ARMED SERVICES BOARD OF CONTRACT APPEALS
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Re: ASBCA Nos. 56105, 56322
Appeals of J.F. Taylor, Inc.
Under Contract No. N00421-94-D-0012 *et al.*

Dear Counsel:

Enclosed is one authenticated copy of the Board's decision.

Very truly yours,

CATHERINE A. STANTON
Recorder

Enclosure

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ARMED SERVICES BOARD OF CONTRACT APPEALS

Appeals of --	)	
	)	
J.F. Taylor, Inc.	)	ASBCA Nos. 56105, 56322
	)	
Under Contract Nos. N00421-94-D-0012	)	
N00421-96-C-5286	)	
N00421-97-C-1234	)	
N00174-99-D-0020	)	
N00421-01-C-0422	)	
N00421-02-D-3179	)	

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OPINION BY ADMINISTRATIVE JUDGE SHACKLEFORD

These appeals present the issue of the reasonableness of compensation paid to four executives of J.F. Taylor, Inc. (JFT), a privately held company, in four fiscal years. In the context of examining JFT's final indirect cost proposals for reimbursement of incurred costs, and for making a recommendation to the contracting officer for indirect cost rates, the Defense Contract Audit Agency (DCAA) determined that a portion of the compensation for each of the executives for the company for fiscal years ending 31 March 2002, 2003, 2004 and 2005 was unreasonable. The administrative contracting officer (ACO) subsequently issued final decisions demanding repayment of alleged overpayments. ASBCA No. 56105 relates to FY 2002, 2003 and 2004. ASBCA No. 56322 relates to FY 2005. The appeals were consolidated for hearing and decision. Both entitlement and quantum are before the Board.

FINDINGS OF FACT

1. John F. Taylor, Sr. (Mr. Taylor) founded J.F. Taylor, Inc. (JFT) in 1983, two years after retiring from the U.S. Navy. He has a bachelor's degree in physics from Providence College, a master's degree in electrical engineering from the Naval Post Graduate School and a master's degree in science and technology administration from The George Washington University. (Tr. 1/30) Mr. Taylor is and was at all times relevant to these appeals, Chairman of the Board of JFT (tr. 1/40).

2. Mr. Taylor's son, John F. Taylor, Jr. (John Taylor) and the son's friend David Lowe both graduated from Virginia Polytechnic Institute (Virginia Tech) and joined JFT in 1983. Another son, Mark Taylor, also an electrical engineering graduate of Virginia Tech, joined the company in 1985. (Tr. 1/31-32) A third son, Wayne Taylor joined the firm in 1986 following graduation from Towson University with a degree in business management (tr. 1/49).

3. JFT is headquartered in Lexington Park, Maryland near a major naval installation with offices also in Orlando, Florida. Its primary customer is the United States Navy, but it also does work for the United States Army and other service branches. Its primary business includes engineering services, aircraft trainers and trainer-related products. Engineering services includes a simulation group, a Test & Evaluation (T&E) group, and a systems engineering group. (Tr. 1/50)

4. Mr. Taylor has organized his company in such a way that he is the one person in charge and he has four vice presidents who run the company (tr. 1/29). Wayne Taylor has been a vice president of the company since the early 1990's with company-wide responsibility for business operations and infrastructure including accounting, payroll, human resources, facility management, information technology, contract management, purchasing and receiving (tr. 1/48-49, 52). John Taylor is vice president with overall responsibility for a group of contracts related to T&E and systems engineering and is heavily involved in security management and government property controls (tr. 1/51).

5. David Lowe is a vice president who handles contracts that fall within the simulation services group. Mark Taylor is a vice president who handles the trainer and trainer-related products, manages quality systems and is responsible for obtaining company ISO certification. According to Wayne Taylor, the vice presidents cross over lines of demarcation between responsibilities. When they prepare proposals, they meet together to devise bid strategies and in that sense the work overlaps. (Tr. 1/51)

6. Each of the vice presidents also has other corporate wide responsibilities. Wayne Taylor leads a compensation team that does salary reviews and all vice presidents are part of that team (tr. 1/51). But the team does not review executive compensation nor

does it advise Mr. Taylor on setting compensation for executives in the company (tr. 1/71). The team also works together in preparing bids and proposals as that is an expensive and time consuming procedure. While one vice president takes the lead on preparing a proposal, the leader gets inputs from the others because all are technically trained and can help with the management plan. While Wayne Taylor takes the lead in preparing the cost portion of the proposal, he gets input from other vice presidents on pricing. (Tr. 1/52)

7. JFT is also described organizationally as a flat line of four vice presidents who report to the president (tr. 1/50-51). Mr. Taylor says he is the one person in charge and his vice presidents are "equal in [his] consideration and therefore, their pay should be equal" (tr. 1/29).

8. In a letter dated 9 April 2007, counsel for JFT described the organization as follows:

> JFT does not employ the conventional vertical organizational hierarchy of CEO, COO, Executive Vice President, and CFO. Rather, as has been borne out by results such as those depicted over the past 24 years, JFT has found that a horizontally oriented executive scheme works best for the company. This approach vests responsibility for the company's management in four key executives who report directly to the JFT President. Each of these vice presidents ("VPs") has responsibilities that are substantively equal: three are responsible for operations of the company's major contract and technology areas, as noted above. The sum of the contracts in these three areas comprise virtually 100% of the firm's revenues and all technical employees report to them. The fourth VP works integrally along-side the other VPs with responsibility for the administrative and business aspects of each program area. Each VP has experienced a significant increase in personnel and responsibility that correlates with revenue growth in recent years.

(R4, tab 15 at 3-4)

9. Initially conceived as a small engineering consulting practice, JFT expanded to include automation in the field of naval aviation test and evaluation after John Taylor and David Lowe joined the firm in 1983 and Mark Taylor in 1985. They brought an infusion of knowledge and the latest in computer technology and engineering to the firm. (Tr. 1/31-32)

10. During the first few years, the company worked most in test and evaluation of an avionic system which they continue to do. However, they later got involved in simulation when they won a contract to build a simulation laboratory for the P-4 aircraft, and while the aircraft was never bought by the Navy, the work performed by JFT was well done so when the Navy sought help to run its flight simulator program for the F-18 aircraft, JFT bid and won that competitive procurement and has maintained that contract for over 20 years. (Tr. 1/32-33)

11. The simulation work taught them how to build flight trainers and now an additional product line is offered for building flight simulators for the Hercules helicopter and for fixed wing aircraft (tr. 1/33).

12. During JFT fiscal years 2002 through 2005, the company experienced dramatic growth and expansion. Wayne Taylor testified in that regard as follows:

> The company performance has been outstanding from the very beginning from 1983, but in particular, during these years we've seen revenue growth of 20 to 25 percent a year on average year over year pretty much from the time we started.
>
> The number of employees during this period was growing. I think we were at 90 employees at the beginning of the 2000 and we grew to like 225 at the end of this period which is [a] 250 percent increase in employees. And the revenue was even more profound than that.
>
> The thing that we look to in our performance, though, ultimately and that's one of the reasons that we try so hard to please our customers, to get good employees, we may not grow as fast as some of these other companies who go up to the big contracts and then go up and go down....[W]e've set up a culture and a management style and a philosophy that has proven to work very well for our employees, our customers and ultimately it makes it so that we can have consistent win rates when we bid contracts, which adds continuity to the company.

(Tr. 1/63)

13. Wayne Taylor also testified that the company aggressively manages costs in order to maintain its competitive advantage, stating:

> One of the things that is unique about why we are so successful in terms of our bidding besides the technical advantage that we created is that we keep our cost very competitive. And we've done that. We didn't have to do that. During good years a lot of companies go and add bureaucracy because they can. We wanted to keep a lean management team in place so that we could stay nimble, we could continue to make quick decisions. Again, put together these quality proposals that we put together and rest on our laurels of all these positive feedback that we get from our customers and our loyalty and it's worked out very, very well.

(Tr. 1/64)

14. For FYs 2002, 2003, 2004 and 2005, JFT retained work they have had for 26 years in their main contract area IFF (Identification Friend or Foe). This work is competed but JFT gets little competition (tr. 1/33-34). The area in which JFT is located is technically intensive in that a large number of large and small companies compete for business, including, according to Wayne Taylor, Lockheed Martin, ManTech and SAIC (tr. 1/34).

15. It is undisputed that JFT performs at a high level. The government's Contract Performance Assessment Reports (CPARS) have rated JFT superb over the years. (Tr. 1/35-36) While there is no precise comparative evidence of how JFT performs year to year in relation to specific peer companies, there is ample evidence from which to infer that JFT has performed at a higher level when compared to other companies, especially the evidence of contract retention over a 26 year period, including 2002, 2003, 2004 and 2005 while competing with companies of varying sizes (*see* finding 14), and the evidence of dramatic growth and expansion including revenue growth of 20 to 25 percent on average per year during the years 2002 through 2005 (finding 12).

<u>How compensation is determined by JFT</u>

16. Mr. Taylor testified that he has been making compensation decisions about this particular executive team for over 26 years (tr. 1/41). Yet, he does not have a compensation plan (tr. 1/41-42) and does not employ a consultant to advise on setting the compensation for executives (tr. 1/46). Rather, Mr. Taylor described his compensation philosophy as follows:

My philosophy, first thing is you want to pay for performance. You want to make sure that you are paying them what they deserve. At the same time you don't want to pay so much that you're in a position where you are no longer competitive.

Additionally, you got to pay enough to make sure that your people don't wander off to either the Government or competitors.

One of the biggest problems acquiring people is that in the actual area where we're located it's rural and it's hard to attract people who have come to like city life, if you will. And the result is it's very difficult to attract engineers. Once you get them, everybody wants them around you including the Government and especially the Government.

And our biggest loss of people is to the Government. And so, therefore, the Government pay scales are very important to us because they dictate how much I've go[t] to pay to make sure I keep my people. And now the Government – it used to be the Government would always hire at 12 step 1 down in our area. But now because [NAVAIR] moved down to the area, the driven level is 13 and they hire a[t] step 10. And so, therefore, they'll – if a person's pay requires a step 10, they hire at that level.

So we have a real big problem trying to keep our people away from the Government, if you will. And they use us as their major recruiting rounds and it apparently is going to get worse going forward here.

