

GAO

Fact Sheet for the Honorable
William V. Roth, Jr.,
U.S. Senate

August 1990

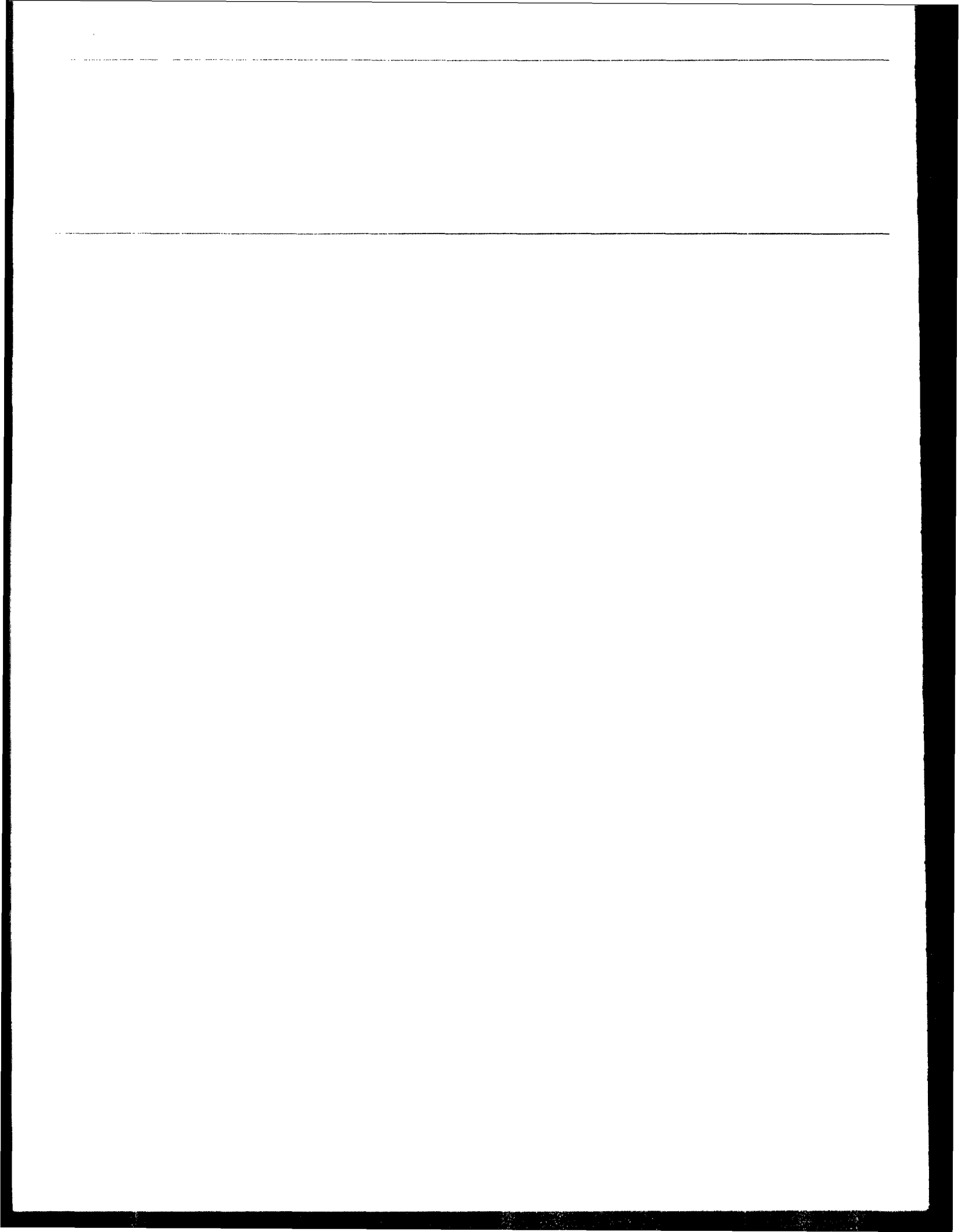
CONTRACT PRICING

Reviews of Defense Contractor Compensation Costs



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**National Security and
International Affairs Division**

