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STATEMENT OF

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NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT & INVESTIGATIONS

OF THE

COMMITTEE ON ENERGY AND COMMERCE

UNITED STATES HOUSE OF REPRESENTATIVES

ON

DEFENSE CONTRACTORS' OVERHEAD COSTS

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Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the Department of Defense's (DOD's) system to prevent payment of defense contractors' unallowable overhead costs. Overhead or indirect costs at contractors' operations represent a significant amount of costs reimbursed to contractors under government contracts. On average, overhead represents almost 66 percent of total in-plant costs. Indirect costs are any costs not directly identified with a particular contract.

#### THE OVERHEAD COST PROBLEM

There are some overhead costs incurred by contractors which the government deems to be unallowable and, therefore, not reimbursable under government contracts. Unallowable costs are those that under the provisions of any pertinent law, regulation, or contract cannot be included in prices, cost reimbursements, or settlements under a government contract. The government, through the Federal Acquisition Regulation (FAR), provides guidance on the allowability of contract costs.

DOD through its Administrative Contracting Officers (ACOs) routinely negotiates annual overhead agreements with contractors. These agreements determine what indirect costs are to be allowable for reimbursement in overhead. The contracting officer has the responsibility to negotiate the overhead agreement with the contractors. In discharging this responsibility the ACO seeks advice from the Defense Contract Audit Agency (DCAA).

This agency has the responsibility to audit the books and records of defense contractors and make recommendations to the ACOs regarding the audited costs. DCAA's reports evaluate the costs being claimed by the contractor and make recommendations to the contracting officer regarding the propriety of such costs. DCAA's audit reports are used to assist in these negotiations.

Overhead negotiations between the government and the contractors are complex and differences concerning the allowability of certain costs are not easily resolved. The negotiations are based on the allowability criteria established in the FAR. We believe that overhead negotiations could be improved if FAR was less ambiguous in its definitions on the allowability of specific overhead costs.

Ambiguities in FAR cause contractors, DCAA, and contracting officers to have different interpretations on allowability. If a contractor believes a specific cost item is subject to interpretation, the contractor generally includes the cost in overhead. DCAA, in performing its overhead audits, uses the same FAR criteria but often arrives at a different interpretation and, therefore, questions the costs. If the contractor does not concede the questioned costs, they will be introduced into negotiations between the contracting officer and the contractor.

In <sup>1970</sup>1980 the Congress established the Cost Accounting Standards Board. In the 10 years of its existence, this Board issued 19 cost accounting standards which are designed to improve the process of accounting for costs on government

contracts. One of those Cost Accounting Standards is CAS 405, "Accounting for Unallowable Costs." CAS 405 was promulgated to facilitate the negotiation, audit, administration, and settlement of contracts by establishing guidelines covering: (1) the identification of costs specifically described in the FAR as unallowable and (2) the accounting treatment to be accorded such costs. According to the Standard, costs expressly unallowable or mutually agreed to be unallowable are to be identified and excluded from any billing, claim, or proposal applicable to a government contract.

In 1984, we reported on our review of ACO final overhead cost settlements at 12 contracting activities.<sup>1</sup> These activities were General Dynamics headquarters, General Dynamics-Fort Worth, Hercules Aerospace Division, Hughes Aircraft Company, LTV, McDonnell-Douglas Corporation, Martin Marietta Aerospace-Denver Division, Raytheon Company, Sanders Associates, Texas Instruments, Thiokol-Wasatch Division, and United Technologies Corporation. Our work disclosed that noncompliance with CAS 405 did not appear to be a problem. We noted, however, that there were numerous instances where DCAA was challenging, as unallowable expenses, significant amounts of contractor costs, but the ACOs were overruling DCAA and allowing a significant percentage of the costs questioned by DCAA. We also observed that the ACO, in the interest of expediency, was not preparing adequate documentation regarding the disposition of the costs questioned by DCAA.

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<sup>1</sup>Testimony before the Subcommittee on Legislation and National Security, House Committee on Government Operations, July 25, 1984.

Additionally, there is a reluctance on the part of contractors and ACOs to negotiate and agree to items of cost questioned by audit reports on an item-by-item basis. This reluctance apparently stems from the knowledge that once an item of cost, such as institutional advertising, had been mutually agreed to as being unallowable, CAS 405 would require that, thenceforth, such costs would have to be excluded from any billing, claim, or proposal applicable to a government contract.

It is the reluctance to identify and mutually agree to specific cost elements on the part of the contractors and the acquiescence to this procedure by contracting officers which produces the "bottom line" negotiations which we found prevalent. By agreeing to the compromise figure in total, without addressing any specific cost element such as airshows, models, or giveaways, the contractor can continue, year after year, to keep these cost in the overhead proposal for "bottom line" negotiations. I believe more aggressive pursuit by contracting officers in identifying and documenting individual elements of cost in overhead settlements as unallowable will contribute to the effectiveness of CAS 405 and will be a major step in helping DOD's system of preventing reimbursement of unallowable costs on government contracts.