(Tr. 1/36-37)

17. Further explaining the risk of executives leaving for competitors, Mr. Taylor said that even his children who are executives get approached by competitors so this is a reason for paying them well. Another example he gave was David Lowe, who is not one of his sons, but whose wife is head of contracts for JFT and referring to the Lowes' he said:

[T]here's a combination there that could actually just walk out tomorrow and start their own company. They've got it all. They've got the contracts part, they know DCAA. They know

> how that all works and they got the technical all in a package there. I had to make sure that team is compensated [so] that that inducement is not there in his life.

(Tr. 1/38)

18. Regarding his three sons who work for him, Mr. Taylor was asked didn't they "have to work for" him. He agreed but accepted that the possibility existed that they might try to go out and start their own business. (Tr. 1/39) Further he testified:

> If I look at these three kids and I mentioned before their education of my technical sons and my son Wayne, you know, he began working in the business when he was in college. He worked at Towson and on weekends and he would run the general ledger and the payroll for us as we were starting up business, you see.
>
> And those three sons plus David Lowe have – have become the culture of our business. They have made this business what it is. You know, I get the credit of being a founder, okay. But the fact of the matter is, these are the guys in the trenches who have made this thing work to give us the reputation that we have in the community as a viable, valuable technical company.

(Tr. 1/39-40)

19. JFT made a substantial profit in 2002, but Mr. Taylor made a decision not to distribute that profit through dividends to the stockholders. His rationale for that decision was if he distributed profits based upon percent of ownership, the distribution would not be equitable since he owned one-third of the business, and his children collectively, including a daughter not working in the business, owned two-thirds and he wanted to distribute the profits equitably to the persons who made the profit. He wanted to avoid giving money to his daughter who was no longer active in the company and who he felt, due to her personal circumstances, did not need any money. (Tr. 1/44) Therefore, Mr. Taylor used a bonus system to distribute profits for 2002, 2003, 2004 and 2005 and he did not seek reimbursement from the government for the bonus money distributed from profit (tr. 1/46).

Contract Clauses and FAR Provisions

20. These appeals were brought under six contracts administered by DCMA. Contract No. N00421-02-D-3179 was awarded to JFT on 26 April 2002 (with an effective

date of 25 April 2002) by the Naval Air Warfare Center Aircraft Division, Patuxent River, MD (NAVAIR) (R4, tab 1). Contract No. N00421-01-C-0422 was awarded to JFT on 27 September 2001 by NAVAIR (R4, tab 2). Contract No. N00174-99-D-0020 was awarded to JFT on 26 August 1999 by the Naval Surface Warfare Center, Indian Head, MD (R4, tab 3). Contract No. N00421-97-C-1234 was awarded to JFT on 1 July 1997 by NAVAIR (R4, tab 4). Contract No. N00421-96-C-5286 was awarded on 30 September 1996 (with an effective date of 24 September 1996) to JFT by NAVAIR (R4, tab 5). On 3 October 1993, NAVAIR awarded Contract No. N00421-94-D-0012 to JFT (R4, tab 6).

21. Several iterations of FAR 52.216-7, ALLOWABLE COST AND PAYMENT,[1] were included in the respective contracts. That provision in all its iterations generally provides that the government will make payments to the contractor in amounts determined to be allowable by the contracting officer in accordance with FAR Subpart 31.2 in effect on the date of the contract. FAR 52.216-7 also provided as follows:

> (d) *Final indirect cost rates.* (1) Final annual indirect cost rates and the appropriate bases shall be established in accordance with Subpart 42.7 of the Federal Acquisition Regulation (FAR) in effect for the period covered by the indirect cost rate proposal.

(R4, tabs 1-6)

22. Subpart 42.7 prescribes policies and procedures for establishing billing and final indirect cost rates. Subpart 31.2 establishes in 31.201-2 that a cost is allowable only when it meets certain enumerated requirements, one of which is reasonableness.

23. FAR 31.201-3 DETERMINING REASONABLENESS, provides as follows:

> (a) A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. 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.

---

[1] (JUL 1991) (APR 1998) (MAR 2000).

(b) What is reasonable depends upon a variety of considerations and circumstances, including –

(1) Whether it is the type of cost generally recognized as ordinary and necessary for the conduct of the contractor's business or the contract performance;

(2) Generally accepted sound business practices, arm's-length bargaining, and Federal and State laws and regulations;

(3) The contractor's responsibilities to the Government, other customers, the owners of the business, employees, and the public at large; and –

(4) Any significant deviations from the contractor's established practices.

24. Compensation for personal services is an allowable cost under the circumstances described in FAR 31.205-6, COMPENSATION FOR PERSONAL SERVICES. As in effect on the date of award for all of the contracts except Contract No. N00421-94-D-0012, FAR 31.205-6 provided in part as follows:

(a) *General.* Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance.... Compensation for personal services is allowable subject to the following general criteria and additional requirements contained in other parts of this cost principle:

(1) Compensation for personal services must be for work performed by the employee in the current year and must not represent a retroactive adjustment of prior years' salaries or wages....

(2) The compensation in total must be reasonable for the work performed; however, specific restrictions on individual compensation elements must be observed where they are prescribed.

(3) The compensation must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply, in effect, an agreement to make the payment.

....

(b) *Reasonableness*. The compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. This paragraph addresses the reasonableness of compensation, except when the compensation is set by provisions of a labor-management agreement under terms of the Federal Labor Relations Act or similar state statutes.... In addition to the provisions of 31.203-3, in testing the reasonableness of individual elements for particular employees or job classes of employees, consideration should be given to factors determined to be relevant by the contracting officer.

(1) Among others, factors which may be relevant include general conformity with the compensation practices of other firms of the same size, the compensation practices of other firms in the same industry, the compensation practices of firms in the same geographic area, the compensation practices of firms engaged in predominantly non-Government work and the cost of comparable services obtainable from outside sources. The appropriate factors for evaluating the reasonableness of compensation depend on the degree to which those factors are representative of the labor market for the job being evaluated. The relative significance of factors will vary according to circumstances. In administering this principle, it is recognized that not every compensation case need be subjected in detail to the tests described in this cost principle. The tests need be applied only when a general review reveals amounts or types of compensation that appear unreasonable or unjustified. Based on an initial review of the facts, contracting officers or their representatives may challenge the reasonableness of any individual element or the sum of the individual elements of compensation paid or accrued to particular employees or job

> classes of employees. In such cases, there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question. In doing so, the contractor may introduce, and the contracting officer will consider, not only any circumstances surrounding the compensation item challenged, but also the magnitude of other compensation elements which may be lower than would be considered reasonable in themselves....
>
> ....
>
> (2) Compensation costs under certain conditions give rise to the need for special consideration. Among such conditions are the following:
>
> (i) Compensation to (A) owners of closely held corporations, partners, sole proprietors, or members of their immediate families, or (B) persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that salaries are reasonable for the personal services rendered rather than being a distribution of profits. Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits. For closely held corporations, compensation costs covered by this subdivision shall not be recognized in amounts exceeding those costs that are deductible as compensation under the Internal Revenue Code and regulations under it.

On the date of award of Contract No. N00421-94-D-0012, FAR 31.205-6(b) provided:

> (b) *Reasonableness*. (1) The compensation for personal services paid or accrued to each employee must be reasonable for the work performed. Compensation will be considered reasonable if each of the allowable elements making up the employee's compensation package is reasonable. In determining the reasonableness of individual elements for particular employees or classes of employees, consideration should be given to all potentially relevant facts. Facts which may be relevant include general conformity with the compensation practices of other firms of the same size, the

> compensation practices of other firms in the same industry, the compensation practices of firms in the same geographic area, the compensation practices of firms engaged in predominantly non-Government work, and the cost of comparable services obtainable from outside sources. While all of the above factors, as well as any other relevant ones, should be considered, their relative significance will vary according to circumstances. For example, in the case of secretarial salaries, conformity with the compensation paid by other firms in the same geographic area would likely be a more significant criterion than conformity with the compensation paid by other firms in the same industry wherever located. In administering this principle, it is recognized that not every compensation case need be subjected in detail to the above or other tests. The tests need be applied only when a general review reveals amounts or types of compensation that appear unreasonable or unjustified. Based on an initial review of the facts, contracting officers or their representatives may challenge the reasonableness of any individual element or the sum of the individual elements of compensation paid or accrued to particular employees or classes of employees. In such cases, there is no presumption of reasonableness and, upon challenge, the contractor must demonstrate the reasonableness of the compensation item in question. In doing so, the contractor may introduce, and the contracting officer will consider, not only any circumstances surrounding the compensation item challenged, but also the magnitude of other compensation elements which may be lower than would be considered reasonable in themselves....
>
> ....
>
> (2) [identical to (b)(2) as quoted above]

DCAA's Executive Compensation Reviews and Resultant Claims

25. In response to requests from the regional DCAA office, the DCAA Mid-Atlantic Compensation Team (MACT) performed Executive Compensation Reviews (ECRs) for JFT for the fiscal years 2002 through 2005. These reviews compared the executive compensation that the company reported on its incurred cost submissions with the MACT's determination of "reasonable compensation" for other companies. For each of those years, the MACT found that JFT's executive compensation exceeded what the MACT determined was reasonable. DCAA concluded that the total excess for all four

years was $849,050. The DCAA then recomputed JFT's indirect rates using the amounts for executive compensation that the MACT determined were reasonable. Relying on the MACT's determinations and the DCAA's recalculation of the company's indirect rates, the ACO issued letters of unilateral determinations of indirect rates. (R4, tabs 8-12, 20-22)

26. On 11 December 2006, the ACO issued a unilateral rate determination with respect to JFT's 2002, 2003, and 2004 fiscal years, focusing on his rationale for disallowing costs for executive compensation. The determination required JFT to submit adjustment vouchers if the rates differed from the rates used in previous interim billings for those fiscal years. (R4, tab 14)

27. In a final decision dated 5 July 2007, the ACO determined that the interim vouchers using rates in excess of the rates he established in his 11 December 2006 determination, resulted in overpayments through provisional billings in the amount of $402,511 for fiscal years 2002, 2003 and 2004, and for which a demand was made. The final decision was timely appealed on 6 July 2007 and was docketed as ASBCA No. 56105. (R4, tabs 17, 18)

28. On 18 January 2008, the ACO issued a unilateral rate determination to JFT for fiscal year 2005, which again focused on questioned costs for executive compensation. In that same communication, the ACO also determined, as a final decision, that JFT received payments for interim vouchers using billing rates in excess of the rates unilaterally determined therein. Consequently, a demand was made for payment in the amount of $187,089. The total overpayment was determined to be $215,354, but of that amount, $28,265 was allocable to a contract not administered by DCMA and thus was not demanded. (R4, tab 23) The final decision was timely appealed on 19 February 2008 and was docketed as ASBCA No. 56322.

