

Testimony

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OVERHEAD COSTS

Unallowable and Questionable
Costs Charged by Government
Contractors

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Mr. Chairman and Members of the Committee:

It is a pleasure to be here today to discuss the results of our reviews of contractor indirect costs, or "overhead" as it is commonly known.

Over the years, our office has issued numerous reports on contractor overhead costs. Our reports have examined overhead costs billed by contractors and universities doing business with the Departments of Defense and Energy, the Environmental Protection Agency, and by hospitals claiming reimbursement through the Medicare program. Our work and the audits of the Defense Contract Audit Agency and the Inspectors General shows that unallowable and questionable overhead costs are a significant and widespread problem--costing federal agencies and American taxpayers potentially hundreds of millions of dollars annually. Appendix I lists some of the overhead reports we have issued.

To illustrate the types of problems we have found, I would like to focus my comments today on our recent work at eight defense contractors. The eight contractors included (1) six small contractors with annual government sales that ranged from \$11 million to \$107 million and (2) two major contractors each with annual government sales that exceeded \$1 billion.

In examining overhead costs at these contractors, we sampled only a few accounts, concentrating on areas that we believed were most vulnerable to overbilling. These areas included expenditures for alcoholic beverages, personal use of automobiles and boats, travel, business meetings, and entertainment.

The Federal Acquisition Regulation requires contractors to identify and exclude unallowable costs from their overhead claims. Contractors are also required to certify that, to the best of their knowledge, their overhead claims do not include unallowable costs.

The Defense Contract Audit Agency audits contractors' costs, identifies costs that are questionable, and reports such costs to government contracting officers. Government administrative contracting officers are responsible for negotiating and administering contract costs, including overhead, and for applying penalties required by law, as appropriate.

UNALLOWABLE AND QUESTIONABLE OVERHEAD COSTS AT EIGHT DEFENSE CONTRACTORS

We found that all eight contractors had included unallowable and questionable costs in their overhead claims. For example, in addition to almost \$1 million in costs identified by the Defense Contract Audit Agency at the six small contractors, we identified about \$2 million more in overhead costs that was either expressly unallowable or questionable.¹ Similarly, at the two large contractors, we identified about \$4.4 million in unallowable or questionable overhead costs.

The government will not necessarily bear the burden for all of the unallowable or questionable costs we identified. The government's portion depends on the mix of defense versus commercial business performed by the contractors and the types of contracts being used.

I would like to discuss some of the examples of unallowable and questionable overhead costs we identified at the eight contractors.

ALCOHOLIC BEVERAGES

The FAR states that alcoholic beverage costs are expressly unallowable as a charge against government contracts. Yet, at six of the eight contractors, we found about \$26,000 in overhead charges for alcoholic beverages. For example, one contractor included \$1,621 for a Saturday evening "working" dinner attended by 21 employees and consultants at a cost of \$77 per person. The contractor included the entire bill, even though it included \$745 for alcoholic beverages and a bar fee, a cost of \$35 per person. Another contractor included over \$2,100 in its overhead charges for alcohol consumed at a conference for the company's lawyers, at an employee's farewell dinner, and at the private residence of a company employee.

PERSONAL USE OF AUTOMOBILES AND BOATS

Although costs for the personal use of company automobiles are expressly unallowable under the Federal Acquisition Regulation, five of the six small contractors we visited included about \$173,000 in their overhead costs for expenses involving employees' personal use of company automobiles. We likewise found that one of the major contractors charged about \$28,000 in its overhead claims for employees to use company-furnished vehicles for personal use.

¹Expressly unallowable costs are those costs that are specifically stated to be unallowable under the provisions of an applicable law, regulation, or contract. Questionable costs, generally, are those costs for which the contractor was unable to provide adequate support or where the nature, purpose, and reasonableness of the expenditure is in question.

We also found that one contractor included \$62,000 in its overhead expenses over a 2-year period for employees to use the company's boat for personal matters. According to contractor representatives, the boat, a 46-foot sportfishing vessel, was used for product testing as well as entertainment.

TRAVEL

Airfare costs are limited to the cost of the lowest standard commercial airfare, according to the FAR. However, one contractor included the full cost of two chartered aircraft flights in its overhead claim. These chartered flights, costing about \$19,300, is significantly more than standard commercial airfares. For example, in June 1989, three company executives chartered an aircraft for a trip to a conference. The trip cost \$13,019, or about \$4,340 per person. If standard commercial airfares for these executives had been used, the allowable cost would have been about \$11,000 less.

BUSINESS MEETINGS

Federal regulations allow contractors to charge the government for costs associated with business meetings. However, we found some contractors charged the government for a number of trips to resort locations outside the United States. For example, one contractor included about \$50,000 in its overhead costs for travel expenses associated with its annual management meeting held in Bermuda for 40 employees and a consultant. Thirty-six spouses and guests went on the trip at their own expense.

Another contractor, over a 2-year period, included about \$333,000 in its overhead costs for travel to Mexico, Jamaica, and the Grand Cayman Island for annual management and business meetings. For example, the contractor charged about \$102,000 to its overhead costs for 151 employees (over one-third of its employees) to travel to Jamaica to attend its annual business meeting. The employees brought 112 spouses or guests, mostly at their own expense.

