) Allowance. According to the survey results, the Iraq contractors justified providing deployed employees an R&R allowance in order to maintain employee performance and as a common industry and Government practice. Contractors offer R&R allowances to both their U.S. and non-U.S. citizen employees. Shown below is a summary of the 37 contractors' R&R allowance. For 23 of these contractors, all of their deployed employees were U.S. employees. The following is a summarization of the responses.

# of Contractor(s)	Calculation of R&R Allowances
17	Do not offer a rest and relaxation allowance
8	One trip per year (usually to CONUS)
4	One trip per year (destination not provided)
6	Four trips per year (two to CONUS and two to nearby countries)
2	Use varying combinations of the above, depending on the contract

As shown above, 29 of the 37 contractors either did not offer rest and relaxation allowances or limited them to one trip per year. For contractors offering R&R allowances of more than one trip per year, auditors should review the contractor's R&R policy and practices, the basis to qualify for this allowance (e.g., nationality or job), the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. Verify that reasons for rest and relaxation are justified to maintain employee performance or morale and are based on common industry and/or Government practices. Challenges should be made to a contractor's rest and relaxation allowance if support for trips in excess of one per year is deemed inadequate when compared to known overseas contractor practices for work performed in Iraq, as indicated by the regional data. In accordance with FAR 31.201-3(a), the burden of proof shall then be upon the contractor to establish that the R&R cost is reasonable.

5. Assignment Completion Bonus. Contractors justified providing deployed employees an assignment completion bonus as a common industry practice and necessary for retention of U.S. and non-U.S. citizen employees for essential positions in Iraq. Below is a summary of the responses received on the 37 contractors' assignment completion bonuses being offered. The FAOs surveyed indicated that, at the time of their reviews, generally the contractors that provided this additional compensation had no written policy governing its implementation. Also, the responses indicate that the contractor's basis used to calculate the completion bonus may include costs unrelated to the nature of the completion bonus (e.g., basis included travel costs). The following is a summarization of the responses.

# of Contractor(s)	Calculation of Assignment Completion Bonus
17	Do not offer an assignment completion bonus
8	8%-35% times base pay (based on between 40 – 60 hours per week)
5	$10,000 bonus (4); $3,250 to $5,000 bonus (1)
2	10% times base pay plus overtime and travel costs
1	60% times total pay
1	10% times total Pay
3	Use varying combinations of the above, depending on the contract

As shown above, 17 of the contractors do not offer an assignment completion bonus. For contractors that offered assignment completion bonuses, auditors should review the contractor's assignment completion bonus policy and practices, the basis to qualify for this bonus (e.g., completion of employment agreement term or completion of certain defined and verifiable tasks), the basis to calculate the bonus, the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. Verify that reasons for using an assignment completion bonus are justified (e.g., to maintain employee retention, to complete critical work, or due to common industry practices). In addition, completion bonuses are not allowable if they are not in compliance with FAR 31.205-6(f)(1) wherein they should be 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 payment. Auditors should also challenge the contractor's bases for calculating and paying the bonus if they seem incongruent with the nature of the bonus. In accordance with FAR 31.201-3(a), the burden of proof is then upon the contractor to establish that such a cost is reasonable and necessary for the performance of the contract.

6. Foreign Service Premium or Allowance. Contractors justified providing deployed employees a foreign service premium or allowance based on the additional expenses the employees incur as a result of performing work in a foreign country. Shown below is a summary of the responses for the 37 contractors and the basis used to calculate the foreign service premium or allowance.

# of Contractor(s)	Basis to Calculate a Foreign Service Premium or Allowance
25	Do not offer a foreign service premium or allowance
8	15% times base pay (where the base is between 40-60 hours week)
2	25% times base pay (where the base is between 40-48 hours week)
1	5% times base pay (where the base is a 40 hour week)
1	15% times total pay

As shown above, 25 of the 37 contractors did not offer a foreign service premium or allowance. Auditors should review the contractor's foreign service premium or allowance policy and practices, the basis to qualify for this premium or allowance (e.g., nationality or job), the basis to calculate the premium or allowance, the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. Verify that reasons for providing the service premium or allowance are justified as a result of documented additional expenses for the employee's duty in a foreign country. Ensure that the expense properly reflects the period of time of the deployment and the nature of the anticipated employee expenses (i.e., whether they are of a continuing nature or a one-time reimbursement). Additionally, determine that the allowance does not duplicate any other contractor provided differential or allowance under another name or intent. Auditors should challenge any foreign service premium that is not adequately supported by the contractor. In accordance with FAR 31.201-3(a), the burden of proof then falls upon the contractor to establish that this cost is reasonable.