29. The demands for all four years totaled $589,600.

DCAA's Methodology

30. John Bentz (Bentz) is supervisory auditor for MACT and testified about the DCAA methodology used by the Compensation Specialists in the ECRs at issue. Bentz has been employed by DCAA since 1986, has been a member of the compensation team since 1995 and became the MACT supervisory auditor in 2008. He has a B.S. in accounting from the University of Scranton, is a certified public accountant, and has performed over 1200 ECRs himself. (Tr. 2/8-10)

31. Bentz supervises four team members, two specialists and two senior auditors. Team members are required to be senior auditors within DCAA for at least one year before joining the MACT. Once joining the team, they are mentored for three to six months and

encouraged to attend WorldatWork certification seminars and become members of that organization so that research is available to them. Previously called the American Compensation Association, WorldatWork is the leading non-profit association on compensation and benefits. It publishes research and provides certification courses. MACT relies on that organization for training its team members and on its publications for performing its work. (Tr. 2/6-8)

32. Bentz described the procedural steps typically taken by auditors in performing executive compensation reviews, in part as follows:

> Well, first you want to select the positions that you're going to utilize or review. You want to identify the surveys that you're going to use in that analysis. You're going to select the surveys based [on the] size of the company [and] other relevant factors. [You] try to use at least three surveys.
>
> After you've selected the surveys you want to escalate the data to the midpoint of the contractor's fiscal year. After that you want to get the median value from the survey, and after you have the median values from each of the surveys you want to get a market consensus of those values.
>
> After you have the market consensus, you want to apply the 10 percent range of reasonableness. After doing that you want to look at the data submitted and see if you need to make an adjustment to the claim[ed]-cash compensation or compute an offset for any under market fringe benefits.
>
> We then compare the claim[ed] cash compensation to our audit recommendation, with any consideration for the market adjustment for fringe benefits and determine if there's any unreasonable compensation.
>
> When there is unreasonable compensation or if there isn't, in either case we communicate that to the FAO auditor and the field auditor who should communicate that with the contractor.

(Tr. 2/11-12)

33. Standard procedure is that contractors be given the opportunity to respond to results the auditors might find and if the contractor presents any consultant studies, CPA

reviews or anything of that nature, the auditor will consider it. This methodology described by Bentz has been utilized for about 20 years. In the mid-1980s when the responsibility was being transferred from one organization to another, research was performed by Bentz's predecessor on how compensation professionals do these analyses and found that those professionals used market surveys and from that research the current methodology resulted. (Tr. 2/12-13)

34. That methodology is set out in the DCAA contract audit manual and auditors are required to follow it. Bentz testified about some specifics of that methodology in part as follows:

> Q [by Mr. Duecaster] When obtaining an average or a mean compensation of the surveys, is any more weight afforded to one survey than to any other survey?
>
> A [Mr. Bentz] No, we're trying to determine a market consensus; therefore, we give each survey equal weighting.
>
> Q And you mentioned a 10 percent range of reasonableness factor. All right, could you talk a little bit about that and why it's used?
>
> A Yes, we've historically used a 10 percent range of reasonableness factor. A lot of compensation professionals and publications state that if.... [y]ou are within 90 to 110 percent of the market consensus [your] compensation is reasonable or market competitive.
>
> Q In developing a reasonable or market level of compensation amount for a selected percentile, is any detailed statistical analysis of that data done?
>
> A No, it is not.
>
> Q Why not?
>
> A The survey houses have already done the detailed statistical analysis. We are simply using the surveys as a tool to gather the information on compensation.

(Tr. 2/13-15)

35. The Executive Compensation reviews for Fiscal Years 2002, 2003 and 2004 were performed by Wilhelm Rapp (Rapp). Rapp earned a B.S. degree from Drexel University in accounting. After graduation he worked as an accountant in private practice for five years before joining DCAA in 1986. He was a Compensation Specialist on the MACT from 2001 to 2006 and during that tenure he performed over 1,000 executive compensation reviews. (Tr. 2/37-38)

36. For 2002, Rapp initially found that $288,057 was unreasonable. The spreadsheet below prepared on 8 March 2005 reflects the data used in computing the unreasonable amount.

J.F. TAYLOR, INC.
EXECUTIVE COMPENSATION REVIEW
FISCAL YEAR 2002

EXECUTIVE	CLAIMED CASH COMP	ECS	WTPF	EXEC	DIETRICH	SURVEY AVERAGE +10% ROR	DIFFERENCE
President	$ 375,000	$ 280,100	$339,139	$364,181	$261,000	$342,216	$ 32,784
VP	260,000	240,900	229,941	196,858	210,684	241,555	18,445
VP	260,000	186,900	195,108	ND	179,251	205,795	54,205
VP	260,000	150,300	184,051	161,027	178,364	185,279	74,721
VP	260,000	144,300	ND	126,793	143,719	152,098	107,902
TOTAL	$1,415,000	1,002,500	948,239	848,859	973,018		$288,057

(Tr. 2/40; R4, tab 8 at 3)[2]

37. According to the notes accompanying the analysis, the audit was based on comparisons with the same or similar executive positions from firms of the same size and industry as JFT and all data were aged to the midpoint of the fiscal year and were subjected to a 10% Range of Reasonableness, which practically meant that the average of the four surveys was increased by 10 percent (*id.*). Rapp testified that for the 2002 review, he first looked at the 2001 review and since the JFT executives were market priced to the typical top five executives in an organization, he did the same for 2002 in order to be consistent (tr. 2/41). He then had to select which surveys to use and the first was Watson Wyatt (ECS) because he could input the revenue right into the survey as revenue is a key factor in determining reasonable compensation (tr. 2/42-43). He used data for CEO for President, COO for one Vice President, Executive Vice President for the second Vice President, CFO

[2] Several exhibits are in the Rule 4 files and also in the Jackson Witness Notebook (R4, tabs 8-12, 20-23). Versions in the Jackson notebook are Bates stamped. And thus for those documents when we cite to a page we are typically citing to the version of the document in the Jackson Witness Notebook.

for the third and Top Marketing and Sales Executive for the fourth. He then selected the services sector because there were 110 organizations in the survey, a large number, and because JFT is part of SIC 8711, engineering services, a subset of the services sector. He did not use the engineering services option because there was no data for the last three positions and by using the services sector he was able to use median values for all five executive positions. (Tr. 2/43)

38. The policy is to try always to use the median value in the surveys and that is what Rapp did in this case (tr. 2/44). The policy was also to age the data and Rapp did so in this case. Aging the data means that they take the survey data date and escalate it to the midpoint of the contractor's fiscal year using escalation factors provided by WorldatWork. (Tr. 2/44) Based on the foregoing description of the decisions he made, Rapp recommended a median value of $280,100 for the CEO based on the Watson Wyatt survey (tr. 2/44). He used the same methodology for the other positions based on the Watson Wyatt survey and recommended the median values set for the vice presidents in the matrix above under the ECS heading (tr. 2/44).

39. The second survey used by Rapp was Washington Technical Personnel Forum (WTPF), where he used the top executive positions, CEO, COO, CFO and Top Marketing and Sales Executive (where ND means no data was available for that particular position). He thought this survey was a good one for JFT because it reported on technical and professional services even though it was not predominately a government contractor survey. He also was able to match JFT's sales of $34 million within the sales range in WTPF of $25 to $100 million. Using the same methodology as for the CEO, he aged the data to the midpoint of the fiscal year and used the median value for total cash compensation. He used the same methodology for the other positions as well. (Tr. 2/45)

40. The third survey selected by Rapp was from William M. Mercer, Inc., shown as EXEC in the matrix above and he used the executive positions CEO, COO, CFO, and Top Marketing and Sales Executive for the President and three of the four vice presidents. He used the JFT sales of $34.1 million in the total cash compensation regression formula for the CEO using the Chairman and CEO, Revenues/Professional Services for job scope. (Tr. 2/45; R4, tab 8 at 17) Using the formula shown, he calculated reasonable compensation for the top position at $354,607 and when the data was aged to the midpoint of the JFT fiscal year, he calculated $364,181. Rapp used the same methodology for the other positions available in the Mercer survey. (Tr. 2/45-46; R4, tab 8 at 17)

41. The final survey selected by Rapp was Dietrich which he thought was a good match to JFT since Dietrich is an engineering survey. He tied the JFT sales to the revenue cuts in the Dietrich survey but rejected the median value for the top position because he saw it as an outlier, that is it was out of line with the other surveys so he used the weighted average total compensation, aged it to the midpoint of the JFT fiscal year for a total of

$261,000. He used the same methodology for the other positions. The actual titles in the Dietrich survey he used were President with Less than 50% ownership, Executive Vice President, Financial Executive, Senior Vice President and Vice President of Operating Unit. (R4, tab 8 at 22-26; tr. 2/46)

42. Using the four surveys, Rapp then applied a simple average to the figures he had computed and developed a market consensus (tr. 2/47). This simple average did not take into account the differing sample sizes included in the various surveys. He applied a +10% range of reasonableness to the average and determined that a reasonable compensation for the top position at JFT for 2002 was $342,216. He compared that amount to what was claimed for the top position, in this case $375,000, and the difference he determined to be the unreasonable amount, and in the initial review that was $32,784. He used the same methodology for the other executive positions and found the total unreasonable amount for 2002 to be $288,057. (Tr. 2/47-48)

43. Since this was a first step in a process, Rapp made the initial analysis available to JFT and Wayne Taylor raised four questions or arguments in rebuttal of the methodology (tr. 2/48-49). Rapp responded to each argument as discussed below.

44. JFT first argued that DCAA should not be looking at its executives in the typical fashion in which the top five executives are viewed. So Rapp requested formal position descriptions for the vice presidents. (Tr. 2/49) A first revision, discussed below, was performed before JFT responded to the request.