According to the contractor, the purpose of the trip was to review operating policy and marketing strategy and serve as a stockholders meeting. Company officials advised us that such meetings are:

" . . .intended to promote a corporate 'cohesiveness' via both social and business interaction. . . and . . . combine business and fun via an opportunity to extend to a low cost vacation (at personal expense) in a resort area. Employees are encouraged to bring their spouses or families."

The company claims that the additional costs of meetings in resort areas are a form of incentive compensation.

We do not question the need to have legitimate business meetings. However, we do question whether the government should pay for

events that have the character of a vacation, especially in tropical resorts outside the United States.

ENTERTAINMENT

The Federal Acquisition Regulation does not allow contractors to charge the government for entertainment costs involving social activities and tickets to sporting events and shows. However, the regulation on entertainment costs refers, without any explanation, to the cost principle on employee morale and welfare costs, which are generally allowable. Because of this reference, some contractors maintain that entertainment-type expenses for employees are an allowable cost of maintaining employee morale and welfare and included such costs in their overhead claims. For example, over a 2-year period, one contractor included \$14,000 in its overhead costs for tickets and parking for professional sporting events (Boston Red Sox and Boston Celtics games), \$10,000 for schooner rentals for 40 employees and their guests, \$5,800 for running shoes for employees, and about \$12,000 for cable television charges for retirees.

Using the regulation on employee morale and welfare costs to claim costs for social activities and tickets to sporting events and shows is questionable, we believe, because the Federal Acquisition Regulation on entertainment specifically disallows these costs.

Another contractor included about \$10,600 in its overhead costs for a Christmas party for about 104 of its Washington, D.C., area employees and their guests. The party cost about \$102 per person, which included costs for decorations and flowers, a disc jockey, and a magician. Also included in the overhead charges was the cost of lottery tickets given to employees and their guests as Christmas party prizes.

One contractor charged over \$14,500 to overhead for entertainment. The charges included

- \$3,411 for a banquet for the company's lawyers (identified on the conference agenda as a reception, dinner, and social event);
- \$2,482 to entertain 76 bankers;
- \$2,184 for a hospitality suite at the 1991 Tailhook convention; and,
- \$2,900 for various social activities, including a chili cook-off, an Italian-American dinner, golf outings and greens fees, and the tickets to the Philadelphia Philharmonic.

ACTIONS NEEDED TO SOLVE THE PROBLEM

Over the years a number of actions have been taken in an attempt to address the problem of unallowable costs. In 1985, the Department of Defense started requiring contractors to certify that their overhead claims excluded unallowable costs. Penalties were also legislated by the Congress as a deterrent against unallowable overhead costs.

Despite such actions, however, we continue to see unallowable and questionable overhead costs charged to government contracts. There is no magic solution to this persistent and widespread problem, but we believe improvements are possible if the government would take the following actions.

- Clarify the regulations, especially for selected types of overhead costs, like entertainment and employee morale and welfare.
- Explore innovative approaches to reimbursing contractor overhead costs such as capping the expenses that can be charged for selected types of overhead costs.
- Increase the purchase of commercial products as provided for in current acquisition reform proposals as a way to move away from cost-based contracting toward market-determined prices.

We also believe contractors must do their part. Company executives must send a clear and strong message that unallowable costs are not an acceptable cost of doing business with the government. Likewise, company managers at all levels must pay more attention and place more emphasis on unallowable costs.

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Mr. Chairman, that concludes my statement. I will be pleased to answer any questions that you or other committee members may have.

GAO REPORTS AND TESTIMONY ON OVERHEAD COSTS

Energy Management: Controls Over the Livermore Laboratory's Indirect Costs Are Inadequate (GAO/RCED-94-34, Nov. 16, 1993).

Overhead Costs: Unallowable and Questionable Costs Charged by McDonnell Douglas Corporation (GAO/T-NSIAD-94-60, Oct. 13, 1993).

Medicare: Better Guidance Is Needed to Preclude Inappropriate General and Administrative Charges (GAO/NSIAD-94-13, Oct. 15, 1993).

Overhead Costs: Unallowable and Questionable Costs Charged to Medicare by Hospital Corporation of America (GAO/T-NSIAD-93-16, June 23, 1993).

Superfund: EPA Action Could Have Minimized Program Management Costs (GAO/RCED-93-136, June 7, 1993).

Energy Management: Types of Allowable and Unallowable Costs Incurred Under Two DOE Contracts (GAO/RCED-93-76FS, Jan. 29, 1993).

Federal Contracting: Cost-effective Contract Management Requires Sustained Commitment (GAO/T-RCED-93-2, Dec. 3, 1992).

Contract Pricing: Unallowable Costs Charged to Defense Contracts (GAO/NSIAD-93-79, Nov. 20, 1992).

Review of the Central Oversight of Contracting at the Department of Transportation (GAO/RCED-93-67R, Nov. 19, 1992).

Federal Research: System for Reimbursing Universities' Indirect Costs Should Be Reevaluated (GAO/RCED-92-203, Aug. 26, 1992).