B-219741

August 29, 1990

The Honorable William V. Roth, Jr.
United States Senate

Dear Senator Roth:

In response to your request, we have developed information on Defense Contract Audit Agency (DCAA) reviews of contractor compensation costs. Specifically, this fact sheet provides information on the number of compensation reviews conducted by DCAA, the amount of unreasonable compensation identified by DCAA, and the status of the government's efforts to reduce unreasonable compensation.

Results in Brief

We found that:

- Between October 1, 1987, and December 31, 1989, DCAA completed 361 reviews of defense contractors' compensation costs.
- In 123 of these reviews, DCAA identified about \$340 million in what it viewed as unreasonable compensation.
- As of December 31, 1989, action had been completed on 39 of these reviews which had identified about \$53 million in unreasonable compensation. In negotiations with the government, contractors agreed to contract and rate agreement reductions based on approximately \$17 million of the \$53 million.

Background

Compensation is one of the largest components of costs incurred under government contracts. The Federal Acquisition Regulation (FAR) 31.205-6 (a) defines compensation as

"... 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. . . . It includes, but is not limited to, salaries; wages; directors' and executive committee members' fees; bonuses (including stock bonuses); incentive awards; employee stock options, stock appreciation rights, and stock ownership plans; employee insurance; fringe benefits; contributions to pension, annuity, and management employee incentive compensation plans; and allowances for off-site pay, incentive pay, location allowances, hardship pay, severance pay, and cost of living differential."

Responsibility for determining the reasonableness of contractors' compensation costs rests with the government administrative contracting

officers. Until October 1, 1987, both the Defense Contract Administration Services, an organization within the Defense Logistics Agency, and DCAA jointly reviewed defense contractors' compensation costs and made recommendations to administrative contracting officers regarding unreasonable compensation. Effective October 1, 1987, the Department of Defense (DOD) gave DCAA sole responsibility for reviewing contractor compensation costs.

FAR requires that negotiated contracts include employee compensation costs—such as salaries, bonuses, and fringe benefits—only to the extent that they are “reasonable.” According to FAR, “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.”

DCAA's Contractor Employee Compensation System Review Program

DCAA reviews defense contractors' compensation costs under its Contractor Employee Compensation System Review program. DCAA selects contractors for review based on selection criteria that take into account the government's risk of accepting excessive compensation in government contracts.

In determining which contractors to review, DCAA considers conducting reviews every 2 years on contractors who have annual government sales of \$10 million or greater and receive at least 10 percent of their business from government sales. DCAA also considers the amount of compensation included in the contractor's government sales, previous compensation review findings regarding that contractor, and the expiration date of the contractor's collective bargaining agreements.

Scheduling reviews to coincide with the expiration date of bargaining agreements allows DCAA's findings to be considered in renewing those agreements. DCAA also conducts special purpose reviews that focus on specific groups of employees and follow-up reviews to determine what action the contractor has taken regarding the findings. The availability of DCAA staff is another consideration in planning the number of compensation reviews each year.

How DCAA Determines Reasonableness

Before April 1986, FAR required that compensation be considered reasonable if total compensation generally conformed to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed. Under the total compensation approach, the government had little success in challenging

the reasonableness of compensation costs because there were no widely acceptable measurements of total compensation.

In April 1986, FAR was revised to permit the government to challenge any single element of compensation, such as fringe benefits. When an element is challenged, the burden is placed on the contractor to either defend the reasonableness of the element or show that lower costs for other elements of the compensation package offset the "unreasonable" costs. According to the FAR, a government contractor's compensation costs will be considered reasonable, if each of the allowable elements of the employee's compensation package is reasonable. Consideration should be given to all potentially relevant facts, such as, whether the elements of the compensation package are in 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 other firms in the same geographic area, and the compensation practices of other firms engaged in predominately nongovernment work. The cost of comparable services obtainable from outside sources is another reasonableness criterion identified in FAR.