45. The second JFT argument was that the ECS (Watson Wyatt) survey was not appropriately used because the services sector was too broad a sector and did not capture JFT's business. While Rapp says he did not agree with that contention, he nonetheless narrowed the focus of the services sector and used engineering services and research services values even though it only included data for three of the five executive positions, revising it to meet the JFT argument, but not completely throwing out Watson Wyatt. (Tr. 2/50)

46. JFT argued that the Mercer survey (EXEC) should be excluded because professional services were too broad since JFT was SIC (Standard Industrial Classification) 8711, engineering services. Rapp says he disagreed but nonetheless agreed to delete that survey in its entirety. Taylor also argued that Dietrich should not be used as it did not represent full service engineering firms, but mostly engineering and architectural firms, which were mostly partnerships. Rapp reviewed the Dietrich literature and concluded that only 12% of the firms were architectural-engineering firms and only 3% were partnerships, so he rejected this argument and continued to include Dietrich. (Tr. 2/51)

47. Taylor also asked Rapp to include three other surveys. The first, McGladrey, was rejected because of the 18 firms included in the survey, only three were SIC 8711 and the rest were drug or biotech companies. The second, ERI, was rejected because the supporting documentation provided by JFT was from 2005, and thus not relevant to the fiscal year under review. The third, OCR, was added by Rapp because it was one they had used in the past and the data was in line with the others he already included. (Tr. 2/51-53)

48. Another argument proffered by JFT was that it was a high performing company and should be market priced at the 75th percentile, not the 50th. The submission included a sales table demonstrating sales growth over a five year period and the argument based upon that submission was that such growth equated to the 75th percentile. Rapp noted the absence of comparisons to peer companies so he deemed the argument to be Taylor's opinion. Rapp had performed the analysis for 2000 and 2001 and in those years they were in the 75th percentile, so he used the same methodology for 2002 and concluded that he properly included JFT in the 50th percentile for that year and thus did not adjust the market pricing for performance. (Tr. 2/53-54)

49. The last argument was for an offset for fringe benefits. While Rapp did not use the data submitted by JFT as it was for the wrong year, he went to the proper data source, made the calculation and concluded that an offset was not warranted. (Tr. 2/54-55)

50. A first revision was performed dated 13 April 2005 taking into account the addition and deletion of surveys and the bottom line was that the amount of executive compensation found to be unreasonable was $232,006 (tr. 2/55; R4, tab 8 at 31).

51. In June 2005, Rapp and Bentz met with Wayne Taylor, John Taylor, Sr. and an attorney for JFT and the meeting focused on figuring out what the four vice presidents did and their level of performance. While they discussed duties and responsibilities in some detail, written position descriptions were not provided. However, based upon explanations received from the Taylors at the meeting, including a breakdown of sales percentage, to wit, 55, 30 and 15 percent per VP, Rapp determined that the first VP (Wayne Taylor) should be market priced as a COO and the others as division vice presidents. Rapp perceived that the Taylors agreed with that decision and modified his computations in revision two to the Fiscal 2002 evaluation. (Tr. 2/55-56) This second revision, dated 6 July 2005, reduced the unreasonable amount of compensation to $218,455 (R4, tab 8 at 55), and Rapp is satisfied that this revision reflects a reasonable compensation level for the JFT executives in fiscal 2002 (tr. 2/59).

52. Rapp also performed reviews for 2003 using the same methodology he used for 2002 with the exception that he started out for 2003 market pricing the executives differently and using the percentages provided by JFT for the Vice Presidents (55, 30, 15), meaning he started out on 2003 the way he ended on 2002 (tr. 2/59-60). For 2003 Rapp

concluded that the amount of unreasonable executive compensation was $192,700 (R4, tab 9 at 135; tr. 2/60).

53. Rapp similarly performed a review for 2004 and he used the same methodology as with 2002 and 2003, by market pricing the first vice president (in the second position on the chart) to the COO and the other three VPs to division VPs, apportioning responsibility for sales at 55, 30 and 15 percent as he had done for the two prior years (tr. 2/51-62). The one difference from the previous reviews was that WTPF was not available for 2004, so he replaced it with Comp Data (tr. 2/62). The result of that review was that Rapp found that total unreasonable compensation amounted to $186,138 (tr. 2/62; R4, tab 11 at 159, 186).

54. The executive compensation survey for JFT for fiscal year 2005 was performed by Kelly Convery[3] (Convery) at the request of the field auditor (R4, tab 22; tr. 2/113). Convery holds a B.S. in Accounting from Westchester University and is a Certified Public Accountant. After college she worked for accounting firms prior to joining the government in 2003 as a field auditor with DCAA. Convery joined the compensation team on or about 2006, and was an executive compensation technical specialist on the Mid-Atlantic Region Compensation Audit Team for about a year at time of trial. (Tr. 2/110-11) She has completed over 300 reviews since joining DCAA (tr. 2/111-12).

55. Convery has had WorldatWork training, has a mentor, and was working towards becoming a Certified Compensation Professional (tr. 2/112). During her review, Convery determined that JFT did not provide job descriptions or sales amounts although she asked for them. She was however, provided with a statement of the JFT organizational structure. In the absence of job descriptions Convery reviewed the organizational structure, the prior year executive compensation reviews and determined to market price the JFT executives. (Tr. 2/115)

56. In the Mercer survey she used CEO instead of CEO plus Chairman for John Taylor, Sr. because Mercer was the only one that made a distinction between an executive who was both CEO and Chairman and the executive who held only one of those titles. In the JFT organizational structure there was no indication that Mr. Taylor was both Chairman and CEO. (Tr. 2/116)

57. After requesting but not receiving job descriptions of the four vice presidents she asked for sales responsibility for the four VPs. She received a statement of the organizational structure as follows:

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[3] *Nee* Gallagher at the time of the audit (tr. 2/131). Her new last name is spelled Converi in the transcript and in the government brief; Convery in appellant's briefs. We believe Convery to be correct.

> J.F. Taylor is not organized within the classical structure that DCAA typically sees (CEO, COO, Exec VP, CFO, etc.). Rather, we are organized at the executive level with a structure that avoids layering, and which spreads responsibility for the company's management over four key managers, all of whom report directly to the CEO, referred to as the company president. Each of these four key executive personnel has responsibilities that are substantively equal. Three of them, all Vice Presidents, are each managers of the three major contract and technology areas within the company: CNI Engineering Services, Simulation Systems Engineering Services, and Flight Trainer Design and Fabrication. The sum of the contracts and projects under these three comprise virtually 100% of this firm's revenue producing activities, and all other technical employees of the firm report to them. The remaining Vice President manages the administration and business aspects of the company, including purchasing, contracts, cost accounting, payroll, recruitment, and facilities. All four executives have experienced significant increase in personnel and responsibility that corresponds with the growth in revenue over the past two years.
>
> In addition to the specific duties noted above, these four executive individuals act as direct advisors to the CEO on matters such as capital expenditures, salary structure, benefit changes, sensitive personnel issues and growth strategies. Most importantly all four top executives serve as the principal company agents for business development and Bid & Proposal activities. They are collectively responsible for the dramatic growth in revenue this firm has experienced over our fiscal years 00 to 02 and developing the infrastructure to support future opportunities.

(Supp. R4, tab 20 at 265)

58. Convery surmised that since three vice presidents are each managers of three major contract and technology areas within the company, then the sum of the contract products comprise virtually 100% of JFT's revenue producing activity. Thus she determined that there was a division of responsibility for each of the three VPs, and, after consultation with Bentz and Rapp, decided to use the same percentages as used by Rapp in 2004, *viz* 55%, 30% and 15%. (Tr. 2/117-18)

59. She benchmarked three of the JFT executive positions using those percentages and proceeded to complete the review using Wyatt, Dietrich, Comp Data and Mercer and concluded that $249,725 of the amount claimed for executive compensation for 2005 was unreasonable and that $2,032 was unallowable under FAR 31.205-6(p) resulting in a total of $251,757. The methodology she followed generally follows that described by Bentz and used also by Rapp. (Tr. 2/113-30; R4, tab 22 at 301-02)

60. Bentz reviewed the 2002 executive compensation analysis prepared by Rapp. David Durant, Bentz's predecessor, reviewed Rapp's 2003 and 2004 analyses as well as Kelly Convery's 2005 analysis. At the time of the Durant review, Bentz was a tech specialist in the office and gave input on how the reviews should be performed. He also attended several meetings with Rapp and JFT representatives. Since becoming chief of the compensation team, Bentz reviewed all of the ECRs at issue and testified that they followed the methodology outlined in his testimony, that they met his standards and he agreed with the conclusions. (Tr. 2/17)

61. The DCMA ACO, John Svensson, reviewed the executive compensation reviews, agreed with the conclusions of Rapp and Convery regarding the executive compensation claimed on the incurred cost submissions of JFT for 2002-2005 and consequently asserted government demands for the amounts the compensation specialists found exceeded reasonable compensation for the company's executives for those years (tr. 2/160-62).

62. The government called Paul Dorf (Dorf) as an expert in the field of compensation. Dorf is Managing Director of the firm Compensation Resources. The firm and Dorf "provide ongoing consulting services to clients...assessing their needs, developing compensation programs, assisting them in putting them in place, making sure that, not only do they meet the requirements of the organization as far as the ability to attract, retain, motivate, and focus executives and individuals on specific desired results, but...also...litigation support activities." (Tr. 2/168-69) Dorf has testified 40 to 50 times as an expert witness in the specialty of compensation and has been admitted as an expert in compensation and executive compensation (tr. 2/171).

63. Dorf earned a Bachelor of Business Administration degree from Hofstra University in Long Island, New York in 1961 and in 1968 entered an MBA program at the University of Bridgeport in Connecticut. After a job change required a move to the Tidewater area of Virginia, the University of Bridgeport allowed him to complete the coursework for the MBA at the College of William and Mary and in 1971 he was awarded his MBA in Industrial Relations. Dorf has a long history of employment in the executive compensation field both in his own company and in other consulting firms. (Tr. 2/168-73) He has also taught graduate and undergraduate students in management and executive compensation (tr. 2/172).

64. In 1992 Dorf started a Ph.D. program with Walden University, an online distance learning institution headquartered in Minneapolis (tr. 2/173-74). Dorf testified that he worked on that program until 1998 and had completed all of his coursework and was working on his dissertation when the university changed ownership and administration and he "was having problems with the school." He began "looking around to see about...trying to pick up the pieces and have the credit" and "so [he] contacted a number of different universities, and one of those that had been recommended to [him] was the Cambridge International University (CIU), which was headquartered in Cape Town, South Africa." CIU was not accredited in the United States but according to Dorf was accredited overseas. He "contacted them, submitted [his] paperwork, and in...the spring of...2003...they accepted [his]dissertation and awarded [him] the Ph.D." (Tr. 2/174) Indeed, Dorf's name on his resume is followed by "Ph.D." and on that document under Education, he lists Cambridge International University, says he attended there from 1992 to 1998 and that he has a "Doctor of Philosophy in Business (Ph.D.) Major in Management Analysis" (app. supp. R4, tab A-2).

