Treatment of A/E Firm Bonuses by Illinois DOT (IDOT)

Introduction

ACEC Illinois (ACEC-IL) has been in discussion with IDOT since late 2014 regarding its treatment of A/E firm bonuses. ACEC-IL and IDOT came to agreement on what was believed an acceptable policy in the fall of 2015. However, the application of the policy by the IDOT auditors is not consistent with the Federal Acquisition Regulation (FAR) or the AASHTO Audit Guide. Specifically, IDOT is arbitrarily capping bonus awards during the Statement of Experience and Financial Condition (SEFC) process and the associated indirect cost rate review process.

The IDOT auditors have expressed that it is their duty to check for allowability of bonuses using an arbitrary method referred to as the "Wolaver Method," referring to a 1988 IDOT Memorandum which describes the methodology. This memo is attached. The "Wolaver Method" is illogical, arbitrary and should not be considered a fair determination for bonus allowability. If anything, the "Wolaver Method" is an improper test for reasonableness of bonus awards. But FAR Part 31 is clear that reasonableness is applied only to the aggregate of all elements of executive compensation, not to individual elements such as bonuses.

Additionally, the IDOT Auditors are not properly giving credit to firms that have, and are following, FAR-compliant bonus policies, as they agreed they would in discussions in the fall of 2015. Specifically, they are subjecting all closely held firms to Paragraph E, Item b shown in the attached IDOT Policy dated December 24, 2015 regardless of whether they have an acceptable bonus plan as defined in the AASHTO Audit Guide. By treating closely held firms differently from larger firms, they have created a policy that treats small firms much more harshly than larger firms, such that a small firm could have its overhead rate cut by the IDOT auditors to a level well below its actual costs. Application of this practice could easily drive many small firms out of business.

FAR Requirements and AASHTO Audit Guide Interpretation

FAR Part 31 establishes the requirements for the allowability and reasonableness of compensation costs. FAR 31.205-6 requires a two-part test: 1) determine the allowability of individual elements of compensation (such as salary, bonus, retirement), and 2) evaluate reasonableness of TOTAL compensation costs for the employee or class of employees. In regards to reasonableness, the specific FAR reference is 31.205-6(b)(2) which states "Compensation is reasonable if the aggregate of each measurable and allowable element sums to a reasonable total." This two-part test has been upheld by FHWA and AASHTO in development of AASHTO Audit Guide and National Highway Institute training.

The FAR Part 31 requirements specific to bonuses are stated in FAR 31.205-6(f):

> (f) Bonus and incentive compensation. (1) Bonuses and incentive compensation are allowable provided the –

(i) Awards are paid or accrued in accordance with 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.

The authors of the AASHTO Audit Guide (a group consisting of representatives of AASHTO, ACEC, and FHWA) established clear guidance for the interpretation of this FAR requirement in the 2010 AASHTO Audit Guide, which has since seen only minor revisions in that section. Specifically, the Audit Guide lists specific ***best practices*** for bonus and incentive pay plans, and clarifies that these are best practices, not requirements. ACEC-IL supports the position that firms should follow FAR and recommended best practices for bonus and incentive pay plans. The bonus policy negotiated with IDOT in the fall of 2015, dated December 24, 2015, was intended to comply with FAR by properly treating bonuses as allowable costs for firms that have bonus plans which follow these AASHTO Guide best practices. Instead, the IDOT audit staff have chosen to deviate drastically from the intent of the policy.

IDOT's Approach

Through the experiences of ACEC-IL member firms and direct discussions with IDOT audit staff, IDOT is applying the bonus policy as follows:

Procedure for large firms:

- Evaluate bonus policy; if it meets AASHTO best practices, no further evaluation of bonuses is performed.

Procedure for closely held firms:

1) Evaluate bonus policy. If it does not meet AASHTO best practices, auditors may question any or all bonuses. If it meets best practices, proceed to next step.
2) Obtain a listing of salary and bonus amounts for all employees, noting who are shareholders / owners.
3) For each non-owner, calculate bonus as a % of salary.
4) Rank / order the list by descending % (bonus as % of salary).
5) Look for any breaks in the sequence of % from low to high to identify what the IDOT auditors consider "outliers". For example, in a bonus % sequence of 1%, 2%, 3%, 4%, 9%, 10%, 11%, 12%, 13%...increasing by 1% all the way up to 30%, the IDOT auditors have shown that they would consider any bonus above 4% to be an "outlier" simply because of the break in sequence. This would be done even if the employees receiving 4% bonuses are junior level staff and the employees receiving 10% and higher bonuses are mid-level and senior level staff. There is no consideration given to the job duties or level of the staff receiving the bonuses, only to the sequence of percentages.
6) Throw out all outliers for purposes of the calculation.
7) Limit bonus as % of salary of owners to the highest bonus % for non-owners, excluding outliers, plus 10%. In the above example, this would mean that all owners would have

their bonuses limited to 14%, even though many non-owners received substantially more than 14% bonuses.