7. Miscellaneous Bonuses, Benefits, and Allowances. The survey responses also highlighted other miscellaneous bonuses, benefits, and allowances that are similar in nature to those previously explained above. In some cases, the responses did not include the contractor's bases for calculating the item. These miscellaneous items are:

- Management Performance Bonus (2 contractors) - 30% times base pay where the base is a 40 hour week
- Key Management Performance Bonus (1 contractor) - 10% to 20% times base pay where the base is a 40 hour week
- Performance Bonus (3 contractors) – one contractor offered a maximum of $2,000; another offered 10% times total pay; a third offered 3% to 5% times base pay where the base is a 40 hour week
- Program Completion Bonus (1 contractor) – 5% times base pay where the base pay is a 40 hour week
- Holiday Pay (1 contractor)
- Clothing Allowance (2 contractors)
- Separate Maintenance Allowance (2 contractors)
- Cost of Living Allowance (1 contractor) – 20% times base pay where the base pay is a 40 hour week
- Per Diem (2 contractors) – approximately $40 per day at one; the other offered $50 per day
- Special Pay (2 contractors) – 20% times base pay (40 hour week) to handle munitions; 25% times base pay (40 hour week) for mission essential personnel
- Post Allowance (1 contractor) – 60% times spendable income

As shown above, no more than 3 of the 37 contractors offer any given miscellaneous bonus, benefit, or allowance. When these items are offered, auditors should review the contractor's bonuses, benefits, and allowances policy and practices; the basis to qualify (e.g., nationality or job, special circumstances); the basis to calculate the bonus, benefit, or allowance; the deployed employees' compensation agreements, and consider factors determined to be relevant by the contracting officer. Verify that the reasons identified for making the payments are justified and that they do not duplicate any other contractor provided differential or allowance. Challenge a contractor provided bonus, benefit, or allowance based on factors not determined to be relevant by the contracting officer, or if support is deemed inadequate when compared to other known overseas contractor practices as indicated above. In accordance with FAR 31.201-3(a), the burden of proof shall then be upon the contractor to establish that such a cost is reasonable.

Guidance to Evaluate the Aggregate of the Elements of Employee Compensation

While the guidance provided above addresses the individual elements of compensation that are being offered and paid to contractor employees performing work in Iraq, FAR 31.205-6(b)(2) provides that employee compensation must be reasonable for the work performed, and is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total. Implied in total compensation reasonableness is the concept of offsets between otherwise allowable employee compensation elements, such as base pay, bonuses, differentials, and allowances. CAM 6-413.7 provides guidance related to compensation offsets. By using offsets, a contractor can demonstrate that, in total, the cost of the compensation package is reasonable despite the fact that one element of compensation may be outside the general norm or higher than compensation practices of other firms (i) of the same size; (ii) in the same industry; (iii) in the same geographic area; and (iv) engaged in similar non-government work under comparable circumstances.

When offsets are claimed in response to auditor challenges of reasonableness of a compensation element, a determination has to be made on the acceptability of the contractor's demonstration of its policy, practice, and/or rationale for their use for offset purposes. For example, when a contractor is challenged as to the reasonableness of their foreign service allowance, and the contractor proposes in response to this challenge an offset using a completion bonus which they do not offer but 50 percent of the contractors in Iraq do, then the contractor must demonstrate an acceptable rationale for it to be considered. In this instance, for example, the contractor may be able to reasonably justify the higher level of foreign service allowance by demonstrating that their total compensation package achieves the same objective as if they offered a completion bonus (e.g., successful retention of employees). Thus, due to the unique circumstances, mission requirements, and working conditions throughout Iraq and neighboring countries for the reconstruction contracts, auditors need to consider the reasonableness of contractor-provided rationale and documented support for offsets on a case by case basis. As a result, auditors should coordinate with the contracting officer and their regional special programs office to ensure all matters are considered prior to questioning deployed employee compensation costs.

Concluding Remarks

Questions regarding this memorandum should be directed through the regions to Mr. John Galiatsos, Program Manager, Policy Programs Division, at (703) 767-2270.

/Signed/
Robert DiMucci
Assistant Director
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