Energy Management: Entertainment Costs Under DOE's Uranium Enrichment Production Contract (GAO/RCED-92-230FS, July 30, 1992).

Federally Sponsored Contracts: Unallowable and Questionable Indirect Costs Claimed by CH2M Hill (GAO-T-RCED-92-37, Mar. 19, 1992).

Federally Sponsored Research: Indirect Costs Charged by Selected Universities (GAO/T-RCED-92-20, Jan. 29, 1992).

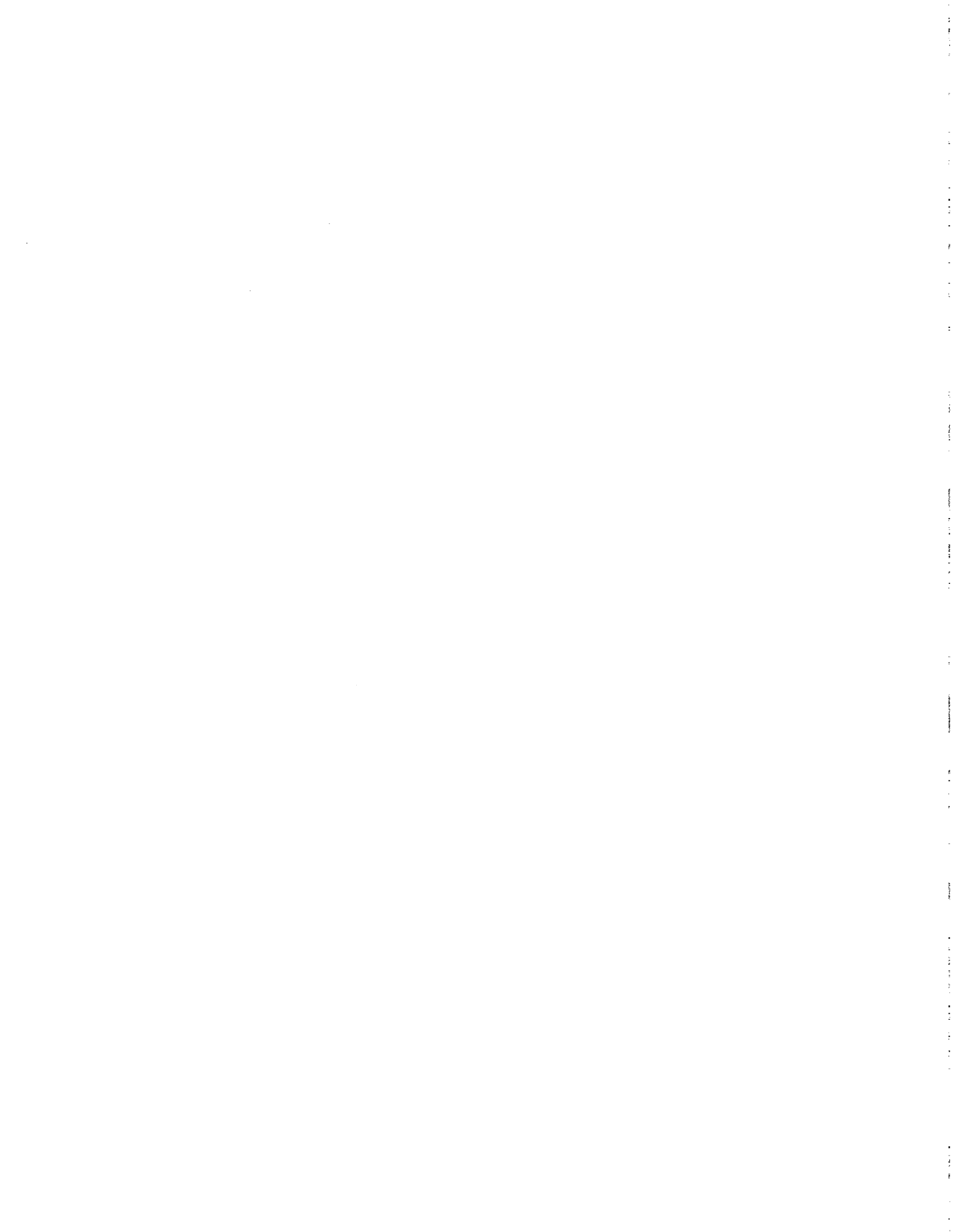
Federally Sponsored Research: Indirect Costs Charged by Stanford University (GAO/T-RCED-91-18, Mar. 13, 1991).

Government Contracting: Contractor Promotional Advertising Costs Are Unallowable (GAO/NSIAD-90-52, Apr. 10, 1990).

Unallowable Costs: Improved Cost Principles Should Reduce Inconsistent Treatment of These Costs (GAO/NSIAD-87-11, Oct. 10, 1986).

Improvements Needed in Department of Defense Procedures to Prevent Reimbursement of Unallowable Costs on Government Contracts (GAO/NSIAD-85-81, May 7, 1985).

Ambiguous Federal Acquisition Regulation Criteria on Defense Contractors' Public Relations Costs (GAO/NSIAD-85-20, Oct. 29, 1984).



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