#### DCAA OVERHEAD AUDITS AND ACO NEGOTIATIONS

DCAA's system for planning its overhead audits is generally adequate. There is, however, some room for improving the quality of the audits. For example, our review disclosed some

instances where DCAA could have used better audit techniques or obtained and presented more substantive documentation for its findings.

DCAA auditors told us that they often could not find the contractors to be in non-compliance with CAS 405 because the procurement regulations are not specific enough as to what costs are unallowable.

The rules as to what costs will be allowable for reimbursement against government contracts are set forth in the FAR (formerly Defense Acquisition Regulations (DAR)). These rules are extensive and complex. Differing interpretations cause a wide divergence of views regarding what is and what is not allowable.

The contracting officer, as the final authority at the contract level, must weigh these differing opinions and decide. This decision is usually made through a negotiation process. And, as mentioned above, negotiations are usually done on a total basis without specific agreement on individual elements of cost. Since these negotiations are on a total basis, a 50/50 split is generally the rule rather than the exception. For example, at the 12 contracting activities we reviewed, \$31 million of costs challenged by DCAA as unallowable were introduced into negotiations. In the ensuing negotiations, the contracting officers allowed into overhead \$16.5 million or 53 percent.

## EXAMPLES OF QUESTIONED COSTS

Following are some examples of costs questioned by DCAA and the disposition of these costs by ACOs during negotiations.

### Air shows

We found that DCAA questioned \$1.04 million in costs incurred by six of the contractors for the Paris Air Show, the Farnborough Air Show, and similar events on the basis that these costs were unallowable advertising. These contractors were General Dynamics headquarters, GD-Fort Worth, Martin Marietta, McDonnell-Douglas, Raytheon, and UTC. Contractors believe these costs are allowable under the FAR's definitions for "Selling Costs" and "Trade, Business, Technical, and Professional Activity Costs." The contracting officers took widely disparate views in settling these costs, ranging from total allowance to total disallowance. For example, the contracting officer at GD-headquarters allowed into overhead 100 percent of the \$28,000 questioned by DCAA for exhibits at the Paris Air Show.

At Raytheon the contracting officer disallowed 100 percent of the \$388,000 incurred for constructing, operating, and dismantling a chalet at the Paris Air Show because these costs were held to be unallowable advertising and entertainment. At Raytheon also the contracting officer allowed 100 percent of the \$35,000 questioned by DCAA for trips made by high level contractor marketing and public relations personnel to the Paris Air Show. The contracting officer considered these costs to be allowable selling and public relations functions.

## Advertising

Of \$574,000 in advertising costs questioned by DCAA at Hughes, Raytheon, and UTC contracting officers allowed approximately \$218,000 and sustained \$356,000 of DCAA's questioned costs.

For example, at Hughes the contracting officer allowed \$202,000 of \$532,400 questioned by DCAA. These costs were for advertisements in magazines such as Newsweek and Time. The full page ads in the magazines contained extensive descriptions of the company's products with approximately 15 percent of the ads devoted to employee recruitment. The contracting officer felt that the recruiting portion of the advertisement should be allowed and thus reinstated the costs.

At UTC the contracting officer allowed \$15,000, or 44 percent of the \$34,244 questioned by DCAA as unallowable advertising. This amount was apparently allowed because it represented costs incurred in producing a technical public relations film.

## Exhibits, displays, promotions, and giveaways

DCAA questioned approximately \$2.33 million incurred by six contracting activities (GD-headquarters, GD-Ft. Worth, McDonnell-Douglas, Martin Marietta, Thiokol, and UTC) for exhibits, displays, promotions, models, and giveaways on the grounds these were unallowable advertising costs. Notwithstanding DCAA's recommendations, contracting officers allowed into overhead \$1.04 million, or 45 percent of the amount questioned.

For example, we reviewed GD-Fort Worth's cost data amounting to about \$358,000 associated with aircraft models and other give away items. The contractor stated that these were allowable costs to promote the sale of a company product as defined under the FAR provision on Selling Costs. The contractor argued that the costs were allowable public relations marketing expenses because the contractor kept a list of the recipients of the models and giveaways. For these reasons, the contracting officer allowed about \$250,000, or 70 percent of these costs to be charged to the government.

Another contractor, Martin Marietta claimed technical display costs of \$33,000 for brochures, prints, models, and mock-ups as allowable public relations costs. According to the contractor, the models were displayed and brochures distributed at the Paris Air Show and other shows, as well as in local banks and other public places. The contracting officer allowed \$18,000 because these costs were considered to be "gray area" expenditures.

#### Consultants

Of \$945,000 in consulting expenses questioned by DCAA at six contracting activities (LTV, McDonnell Douglas, Hughes, Raytheon, Sanders, and UTC), ACOs allowed approximately \$271,000 and sustained \$674,000 of DCAA's questioned costs. For example, at LTV DCAA questioned \$57,000 which was paid to two consultants. DCAA argued that payments to the first consultant, a former company employee were not allowable because he did not provide services to the corporation. Expenses paid to the

second consultant were questioned because the consultant was a Public Relations firm which arranged a meeting for customers of LTV's subsidiary, a food company. In DCAA's opinion, this meeting had nothing to do with government contracts.