Industry Practice and Effect of IDOT Bonus Policy

It is standard practice in the A/E industry for firms to compensate their staff using a combination of salary and bonus. Salaries are intended to compensate staff for performance of the ongoing responsibilities of their position, while bonuses are intended to reward employees for outstanding performance, including meeting and exceeding established performance goals. Because the attainment of performance goals is not guaranteed from year to year, firms do not reward outstanding performance by simply increasing the employee's salary; in fact, that would be a very bad business practice. If A/E firms gave all high performing senior staff raises, then the first time they did not meet their performance goals (possibly the next year), the firm would be faced with the decision to either terminate the employee (with possible legal consequences) or accept the fact that the employee is now overpaid. Quite simply, salary increases are permanent, while bonuses reward performance in the current year only.

However, in Illinois, the DOT has taken a negative position on the use of bonuses as a form of compensation by penalizing firms for paying bonuses to senior staff. IDOT's application of Wolaver policy limits the bonuses to owners; however, it is important to note that in small firms, the owners and senior staff are one and the same. In the same way that bonuses are used as an important part of the compensation of senior staff, the opportunity to become owners in the firm is used as an incentive to motivate employees and build commitment to the firm. Because firms typically offer share ownership only to their high performing staff, the owner group by definition consists of the firm's highest performing staff. It naturally follows that they would receive the highest performance-based bonus awards as a percentage of their salary.

Distributions of Profit

The IDOT audit staff have argued that application of the Wolaver policy is their way to ensure that they identify and disallow distributions of profit, which are unallowable under FAR Part 31. Actual distributions of profit to owners are indeed unallowable. However, the method that IDOT has used to define a distribution of profit is incorrect, and is not used by any other state DOT. Essentially the core premise of the Wolaver policy is that if a senior level staff or executive, who happens to be an owner, gets a larger bonus (as a % of salary) than a lower level (non-owner) employee, then the difference MUST be a distribution of profit. That position has no basis in FAR, DCAA guidance, or the AASHTO Audit Guide, and is not a position held or applied by any other state DOT.

In most A/E firms, especially smaller firms, the owner group is the executives and some of the senior staff. By definition, they make a larger contribution to the success of the firm than lower level staff. For IDOT to take the position that owners and non-owners "deserve" the same level of bonus is completely without basis, because they are saying that senior staff and lower level staff should receive the same bonuses. That simply does not fit with the reality of the A/E industry or any other industry where incentive compensation is used.

The IDOT audit staff have repeatedly referenced FAR 31.205-6(a)(6)(i) which states:

> Compensation costs for certain individuals give rise to the need for special consideration. Such individuals include:
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> (A) Owners of closely held corporations, members of limited liability companies, partners, sole proprietors, and members of their immediate families; and
> (B) Persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise.
>
> (ii)For these individuals, compensation must -
>
> (A) Be reasonable for the personal services rendered; and
> (B) Not be a distribution of profits (which is not an allowable contract cost).

IDOT staff have used the above FAR section as the basis for treating small (closely held) firms differently from large firms by continuing to apply the Wolaver policy.

However, this FAR section is only intended to highlight a potential risk area, not to impose additional, more stringent requirements on the individuals listed. Item (A) notes compensation must be reasonable for the work performed. This is already a general requirement of FAR 31.205-6(a), which notes that compensation for all contractor employees must be reasonable for the work performed. Item (B) notes that the compensation must not be a distribution of profits, which is not an allowable contract cost. However, the widely accepted interpretation of FAR 31.205-6 in the A/E industry is that any distribution of profit would be an unallowable cost, so this is not a concept confined to owners of closely held firms. The reason that A/E firms are expected to have documented bonus plans is to determine whether those plans meet the criteria to support that the awards are allowable bonus awards, based on employee performance, and are not distributions of profit. So, because this FAR section does not impose any additional requirements on small or closely held firms, there is no basis for IDOT to impose the Wolaver policy on those firms.

Negative Impact on Small Firms

If IDOT is allowed to continue applying the Wolaver policy to small firms, they would only have a choice between 1) no longer working on IDOT projects, or 2) reducing the bonuses to their senior staff / owners in an effort to avoid Wolaver disallowed costs. Option 2 would result in small firms losing their most valuable resource, their senior staff who win work, manage client relationships, and are key to the success of the firm. Instead, those firms will be forced out of working on IDOT projects, or on projects for any agencies that require an IDOT-approved overhead rate. Many of those firms will go out of business from the loss of work and loss of staff that would result. Under either option, the Wolaver policy causes small firms to lose work, lose staff, and in many cases, cease to exist as viable businesses. Because many small A/E firms are Disadvantaged Business Enterprise (DBE) firms, the Wolaver policy would drive many DBE firms out of business, making it harder for IDOT to achieve its DBE goals.

Conclusion

The Wolaver policy violates the intent of FAR Part 31, the AASHTO Audit Guide, and commonly accepted practice by state DOTs throughout the country. FHWA should require IDOT to rescind the Wolaver policy in its entirety, and require that IDOT follow the AASHTO Audit Guide in determining allowability and reasonableness of compensation, including bonuses, without any further tests or disallowances of bonuses for owners or non-owners, when firms (small or large) can demonstrate that their bonus plans meet the best practices criteria established in Chapter 7 of the Audit Guide.