65. Prior to hearing, Dorf had been deposed by counsel for appellant, and apparently counsel had questioned the legitimacy of that doctorate and consequently Dorf testified that he had ceased using the doctorate and had new business cards printed (tr. 2/174).

66. On *voir dire* appellant cast additional doubt on the legitimacy of Dorf's doctorate and on his credibility as a whole. The resume entry included the inaccurate assertion that he attended Cambridge from 1992-1998 with no mention of Walden (app. supp. R4, tab A-2 at 5; tr. 2/180). Dorf could not produce his dissertation and testified that he could not locate it (tr. 2/177-78).

67. The record includes a letter from American Institute of Business of Rainbow City, Alabama to Dorf stating in part:

> Congratulations on your accomplishments. Please treat this letter as your proof of registration with Cambridge International University in Cape Town and your receipt with American Institute of Business (AIB)....
>
> The American Institute of Business is an authorized organization and as such will process all of your information and requests with Cambridge International University. We are committed to meeting all the needs of our students. Please note that your bank check or credit card statement will reflect payment to "AIB" (American Institute of Business).

> Included in your credentials is your prestigious diploma, official transcripts in a protective cover and a wallet size copy of your diploma.

(App. supp. R4, tab A-3)

68. Dorf knew when he went through the process of obtaining a degree from CIU by way of AIB that it was not accredited in the United States although he believed it to be accredited in other countries (tr. 2/185). The State of New Jersey, where Dorf resides and conducts his business (tr. 2/167; app. supp. R4, tab A-2), makes it unlawful for a person to append an academic degree to his or her name as evidence of having earned that degree unless it was conferred by a regionally accredited institution or if outside the United States, one which is generally recognized as equivalent to those accepted by an accredited body in the United States. N.J.A.C. 9A:1-8.1 (2009).

69. While the fiasco of the Ph.D. degree diminishes the overall credibility of Dorf, his experience in executive compensation is extensive and clear. While appellant ably brought the deficiencies in Dorf's record to the Board's attention, it nonetheless, did not object at trial to his acceptance as an expert witness in executive compensation and he was accepted as such. (Tr. 2/202)

70. Dorf was asked by the government to review the audit work that resulted in the findings of unreasonable executive compensation and to determine if it was consistent with good practice for evaluating compensation, but was not asked to recalculate the results or to go back and look at the data. He opined that Rapp and Convery did a fairly good job of evaluating compensation, stating further:

> As in any area of an art, rather than a science, I felt that there were areas that could have been done differently and I might have done differently....But I thought that, for the most part, it was acceptable.

(Tr. 2/203-04)

71. When asked his opinion of the actual methodology used by Rapp and Convery to reach their conclusions, Dorf stated:

> Well...I think one of the things that's very important is following a consistent pattern so that you're doing the same thing wherever you can. And I believe that's what they did. They followed a systematic process to review the information.

> Again, I believe that there's usually some level of antagonism [in a general sense] in this type of arrangement and, therefore, some of the information that would have been helpful to them was not supplied. So with the data that they had, I think that they did an appropriate evaluation.

(Tr. 2/204-05)

72. When asked if the methodology used to reach their conclusions was in accordance with general industry standards, Dorf replied "I believe so, yes" (tr. 2/205).

73. Dorf was asked to explain the rationale behind the 10% range of reasonableness used by DCAA. He responded that the study is done in order to come up with a market consensus, meaning they are looking for a "central tendency." While the studies come up with a number for compensation, he continued:

> The reality is that the likelihood of paying individuals in that particular occupation in that industry and that size company at that one number is highly unlikely. So around that number we have a range, and that range, traditionally, has been plus or minus 10 percent. So...let's assume for the sake of discussion...that number is $200,000....[W]e don't expect that the surveys and all the people in that job are going to be making $200,000, but we do think that they would probably be making somewhere in between, and I think 10 percent...would be $180,000 [to] $220,000. In reality we're saying this is the range of reasonableness, and that's where that plus or minus 10 percent comes from.
>
> The DCAA auditors kept calling this plus 10 percent. It really is minus 10 percent to plus 10 percent....The fact is this is a reasonable range.

(Tr. 2/206-07)

74. On cross-examination Dorf agreed that it is not good practice to focus exclusively on revenue as a measure of reasonableness (tr. 2/216).

75. When talking about art versus science, Dorf testified that art in the compensation context means the judgment of a compensation professional as to what surveys are appropriate, what data should be included or excluded as an outlier and what

job descriptions one should be looking at. After that, what becomes important is mathematical accuracy to make sure the arithmetic is done correctly. (Tr. 2/232-34)

76. On redirect, Dorf testified again about the art versus science parts of the process of determining reasonable compensation for executives:

> [C]ompensation is not an exact science. We are not looking in compensation for the 99.99 percent of accuracy, as they were in a drug company where [there is a] life and death situation. What you're looking for is to try to come up with [an] amount of compensation that is appropriate for a job based on all given information that will allow an organization to recruit, retain, [and] motivate their individuals, their executives. In the case of Taylor, one of the things that is a little bit unusual, and it's not the only company that does this but a little unusual in that all four of the vice presidents are paid the same. And I don't believe there's anything in the rules that says you can't pay everybody the same, it's just that you can't turn around and charge the government for doing that. People are paid, they should be paid based on what the job is valued at in the marketplace.... We see this happen, and that's fine. That's their choice to do that, particularly if they're family members and they don't want to have any infighting between the family. That's fine. But the idea is that when you market price that job it has to be based on what they are individually doing, and that's, I believe, what the DCAA auditors did in that case was to, even though the company has maintained that they have a perfectly horizontal organizational structure, they looked at them based on the size of their individual areas of responsibility....

(Tr. 2/246-47)

77. Appellant called Jimmy J. Jackson (Jackson) as an expert witness. Jackson earned a Bachelor of Science in Management from the Sloan School of the Massachusetts Institute of Technology in 1970 with a specialization in financial and mathematical modeling including training in statistics, statistical sampling and regression analysis (R4, tab A-1), and entered into active duty with the United States Air Force for three years thereafter. While on active duty, Jackson entered into an educational program offered through Southern Illinois University (Edwardsville) and received an MBA in Finance in 1973. He thereafter reentered MIT and in 1974 earned a Master of Science in Management at the Sloan School specializing in financial and mathematical modeling. From 1974 to

1984 he was with Arthur Andersen and Co. with ever increasing management and technical responsibilities. Jackson transferred into litigation consulting in 1984 where he became Worldwide Director of Advanced Quantitative Analysis. He left Arthur Andersen in 1991 when he formed his own consulting firm. (App. supp. R4, tab A-1; tr. 1/75-77)[4]

78. The work Jackson does as a litigation consultant in his own firm is the same he did for his last seven years at Arthur Andersen. He generally assists outside counsel in commercial disputes by analyzing details in all facts and assisting them in preparing for trial, including assistance in quantifying damages or analyzing the opposing side's damage calculation. (Tr. 1/77-78) He has been a member of the American Statistical Association for 24 years (app. supp. R4, tab A-1 at 2 of 37).

79. Jackson was offered and accepted as an expert witness in statistical analysis, mathematical modeling, financial analysis and accounting (tr. 1/85, 87), but was not offered as, and admittedly is not, an expert in executive compensation (tr. 1/85, 183-84).

80. Jackson's overall opinion of the DCAA methodology for evaluating the reasonableness of executive compensation is in part as follows:

> While there is room for professional judgment in the evaluation of the reasonableness of executive compensation, an essential and fundamental element of the DCAA methodology involves the use of survey data which is validated, analyzed, and employed using mathematical and statistical calculations to derive reasonable ranges. My in-depth review of the DCAA workpapers, which was confirmed by the depositions of the DCAA auditors who performed the...compensation reviews, prove that while the DCAA's executive compensation review methodology has the look of an objective mathematical model for determining unallowable executive compensation, there is no substance behind this scientific veneer. Instead, there are <u>fundamental flaws</u> in the DCAA's methodology and in addition there are <u>numerous flaws</u> in the DCAA's <u>execution</u> of the Taylor reviews. These <u>methodology and execution flaws</u> render the DCAA's estimation of unallowable Taylor executive compensation to be significantly overstated and speculative.

(App. supp. R4, tab A-1 at 6-7 of 37)

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[4] Tab A-1 is Jackson's expert report.

81. Jackson cited nine separate errors committed by DCAA in performing the ECR's and each is examined below (app. ex. B).

I. Ignored Data Dispersion/Used Arbitrary 10% ROR Allowance

82. According to Jackson, the most significant flaw in the DCAA methodology that he believes accounts for most of the compensation deemed unreasonable is DCAA's failure to consider the actual amount of dispersion among the survey data and instead applying an arbitrary 10% range of reasonableness (R4, tab A-1 at 22-27; tr. 1/136-43). Jackson says data dispersion is a measure of how close the data are to each other and therefore how accurate and how precise the prediction of reasonable compensation is as a result of using that sample (tr. 1/136).

83. To illustrate his point, Jackson referred to the first version of the 2002 review (R4, tab 8 at 3). He uses the amount for Chief Executive Officer under the Watson Wyatt data (ECS) which is $280,100 (*id.*) for sector services, with total sales of $34 million, where the estimated salaries are based on a sample size of 110 organizations (R4, tab 8 at 7; tr. 1/93-96).

84. Using that example Jackson proceeded to explain data dispersion, starting with an explanation of the percentiles as follows:

> What the 25th percentile means...is that 25 percent of all executives based on this sample of 110 earn less than $211,800, in 2002 after adjustment for revenue.
>
> Looking at the 75th percentile column what that means is 75 percent of all executive[s] of companies with revenue of $34 million earned less than [$370,400]. What that also means is that 25 percent of all executives after adjustment for revenue earn more than [$370,400]....
>
> ....
>
> Median is exactly the same as the term 50th percentile. That means half of all executive[s] earn less than [$280,100]. All companies adjusted for revenue of $34 million.

