

United States General Accounting Office

**GAO**

Report to the Chairman, Legislation  
and National Security Subcommittee  
Committee on Government Operations  
House of Representatives

April 1990

# GOVERNMENT CONTRACTING

## Contractor Promotional Advertising Costs Are Unallowable





United States  
General Accounting Office  
Washington, D.C. 20548

National Security and  
International Affairs Division

B-238691

April 10, 1990

The Honorable John Conyers, Jr.  
Chairman, Legislation and National  
Security Subcommittee  
Committee on Government Operations  
House of Representatives

Dear Mr. Chairman:

As requested in your letter dated July 24, 1989, we reviewed the costs of major defense contractors' national advertisements urging public support of weapons programs such as Northrop's B-2 advanced technology bomber, McDonnell Douglas' F-15E Strike Eagle, Grumman's F-14D Tomcat shipboard interceptor, and Boeing-TeXtron's V-22 tilt-rotor aircraft. You asked us to determine the Department of Defense's (DOD) policy with respect to such advertisements and whether the contractors treated these advertising costs as unallowable charges to government contracts. You also asked us to determine the total dollar amount that was to be spent on advertising these four weapon systems during 1989, and whether the contractors planned to claim these costs as deductible business expenses for federal income tax purposes.

## Results in Brief

The government policy on the allowability of these costs, as set forth in the Federal Acquisition Regulation (FAR), is that such costs are unallowable charges to government contracts. The contractors we visited treat promotional advertising costs as an unallowable charge to government contracts in accordance with the FAR. Cost Accounting Standard (CAS) 405, Accounting for Unallowable Costs, provides that costs that are expressly unallowable shall be identified and excluded from any billing claim or proposal applicable to a government contract. Contractor accounting and advertising officials were aware that promotional advertising costs, such as those in question here, cannot be charged to government contracts. Current accounting policies and procedures at each of the contractors we visited require that these advertising costs be placed in unallowable accounts. The advertising costs examined were properly charged to corporate accounts and clearly labeled as not to be allocated to government contracts, complying with both the FAR and CAS 405.

The total aggregated amount that the contractors planned to spend advertising these four weapon systems during 1989 was approximately \$2 million. Final determination of the amount deductible for federal

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Each of the accounting and advertising officials we interviewed was aware that the FAR prohibits contractors from charging these promotional advertising costs to government contracts. During our visits, these officials discussed the corporate accounting procedures that are used to treat promotional advertising as an unallowable cost to government contracts. These procedures appear to meet all aspects of the FAR requirements for promotional advertising.

All the costs for the specific advertisements in question had not yet been recorded in the official books of account. Consequently, at each contractor, we selected similar recent advertising costs and traced these costs through the accounting system. All the costs traced were properly placed in accounts to be charged to the contractor, not to government contracts. One contractor official also pointed out that a contractor is required to certify that its indirect cost claim does not contain any unallowable costs. The official regards this certification as an additional safeguard for the government against unallowable costs, such as those in question here, from being charged to government contracts.

According to Defense Contract Audit Agency (DCAA) officials, DCAA teams regularly review contract accounts to ensure that costs are properly charged. In addition, the cognizant administrative contracting officials are responsible for day-to-day contract administration, and are familiar with the contractor's policies and practices. Cognizant DCAA and government administrative contracting office officials for these contractors believe that these contractors follow the FAR requirement and do not charge government contracts for unallowable advertising costs.

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## Expected Advertising Expenses for the Four Selected Weapon Systems

Table 1 contains the aggregated total dollars that the four contractors budgeted for and expected to spend for advertising the four systems in question during 1989. We have aggregated the data because each of the contractors regards the actual totals for each system as proprietary information.<sup>1</sup>

The contractors regard most of these promotional advertising expenses as normal business expenses that are considered deductible for federal income tax purposes. They plan to claim these deductible expenses in accordance with U.S. Treasury regulations regarding federal income tax.

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<sup>1</sup>Disclosure of proprietary information, such as the amount of any expenditure of any firm, is prohibited by 18 U.S.C. section 1905, unless such disclosure is authorized by law.

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We did not trace all of the actual costs in question through the process because they had not yet been entered in the account books. Even for those we did trace, we could not determine whether subsequent adjustments would be made and the costs actually charged to government contracts because finalization of these costs to contracts will not occur for several years when DCAA does its final review of the contractors' cost claims. In lieu of that, we traced similar costs through the accounts and verified with DCAA auditors that the contractors historically have not inappropriately charged these accounts to government contracts.