To determine whether a contractor's compensation is reasonable, DCAA compares it to comparable data from compensation surveys. Compensation surveys are prepared by private companies (as well as defense contractors) using compensation data collected from various firms. DCAA considers a contractor's compensation reasonable if it is within 14 percent of appropriate survey compensation (within 25 percent for executives). DCAA allows the 14 and 25 percent variances because of an Armed Services Board of Contract Appeals decision that reasonableness of compensation is better represented by a range than by a precise figure. A range also allows for variations in surveys based on the way employees doing comparable work are paid in different firms.

Results of DCAA Compensation Reviews

Between October 1, 1987, and December 31, 1989, DCAA completed 361 compensation reviews, some of which are for different divisions of the same parent companies. The DCAA Compensation Program Manager said that most major contractors (those with over \$40 million in government sales) have had at least one compensation review.

DCAA initially identified about \$450 million in unreasonable compensation in 140 of the 361 reviews. As of December 31, 1989, DCAA had made about \$110 million in reductions to the unreasonable compensation findings in these reports, based on such things as additional contractor data

or changes in DCAA audit guidance. These revisions reduced the number of reviews with findings of unreasonable compensation to 123 and the total amount of those findings to approximately \$340 million.

Government's Success in Reducing Unreasonable Compensation

If DCAA determines that a contractor's employee compensation is more than 14 percent above the appropriate wage survey average (25 percent above for executives), it requests the contractor to either justify the compensation or submit an action plan to reduce the compensation to a reasonable level. DCAA then submits a report of its findings and the contractor's response to the cognizant administrative contracting officer.

According to the Office of the DOD Inspector General, the administrative contracting officer may

- negotiate a settlement or other agreement to reduce the contractor's unreasonable compensation,
- issue a formal notice of intention to disallow unreasonable compensation included in future contract costs, or
- take no action if it is determined that the contractor's compensation is not unreasonable.

Of the approximately \$340 million in unreasonable compensation identified in the 123 reviews, the DCAA Compensation Program Manager said that action has been completed on 39 DCAA reviews with identified unreasonable compensation of about \$53 million. The program manager said that in negotiations with the government, contractors agreed to contract and rate agreement reductions based on approximately \$17 million of the \$53 million in unreasonable compensation identified in the 39 reviews.

Scope and Methodology

We obtained information for this fact sheet from quarterly and annual DCAA status reports of compensation reviews, and made a limited analysis of 10 DCAA reviews that reported large dollar amounts of unreasonable contractor employee compensation. We validated selected data by examining the relevant individual compensation review reports.

We also interviewed DCAA officials at their Washington headquarters office and several regional offices and met with DOD Inspector General officials who were conducting a related review. Our work on this assignment did not include discussions with government contracting officers or contractor representatives. As agreed with your staff, we will, in a

separate review, evaluate whether certain DCAA compensation findings and recommendations were supportable and convincing and why DOD contracting officers have not acted on them.

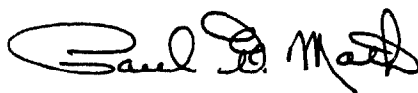
Our review was performed from August 1989 to May 1990. We did not obtain official agency comments on a draft of this report, but we discussed our findings with DCAA officials and have incorporated their comments where appropriate.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to the Secretary of Defense and the Director, DCAA, and make copies available to other interested parties on request.

The major contributors to this fact sheet are David E. Cooper, Assistant Director, and John L. Carter, Assignment Manager, from headquarters; and Joe D. Quicksall, Evaluator-in-Charge, Ronald M. Haun, Site Senior, and Jerilyn Green, Staff Evaluator, Dallas Regional Office.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this fact sheet.

Sincerely yours,



Paul E. Math



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