(Tr. 1/96-97)

85. Continuing his explanation of data dispersion, when asked the significance of the difference between the salaries at the 25th and 75th percentile, Jackson testified:

> That range which is approximately a $160,000 difference between the 25th and the 75th percentile is a measure of data dispersion.
>
> Now, what that tells one from a statistical standpoint and the way one should be interpreting the results of the statistical sample is that the 280.1 thousand dollar amount that's in the median column is not a very precise estimate because you have this huge range from the 25th all the way to the 75th percentile.
>
> Another way of mentally thinking about this is the proverbial bell shaped curve which almost everyone is familiar with. What it means is that the distance from the left side of the bell to the right side of the bell is very large. And that you cannot place a great deal of reliance upon 280.1 thousand being a precise estimate.

(Tr. 1/97-98)

86. According to Jackson, the DCAA never considered data dispersion in any of its calculations, but instead used a multiplier of 1.1 which is the same as the 10% factor, which they used in every instance without regard to whether the 10% accounted for the imprecision in the dollar amount upon which they were relying (tr. 1/136). Using the example of 2002 ECS data for Chief Executive Officer, Jackson testified further:

> The first point is that the top of the bell-shaped curve corresponds to $364,181 at the 50th percentile. That's the exact same number that one sees on both the survey itself and also sees in the summary of the survey results on page 3 at Tab 2.
>
> What the DCAA's methodology did was add 10 percent to that amount which gives you a value of 400,599. And what DCAA's position is is any company that pays more than that amount is exceeding what a prudent company would pay its executives.
>
> As you can see almost half of all companies according to the EXEC's survey paid more than what the DCAA deemed the maximum amount that a prudent company would pay. Statistically, as well as from a common sense standpoint, that is clearly incorrect.

One has to take into consideration the precision of this estimate of $364,000. What that precision of the estimate is based upon is essentially how far is it from the left side to the right side of the bell-shaped curve.

Now, within statistics what one does is establish a confidence level and you allow the data dispersion to direct how you determine whether the compensation is reasonable or unreasonable.

The most typical confidence level used for financial analysis purposes is 95 percent. And, again, all this is directly calculatable. Any person with a freshman statistics course can do the calculation. And what the result is at 95 percent confidence, one is at a compensation level of $747,044. And that this could be deemed to be the maximum amount of compensation before one would fall into the unreasonable category.

Now, a couple of key questions. Focusing on the 95 percent confidence, if one were to utilize a higher confidence level, what occurs is that this vertical line [which] is at $747,000 moves to the right. If one were to apply a lesser confidence, one would move to the left. If one were to use just the data point that is at the middle, you got a 50/50 chance that you are incorrectly assuming a company has an allowable [sic] or is paying an excessive compensation.

The standard that the DCAA applied is such that there is this huge number of companies that they are going to deem to be unallowable because they're claiming that this is in excess of what any prudent company would pay. Yet, something in the order of 40 percent of all companies based upon their own survey are paying more than that.

(Tr. 1/137-39)

87. On a bell curve, where the 95% confidence level falls depends upon the amount of data dispersion (tr. 1/142).

88. He reviewed the amount of data dispersion in each of the surveys utilized by DCAA in its reviews for each of the years in question and in his opinion 10% was not an adequate adjustment to account for the amount of data dispersion in any of the surveys they used (tr. 1/142). According to Jackson, the arbitrary application of a 10% ROR to the estimates derived from these particular surveys accounts for almost the entire amount DCAA deemed to be unreasonable (tr. 1/143).

89. It is Jackson's opinion that the appropriate level of confidence that should be applied to executive compensation reviews is 95%. He holds that view first, because it is the typical level of confidence used in financial analysis and compensation reviews fall within the general area of financial analysis. Second, the IRS also does compensation analysis and they use 95%. Third, DCAA manuals sometimes use 90% but also frequently refer to 95% confidence as the appropriate standard for statistical samples. Fourth, after reviewing compensation surveys used by DCAA, looking at the company websites, he found that at least one of them recommends a 95% confidence level. (Tr. 1/140-41)

90. Further Jackson states that the DCAA methodology "relies upon the hypothesis that the level of corporate/division revenue explains 100% of the best estimate of reasonable compensation" and points out that the DCAA "added a 10% 'Range of Reasonableness' ('ROR') allowance to compensate for data variability" even though "the DCAA's ROR was fixed and not determined by the actual data variability." Jackson concludes therefore that the 10% factor is "arbitrary, unsupported, and unsupportable." (App. supp. R4, tab A-1 at 8 of 37, footnotes omitted)

II. Ignored Differences in Survey Sizes

91. Jackson expressed the opinion that it was improper as a matter of statistical analysis to ignore differences among the sample sizes of the surveys relied upon. Both Rapp and Convery testified that they took a straight average of the survey data (typically at the median compensation amount) and then applied the 10% ROR factor. Jackson testified in that regard as follows:

> In looking at the various surveys upon which DCAA relied, the sample sizes ranged anywhere from a sample of only five companies for a given survey to as many as 110 [companies]. And what DCAA assumed was that...a 50th percentile number from a survey of 110...is just as reliable and just as accurate [a] predictor of compensation to the Taylor Company as if [it was] a sample from only five companies.
>
> Again that is just a fundamental statistical flaw. What should have been done is that you [weigh] each of the survey

> results by the number of observations and surveys so that if you've got a survey that's based upon 25, that's five times and gets a weight of five times as much as a survey based on only five companies.
>
> Again, DCAA failed to do that.

(Tr. 1/143-44; app. supp. R4, tab A-1 at 7 of 37)

92. Instead, according to Jackson, "DCAA unreasonably assumed that every survey the DCAA relied upon had equal accuracy and the DCAA accorded each survey equal weight" and Jackson was "aware of no statistical basis that would ever support the DCAA's action and in particular where there is such disparity in sample size and data variability" (app. supp. R4, tab A-1 at 7 of 37).

III. Selection of Revenue Base for Taylor Vice Presidents

93. JFT contends in this appeal that DCAA should have evaluated the compensation of the JFT vice presidents on the revenues of the whole company and not just the percentage of revenue attributed to each vice president by DCAA (app. br. at 99 *et seq.*). Jackson, while conceding that he was not the proper person to determine if the DCAA or the JFT position is the correct one, computed the amount of unallowable executive compensation under both scenarios, but while including the statistical concepts to which he testified. The result of Jackson's computation is that under the JFT version of revenue attribution (100% attributed to each vice president) the total unallowable compensation over all four fiscal years is zero. Under the DCAA version of revenue attribution (different percentages attributed to each vice president) the total unallowable compensation over all four years is $42,437. (Tr. 1/144-45; app. supp. R4, tab A-1, attach. 3). We are persuaded that the DCAA version of revenue attribution is the proper methodology and so find. Mr. Taylor's rationale for treating his vice presidents equally does not comport with the actual contribution to total revenue of each vice president.

IV. Failed to Consider Financial Performance Without Challenge

94. In the course of preparing for his testimony, Jackson learned that it is DCAA policy to automatically assume a company is in the 50th percentile when preparing their first review of executive compensation and will only reconsider financial performance if a company challenges the initial review (tr. 1/146). He considered that factor and others to be flaws in the DCAA system, "and laid that out in [his] report, not because it matter[ed] in [the trial] directly, but because [he] wanted to be sure that in future compensation...evaluations, specifically [for] J.F. Taylor, that they don't assume that

because one hasn't spoken about all the errors in the methodology that somehow that's acceptable" (tr. 1/148-49).

V. Failed to Consider Discriminators Such as Security Clearances, Customer Satisfaction & Other Relevant Factors That May Explain Variations in Compensation.

95. To explain this flaw, Jackson reiterated his earlier testimony that there are three steps to the executive compensation review process–step one is the "art" of selecting the surveys and the industries, step two is the "science" of going from the surveys to the preliminary results, and step three is the consideration of other subjective factors, such as executives with top secret security clearances getting higher compensation, or customer satisfaction, product quality, and geographical location as it relates to the competition, for example, having to compete in the greater Washington, DC market. Jackson contends DCAA failed to perform step three in that those factors were not considered. (Tr. 1/149-50)

VI. Inconsistent on J. F. Taylor's Industry

96. Jackson testified that for the period 2002 through 2005, JFT's business did not change nor did the industry in which JFT participated, and thus he perceives that there should have been no change in the most appropriate industry to use for selecting compensation surveys, yet DCAA shifted "back and forth as to what industry they deemed J.F.Taylor to be in" (tr. 1/150-51). As shown in appellant's hearing exhibit E, the DCAA auditors chose the services sector for 2002, version one, and for 2003, 2004, and 2005. The engineering services industry was chosen for 2002 versions two and three. Versions two and three were changed to engineering services from services sector as a result of arguments made by Wayne Taylor to Rapp. (*See* findings 45-46).

97. Jackson further expressed the opinion that the correct industry is Engineering Services, not Services sector (tr. 1/152).

VII. Inconsistent on Executive Position

98. Jackson points to the fact that Mr. Taylor was deemed Chairman and CEO for purposes of all of the 2002 reviews as well as the 2003 and 2004 reviews, yet for 2005, he was "demoted" to CEO-Non Chairman (tr. 1/154, app. ex. F), representing a swing of $250,000 between the two titles in the surveys (tr. 1/156). Convery explained that she made that change because the JFT organizational structure did not show that Mr. Taylor occupied both spots (finding 56).

VIII. Inconsistent on Which Surveys Upon Which to Rely

99. Jackson finds it arbitrary that surveys are used and then dropped in subsequent reviews and then maybe picked up again in a later review. He gives as an example the Mercer survey which was used in the 2002 version one, dropped for 2002 versions two and three, then picked up again for 2003, 2004 and 2005. He finds this arbitrary. (Tr. 1/158-61) We are cognizant of the explanations given by Rapp and Convery as to why surveys were used or not used. For example Rapp dropped Mercer in 2002, versions two and three, at the urging of Wayne Taylor. Convery used the very same surveys for 2005 as Rapp did for 2004. (Findings 46, 47, 50, 53, 59)

IX. Inconsistent on Use of 50th Percentile vs. Mean

100. Jackson explained that the 50th percentile means half of all companies paid more than the salary at that level and half paid less, while the mean is the sum of the observations divided by the number of observations, also known as the "average." While the two can be close, there is a difference and it is appropriate to be consistent in the analysis or else bias is introduced into the analysis. Jackson's review of the surveys found that the 50th percentile was used consistently except that whenever Dietrich was used, the mean or average was used. (Tr. 1/161-62) Rapp explained that he used the Dietrich weighted average total compensation in lieu of the median because the median figure was an outlier, out of line with other surveys (finding 41).