Our review was made in accordance with generally accepted government auditing standards between July 1989 and January 1990.

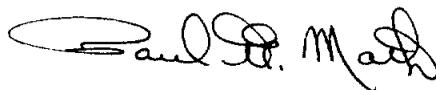
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As you requested, we did not obtain agency comments on this report. However, the views of responsible agency officials were sought during the course of our work and are incorporated where appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to interested congressional committees; the Secretary of Defense; and the Director, Office of Management and Budget. Copies will be made available to other interested parties on request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix I.

Sincerely yours,



Paul F. Math  
Director, Research, Development,  
Acquisition, and Procurement Issues

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However, contractor officials said that some of these advertisements included sections that encouraged constituents to write their federal government representatives on behalf of the weapons programs. This “grass roots” advertising is not a deductible business expense, according to 26 CFR, section 1.162-20(c)(4), and the contractor officials said that these costs will not be claimed. The advertising costs will be reviewed and the final decision on deductibility of about \$600,000 will be made at the time the 1989 income tax is filed.

**Table 1: Expected Advertising Expenses for Selected Weapon Systems of Four Major Defense Contractors During Fiscal Year 1989**

Dollars spent	Dollars tax deductible <sup>a</sup>
\$2,070,603	\$1,438,221 (minimum) <sup>b</sup>
	\$2,038,221 (maximum)

<sup>a</sup>These amounts do not include \$32,382 that was spent for grass roots campaign advertising, and therefore, not deductible according to Treasury regulations, 26 CFR, section 1.162-20(c)(4).

<sup>b</sup>This amount does not include \$600,000 that will be reviewed and the tax deductibility determined when the company files its 1989 federal income tax return in September 1990.

## Conclusion

Based on our discussions with responsible officials, examination of these contractors’ practices for the classification of advertising charges, review of selected advertising transactions, and confirmation of our findings with the DCAA auditors, it appears that the contractors we visited do not charge government accounts for promotional advertising costs. The contractors have an accounting system in place that complies with CAS 405 and the FAR and properly identifies these expenses as unallowable on defense contracts.

## Scope and Methodology

The scope of our review was limited to the contractors for the four specified weapon systems. We visited Northrop, Grumman, and McDonnell Douglas. We also visited Textron Headquarters and its wholly owned subsidiary Bell Helicopter Textron, Inc., which is a joint venture partner with Boeing for the V-22 program. Because of time constraints, we did not visit Boeing Corporation. We met with company accounting officials and officials responsible for advertising, and cognizant DCAA and government administrative contracting officials. We discussed advertising policies, advertising costs, accounting policies and procedures, and safeguards to prevent unallowable advertising costs from being charged to defense contracts. In addition, we examined specific advertising transactions involving promotional advertising, such as those mentioned here, and traced these charges through the accounting system to actual payment.

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income tax purposes has not been completed, but the contractors plan to claim at least \$1.4 million as deductible, in accordance with federal income tax regulations.

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## Advertising Costs Are Unallowable Charges

Section 31.205-1 of the FAR establishes government contract cost principles and procedures for public relations and advertising costs. According to the FAR, advertising costs to promote the sale of products or services are not allowable charges to government contracts. The only advertising costs that are allowable are those specifically required by contract, or that arise from requirements of government contracts, such as recruiting qualified personnel.

The CAS Board promulgates cost accounting standards for defense contractors to establish uniformity and consistency in cost accounting practices. These standards are intended to aid in the negotiation, administration, and settlement of government contracts. One of these standards, CAS 405,

- requires that contractors identify and set aside expressly unallowable costs and
- establishes the cost accounting treatment once unallowable charges are incurred.

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## DOD Policy

DOD officials were aware of the FAR requirement that prohibits contractors from charging government contracts for promotional advertising costs. According to DOD officials, the governmentwide policy for contractors' treatment of promotional advertising costs is embodied in the cost principles section of the FAR, and no separate DOD policy regarding these costs is needed.

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## Advertising Costs Are Properly Charged

The contractors we visited treat promotional advertising costs as an unallowable charge to government contracts as required by the cost principles section of the FAR. Contractor accounting and advertising officials were aware that promotional advertising costs such as those in question here cannot be charged directly or indirectly to government contracts. Current contractor accounting policies and procedures require that these advertising costs be placed in accounts clearly marked as unallowable against government contracts, and the recent advertising costs we examined were properly charged to these accounts.