In settling these costs the ACO split the amount 50/50 based on prior years' settlements. According to the ACO, the amount conceded has an immaterial effect on the final overhead rate.

At Raytheon, DCAA questioned \$87,000 on the basis that, "the contractor still does not provide specific details as to what projects or areas these people consult on." The ACO reinstated the full amount on the basis that the fees were reasonable and because the contractor agreed that future consulting agreements would contain the nature of services rendered.

#### Entertainment

DCAA questioned approximately \$108,000 incurred by four contracting activities (Hughes, GD-Ft. Worth, Martin Marietta, and Raytheon) for entertainment on the basis these were social entertainment. The ACOs allowed into overhead \$61,000 or 57% of the amounts questioned.

At Martin Marietta DCAA questioned \$45,000 in petty cash transactions as unallowable entertainment. These costs included off-site business meetings where the primary purpose appeared to be attendance at a retirement party; personal expenses; golf course fees; and meetings, parties, gatherings, and dinners where supporting documentation showed these functions to be

primarily for entertainment. For example, DCAA questioned the allowability of \$7,704 incurred by the contractor at the Cherry Hills Country Club in Denver and the Lakewood Country Club in New Orleans and at other off-site business meetings combined with golf at Vail, Colorado. The contractor conceded \$509 for "unallowable items inadvertently claimed." The contractor maintained the other costs were allowable off-site business meeting costs and stated "meetings must be held off-site in an interruption free environment which is conducive to the business discussions at hand."

According to ACO personnel, these entertainment costs are in a "grey area" since they could be partial legitimate business expenses. Only \$10,000 of the \$45,000 challenged by DCAA were disallowed.

At GD-Fort Worth, DCAA questioned \$3,018 which was incurred for an Air National Guard and Thunderbird Reunion. The ACO disallowed only \$18.

### Travel

Of \$919,000 challenged by DCAA at seven contracting activities (GD-headquarters, Hughes, LTV, McDonnell Douglas, Martin Marietta, Raytheon, and Thiokol), the ACOs allowed approximately \$599,000 and sustained \$319,000 of DCAA's questioned costs. At Raytheon, for example, DCAA questioned \$181,000 which included such items as first class travel and the costs of hotel rooms, meals, and plane fares for spouses of contractor employees on travel. The ACOs allowed \$125,000 or 69% of DCAA's questioned costs.

## DOCUMENTATION OF NEGOTIATIONS IS INADEQUATE

Preparation of documentation, which establishes the basis for prenegotiation positions and fully explains the rationale for final disposition of DCAA's recommendations, is essential to the overview and control of the negotiation process. The FAR requires the contracting officer to prepare a negotiation memorandum, which addresses the disposition of significant matters in the DCAA audit report and resolution of questioned costs.

At the 12 contractor segments we visited, the ACOs did not adequately document prenegotiation positions. Although they generally prepared a memorandum of negotiated results, they did not always fully explain the basis for negotiated cost determinations. For example, at a Navy contractor activity, we could find no documentation of the rationale for negotiated agreements. Navy officials could not explain why documentation was not prepared.

At an Air Force contractor activity, we found no documentation of prenegotiation positions for a recently completed negotiated settlement. The government negotiator could not explain how some of the cost settlements were derived. After our discussions with the negotiator, a memorandum of negotiation was prepared using data from DCAA and other sources.

## IMPROVING THE SYSTEM

We believe that the system which DOD now employs to prevent reimbursement of unallowable costs on government contracts should be improved in two ways.

First, the appropriate sections of FAR should be clarified in such a way as to eliminate present ambiguities that are allowing such a wide divergence of opinions among DCAA, the contractors, and the ACOs. We recognize that the criteria for all cost elements cannot be written in such a way as to remove all ambiguity and that there undoubtedly will remain differences and disagreements as to the allowability of certain costs. We believe, however, that there are opportunities to clarify the criteria for some of the cost elements so as to reduce these differences and disagreements and, last year, we made certain recommendations to the Secretary of Defense in that regard.

We are pleased to note that a proposed change to FAR is now being circulated for comment. This gives specific definition to public relations and advertising costs and specifically addresses circumstances under which these types of costs are allowable or unallowable. The change in this category of costs is a positive step and should eliminate much of the confusion concerning these costs. We believe, however, that the change should go further and we plan to make recommendations to the Secretary of Defense to accomplish this.

A second improvement to the current system would be the requirement for ACOs to negotiate and settle the costs questioned as unallowable by DCAA on overhead claims on an element-by-element basis. Currently, the FAR requires that the cognizant contracting officer prepare and place in the general file a negotiation memorandum which explains the rationale for

the overhead settlement reached with the contractor. As individual cost elements are mutually agreed to by the government and contractor, those costs would be eliminated from future billings and the perennial negotiations concerning those costs would be eliminated.

We recognize that contractors will continue to be reluctant to negotiate and settle elements of cost on an item-by-item basis. Moreover, all government officials associated with the procurement process, not just the ACO, will have to have the resolve to accomplish this.

Mr. Chairman, this concludes my prepared statement and I will be pleased to answer any questions you or members of the Subcommittee may have.