101. With regard to the portion of the DCAA methodology that market prices the company at a particular percentile that relates to how a company performs compared against comparable companies, Jackson found that methodology lacking as well. He states in his expert report:

> The only time the DCAA adjusted its maximum reasonable compensation amounts was if a company appealed the DCAA's determination and the DCAA then concluded that the company's performance exceeded the 50th percentile for comparable companies. Thus, given the DCAA's methodology, mathematically in half of all instances the DCAA's first official disallowance report understates the DCAA's ultimate maximum allowable compensation.
>
> The DCAA's methodology relies upon an unstated hypothesis that 100% of the compensation variance not explained by corporate/division revenue is explained by the Performance Percentile based upon "Sales Growth," "Return on Assets," "Return on Equity," and "Return on Sales." However,

> there is no evidence that the DCAA even recognized that they were implicitly assuming that their Performance Percentile explains 100% of the compensation variance not explained by corporate/division revenue. DCAA should instead have treated this as a hypothesis and not used it until it had been tested to determine whether there was empirical support for it. The DCAA also assumed that the four (4) metrics equally impacted the amount of reasonable compensation without any testing of this hypothesis; thus rendering the DCAA's methodology arbitrary.

(App. supp. R4, tab A-1 at 9 of 37) (Footnotes omitted)

102. Jackson concludes on this point that it was unreasonable for DCAA to reply upon its implicit hypotheses being true in the performance of the compensation reviews (*id.* at 10 of 37).

<u>Jackson's Analysis of Reasonable Compensation Based on Surveys</u>

103. Having explained his view of the flaws in the DCAA calculations, Jackson incorporated those views into his own calculation of the amount, if any, of unreasonable executive compensation. While Jackson used much of the same data as DCAA, he made substitutes where he deemed it appropriate, and then proceeded to calculate for each position in each year, an "upper limit on reasonable compensation" (ULRC) and if the actual compensation for that position in that year is greater than ULRC, then the unallowable compensation is equal to the difference or else it is zero. (App. supp. R4, tab A-1 at 34 of 37)

104. The adjustments he made to the DCAA data were:

- He used all the surveys from all three of the 2002 reviews as he observed no basis in the work papers for rejecting any of them.
- He did not use the Compdata surveys for 2004 and 2005 because the surveys contained no empirical information concerning precision/reliability and thus he decided there was no valid statistical basis for including them.
- For ECS surveys Rapp deemed JFT most comparable to the "Services Sector" even though that sector included janitorial services and car rental services as well as others far afield of Engineering Services, so Jackson used data from engineering services instead, deeming it more appropriate.

- For VP2, VP3 and VP4 in the 2005 review the ECS surveys did not have percentile data (25th, 50th, 75th) for engineering services due to small sample sizes and thus Jackson reports that he used the CD provided by DCAA for Watson Wyatt Data Services and which was used by DCAA to get the ECS results in its work papers. He determined the 2005 data by using the same input as used by DCAA for the 2004 review but he used 2005 JFT revenue amounts from the DCAA work papers.

- The final data adjustment made by Jackson is in the circumstance where DCAA indicates that no data was available from a particular survey for a particular position, but one did exist in the work papers that was less than 12 months off from the midpoint of Taylor's fiscal year, he used that data with an appropriate escalator/de-escalator factor.

(App. supp. R4, tab A-1 at 28-29 of 37)

105. Jackson explained his process using the CEO position for FY 2002 with the understanding that the process is the same for all five positions for each of the four fiscal years. He starts with the data reported by the DCAA surveys with the exception of EXEC and Compdata. The omission of Compdata was explained above. The percentiles for EXEC are computed using the "EXEC Survey Input and Regression Formula" and said formulae are set forth in Jackson's report (app. supp. R4, tab A-1 at 30 of 37).

106. He then computes the "Data After Escalation/De[-e]scalation Adjustment" and indicates the source of the escalation factor. Where he used an earlier year's survey, he used the same annual escalation rate as used by DCAA to escalate the prior years's amounts to a current fiscal year basis. (App. supp. R4, tab A-1 at 31 of 37, and attach. 4)

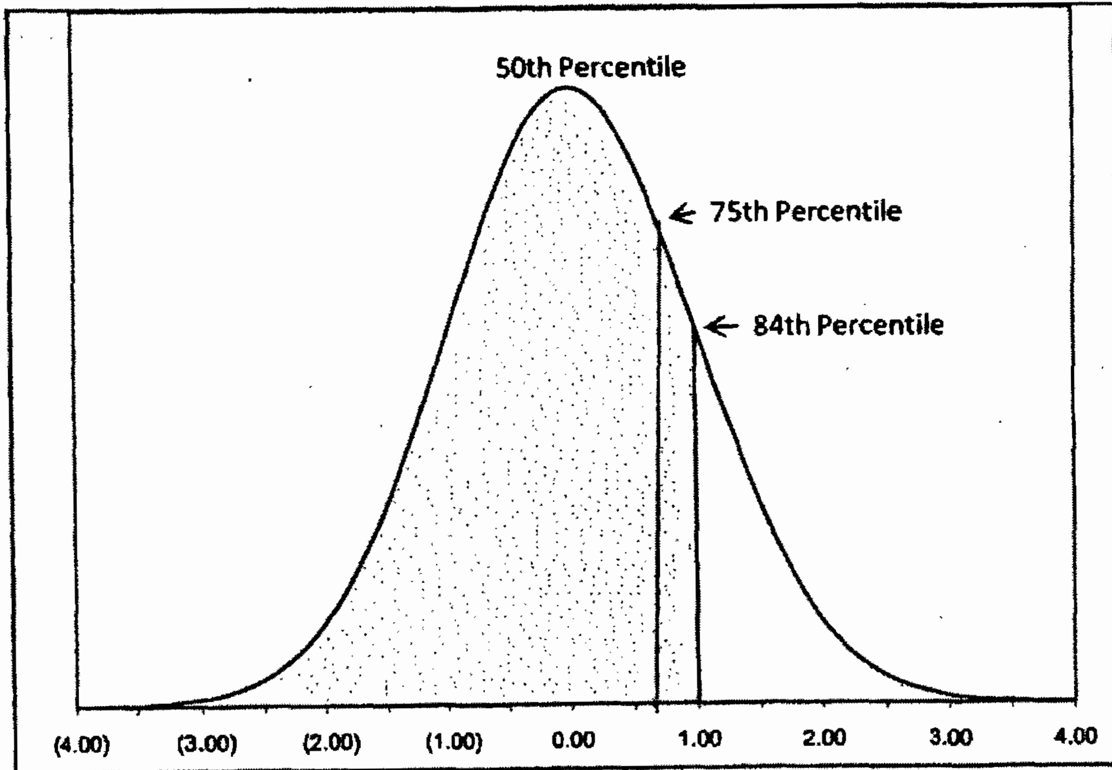
107. The following quote from the report details how the computation continued to conclusion:

> Page 2 of Attachment 4 uses the after escalation/de-escalation information from Page 1 of Attachment 4 and the survey sample sizes to determine the "Weighted Average Compensation," the "Estimated Standard Error" of the individual samples, "Standard Error of the Composite Sample," and the "Upper Limit on Reasonable Compensation." The "Weighted Average Compensation" for Taylor's CEO for FY2002 is $318,772 computed by summing all surveys' "50th Percentile * Number of Observations" on page 2 and dividing by the sixty-seven (67) total observations shown on page 1. As an aside, the simple average of the 50th Percentile

> Escalated/Deescalated Compensation from page 1 is $297,537, which demonstrates that the DCAA's use of a simple average instead of a weighted average can have a material impact on results.
>
> The "Weighted Average Compensation" amount of $318,772 can be thought of as the amount that would have been computed if all sixty-seven (67) observations contained in the five (5) surveys collectively were in a single composite sample of sixty-seven (67) observations. To determine the precision of the "Weighted Average Compensation," it is necessary to determine the "Standard Error" of the "Weighted Average Compensation." If the compensation amounts for each of the sixty-seven (67) observations were known, the "Standard Error of the Composite Sample" could be computed using the standard statistical formulae for so doing. Because the sixty-seven (67) observations were not provided, it is necessary to estimate the "Standard of Error of the Composite Sample" from the available information.

(App. supp. R4, tab A-1 at 31 of 37) (Footnotes omitted)

108. Because the survey results did not provide the standard error of the estimate, but did provide the values for the 50th and 75th percentiles, Jackson was able to estimate all other points using a normal distribution or bell-shaped curve. The diagram below prepared by Jackson demonstrates the concepts underlying the process he used.



(App. supp. R4, tab A-1 at 31 of 37)

109. Jackson continued:

> By definition, 75% of the area under the bell-shaped normal curve is to the left of the 75th Percentile vertical line which is equal to +0.67449 standard deviations. One standard deviation corresponds to the 84th Percentile. Both values can be determined from any "Normal Distribution" table in any statistics book. Given that based upon the DCAA's surveys the 50th Percentile and 75th Percentile values are known, the 84th Percentile value (+1 standard deviation) can be computed with the following formula:
>
> = (75th Percentile Amount-50th Percentile Amount)/0.67449
>
> The second step in computing the "Standard Error of the Composite Estimate" is to compute the variance contribution of each survey to the overall standard error. Because of the data available, it was necessary to estimate the "$\sum(x-\overline{X})$" for each survey using the following formula:

= (Standard Error of the Estimate)^2) * (Number of Observations – 1)

The third step in computing the "Standard Error of the Composite Estimate" is to compute the variance contribution of the difference between each survey's mean and the "Weighted Average Compensation" by using the following formula:

= (No. of Obs.) * (Sample 50th Percentile – Weighted Average Compensation)^2

The fourth step in computing the "Standard Error of the Composite Estimate" is to compute the standard error of the "Variance" by using the following Formula:

= (Variance/(Composite Sample Size-1))^0.5

....

The "Upper Limit on Reasonable Compensation" at 95% Confidence is equal to the "Weighted Average Compensation" plus the "95% Confidence Single Tail Factor" times the "Standard Error of the Composite." If the "Actual Compensation" is greater than the "Upper Limit on Reasonable Compensation," the "Unallowable Compensation" is equal to the difference, else the amount is zero.

(*Id.* at 32-34 of 37) (Footnotes omitted)

110. Below is Jackson's Computation of Combined Survey Characteristics for the CEO for 2002. His report includes similar computations for all positions in each of the years.

FY2002 - CEO

Computation of Combined Survey Characteristics

Survey		50th * N	Estimated Std. Error		$\sum(x-\bar{X})^2$	Mean Difference Squared * N		Variance
ECS	$	2,065,000	$ 145,592	$	127,181,375,374	$ 3,955,866,188	$	131,137,241,562
WTPF	$	3,391,389	$ 58,318	$	30,608,504,808	$ 4,147,988,773	$	34,756,493,581
Dietrich	$	996,820	$ 154,541	$	95,531,095,281	$ 71,291,748,064	$	166,822,843,345
OCR	$	5,800,000	$ 124,539	$	294,687,330,332	$ 16,556,941,108	$	311,244,271,441
EXEC	$	9,104,537	$ 184,989	$	821,301,817,567	$ 51,549,748,727	$	872,851,566,294
Total	$	21,357,746		$	1,369,310,123,363	$147,502,292,861	$	1,516,812,416,223

Standard Error of the Composite Sample	$	151,598
Weighted Average Compensation	$	318,772
95% Confidence Single Tail Factor		1.644854
Upper Limit on Reasonable Compensation	$	568,129
Actual Compensation	$	375,000
Unallowable Compensation	$	-

(App. supp. R4, tab A-1, attach. 4 at 2 of 2)

111. Following are two tables from Jackson's report comparing the DCAA Unallowable Compensation to that as corrected by him:

DCAA Determination of Unallowable Taylor Executive Compensation Compared to Corrected Unallowable Compensation

Position	DCAA Unallowable FY2002	FY2003	FY2005	FY2005	Total
CEO	$ 34,559	$ 10,378		$ 34,052	$ 78,989
VP1				$ 15,361	$ 15,361
VP2	$ 46,455	$ 45,741	$ 46,199	$ 44,547	$182,942
VP3	$ 55,932	$ 61,169	$ 63,663	$ 74,312	$255,076
VP4	$ 81,509	$ 75,412	$ 76,276	$ 83,485	$316,682
Total	$ 218,456	$ 192,700	$ 186,138	$ 251,757	$849,051

Position	Corrected Unallowable FY2002	FY2003	FY2005	FY2005	Total
CEO	$ -	$ -	$ -	$ -	$ -
VP1	$ -	$ -	$ -	$ -	$ -
VP2	$ -	$ -	$ -	$ -	$ -
VP3	$ -	$ -	$ -	$ -	$ -
VP4	$ 3,112	$ -	$ 7,302	$ 32,023	$ 42,437
Total	$ 3,112	$ -	$ 7,302	$ 32,023	$ 42,437

(App. supp. R4, tab A-1, attach. 3 at 1 of 1)

112. Jackson found that the actual compensation for the same position (VP4) in 2002, 2004 and 2005 exceeded reasonable compensation in the amounts of $3,112, $7,302, and $32,023 respectively, for a total of $42,437 (app. supp. R4, tab A-1 at 36 of 37).

113. Bentz testified that he has never encountered the use of statistical analysis, other than that done by the surveys, in the performance of compensation reviews (tr. 2/16, 32).

114. Referring to Jackson's testimony, government counsel asked and Dorf answered as follows:

> Q [by Mr. Duecaster] In using information from these surveys, do you...in your day-to-day work, your routine work...apply the statistical techniques that Mr. Jackson has used in his report to validate your recommendations?

> A [by Mr. Dorf] That's a very interesting question because, obviously, we endured Mr. Jackson's discussion yesterday. In reality, the survey company is responsible for conducting that type of analysis and auditing the material that they put in there. It is very rare that we would go to that level of process in looking at any of the survey data. If the survey data is insufficient, then the companies normally will not publish it. They will put a blank in there or say insufficient data or something. So the data they're collecting meets their standards.
>
> The standards may change from company to company, but, typically, it's a minimum of three or more pieces of data in one of those little categories or buckets...of data by size of company, type of company, industry, and so forth. And, normally, if there's insufficient data, then a company will not put that in there.
>
> I would say very few practitioners follow any of the statistical machinations that were identified. It's because it's just not done. The data is there. What you're doing is you're extracting the data that meets the needs, that identifies similar kind of organizations, and then some type of an averaging to come up with the market consensus or what is the central tendency of that data base.

(Tr. 2/209-10)

DECISION

A cost is reasonable if it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. There is no presumption of reasonableness attached to a cost incurred by a contractor. What is reasonable depends upon several factors, including generally accepted sound business practices and arm's length bargaining. FAR 31.201-3 (finding 23).

In addition to the more general definition of "reasonable" in FAR 31.201-3, FAR 31.205-6, COMPENSATION FOR PERSONAL SERVICES (finding 24), provided at the relevant time that compensation for personal services must be reasonable for the work performed and "must be based upon and conform to the terms and conditions of the contractor's established compensation plan or practice followed so consistently as to imply" an

agreement to make the payment. This clause sets forth factors to consider for testing the reasonableness of compensation that are in addition to those in FAR 31.201-3. Some of the factors are general conformity with the compensation practices of other firms of the same size, other firms in the same industry, and firms in the same geographic area. *Techplan Corporation*, ASBCA No. 41470 *et al.*, 96-2 BCA ¶ 28,426.

In *Techplan* we found that experts in the compensation field generally accept taking the following eight steps to evaluate the reasonableness of executive compensation:

> (1) Determine the position to be evaluated
>
> (2) Identify survey(s) of compensation for the position to be evaluated which match the company in terms of revenues, industry, geographic location and/or other relevant factors
>
> (3) Update the surveys to a common data point for each year through the use of escalation factors
>
> (4) Array the data from the surveys for the relevant compensation elements at various levels of compensation such as the average (mean) or selected percentiles and develop a composite number for each
>
> (5) Determine which of the numbers to use for comparative purposes
>
> (6) Apply a range of reasonableness such as 10% to the number or numbers selected
>
> (7) Adjust the actual total cash compensation for lower than normal fringe benefits
>
> (8) Compare the adjusted compensation to the range of reasonableness

96-2 BCA ¶ 28,426 at 141,989.

These factors were generally followed by DCAA. Appellant, however, presented expert testimony which challenges Step 6 where DCAA used a 10% ROR regardless of the variability of the data and which was not presented in *Techplan*. Accordingly, we must evaluate the reasonableness of the compensation in these appeals in light of that testimony.

Procedurally FAR 31.205-6 provides that, after an initial review, the CO or the representative may challenge the reasonableness of compensation paid to particular employees and in such cases, the contractor must demonstarte the reasonableness of the compensation. Certain conditions may give rise to the need for special consideration and one such condition is where the compensation is to owners of closely held corporations or members of their immediate families as is present here.

To demonstrate the reasonableness of the compensation it paid to the CEO and four vice presidents in fiscal years 2002, 2003, 2004 and 2005, JFT challenges the DCAA's methodology for determining reasonable executive compensation arguing that it is fatally flawed (a) as a matter of basic statistical analysis, (b) because the method market priced JFT's executive compensation at the median without adequate consideration of the company's superior performance, (c) because DCAA failed to evaluate the compensation of the JFT vice presidents based on the revenues of the whole company even though each vice president had companywide responsibilities for the success of the company, and (d) because the method used does not yield auditable and reliable results (app. br. at 67-109).

The government's basic position is that DCAA's methodology for determining reasonable compensation is sufficiently valid to serve as a basis for the ACO's decision, and that the Compensation Specialists who performed the ECRs at issue, followed that methodology. Further, the government contends the MACT's ECRs provided the ACO with sufficient and legitimate reasons for challenging the excessive overhead costs due to unreasonable compensation. Therefore, the government says, appellant has not met its burden under FAR 31.201-3 to prove that the questioned costs were reasonable. (Gov't br. at 5-6, *passim*)

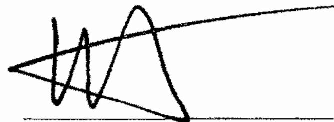
The government made no effort at the hearing or in its brief, to respond to the statistical arguments made by appellant and thus we are left with unrebutted evidence that the methodology used by DCAA was fatally flawed statistically and therefore unreasonable. Moreover, the government effort to support its own methodology was supplanted by an expert witness of questionable judgment. Consequently, we conclude that there are statistical flaws in the government methodology for determining reasonable compensation and that the computations performed by Jackson to overcome those flaws are reasonable.

We find Jackson's testimony to be both credible and unrebutted. We give little or no weight to the testimony of Dorf. While Benz testified credibly that the reviews were performed using the usual DCAA procedures, the nuts and bolts of the JFT presentation challenging these procedures was not credibly addressed and they are therefore unrebutted. We need not address JFT's other arguments in light of this result except to note that we have agreed with the DCAA version of revenue attribution (finding 93). JFT has met its burden of showing its executive compensation costs were reasonable except for $3,112 in 2002, $7,302 in 2004 and $32,023 in 2005.

We find the total unallowable compensation in fiscal year 2002 is $3,112, for fiscal year 2004 it is $7,302 and for fiscal year 2005 it is $32,023. There is no unreasonable compensation for fiscal year 2003.

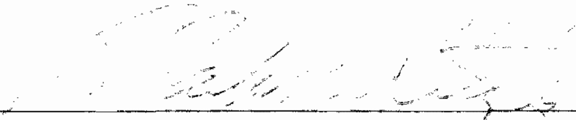
The appeals are sustained and remanded to the parties to resolve any remaining quantum issues in accordance with this decision.

Dated: 18 January 2012



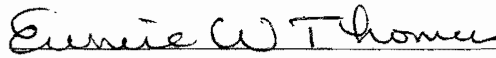
RICHARD SHACKLEFORD
Administrative Judge
Armed Services Board
of Contract Appeals

I concur



MARK N. STEMPLER
Administrative Judge
Acting Chairman
Armed Services Board
of Contract Appeals

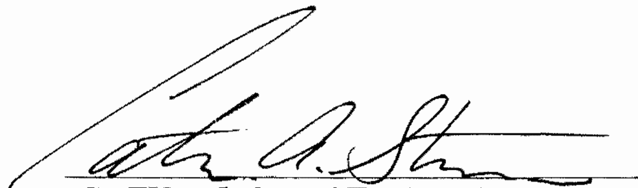
I concur



EUNICE W. THOMAS
Administrative Judge
Vice Chairman
Armed Services Board
of Contract Appeals

I certify that the foregoing is a true copy of the Opinion and Decision of the Armed Services Board of Contract Appeals in ASBCA Nos. 56105, 56322, Appeals of J.F. Taylor, Inc., rendered in conformance with the Board's Charter.

Dated: JAN 18 2012



CATHERINE A. STANTON
Recorder, Armed Services
Board of Contract Appeals