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REPORT TO THE CONGRESS

Need For Improved Guidelines In Contracting For Research With Government-Sponsored Nonprofit Contractors

B-146870

Department of Defense
Atomic Energy Commission
National Aeronautics and Space
Administration

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

FEB 10 1969



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D. C. 20548

B-146810

To the President of the Senate and the
Speaker of the House of Representatives

Enclosed is a report on the need for improved guidelines in contracting for research with Government-sponsored nonprofit contractors.

Copies of this report are being sent to the Director, Bureau of the Budget; the Secretary of Defense; the Secretary of Health, Education, and Welfare; the Secretary of Housing and Urban Development; the Chairman, Atomic Energy Commission; the Acting Administrator, National Aeronautics and Space Administration; the Director, Office of Science and Technology; the Director, National Science Foundation; and the Chairman, Civil Service Commission.

In addition, copies are also being sent to the Secretaries of the Army, Navy, and Air Force and to the Director of Defense Research and Engineering.

A handwritten signature in cursive script, reading "James B. Argets".

Comptroller General
of the United States

D I G E S T

WHY THE REVIEW WAS MADE

On April 30, 1962, the President transmitted to the Congress a report entitled "Government Contracting for Research and Development." Subsequently extensive hearings were held by the House Government Operations Committee. The subject was and continues to be highly important.

Research and development expenditures in 1962 totaled \$10.3 billion; 80 percent was administered through non-Federal Government organizations. For 1969 the total is estimated to be \$17.3 billion; the ratio expended by non-Federal and Federal organizations is about the same.

GAO has reviewed one of the more difficult and controversial elements in the 1962 report: the purpose, amount, and use of the "fee" or management allowance provided for sponsored, nonprofit organizations. Total expenditures for fees--to the extent of about \$9 million annually--is less important than the question: have the purpose of the fee and the 1962 guidelines been carried out?

FINDINGS AND CONCLUSIONS

GAO concluded that the purpose established for the fee in 1962 has not been accomplished satisfactorily and the fee has not been administered in accordance with the 1962 guidelines.

GAO found that the allowances paid to nonprofit organizations and the bases used for determining those allowances varied significantly among Government agencies. In some they were being accumulated to permit diversification into new fields. Allowances were not being used to an appreciable degree to conduct independent research. (See pp. 21 to 44.)

The issue of the purpose, amount, and use of the fee, in GAO's opinion, is a major one--although only one of several--in defining the appropriate role of the Government-sponsored nonprofit organizations.

GAO noted, for example, that no action has been taken with respect to one important recommendation in the 1962 Presidential report: that consideration be given to the establishment of Government "Institutes." The proposal envisioned that these institutes, although subject to the supervision of a Cabinet officer or agency head, would be "a separate corporate entity directly managed by its own board of regents" and would "enjoy a considerable degree of independence in the conduct of its internal affairs." The objective would be to provide for in-house research and development programs and needed flexibility while retaining "effective public accountability and control." (See p. 59.)

RECOMMENDATIONS OR SUGGESTIONS

GAO suggested in its draft report sent to various Government agencies and to the 15 nonprofit organizations for comment that Government-wide guidelines as to the amount

and usage of fees be established (see p. 45) and that the establishment of Government "Institutes" to administer certain research and development programs be considered (see p. 59).

AGENCY AND CONTRACTOR RESPONSES

Many agencies agreed that there was a need for Government-wide guidelines concerning management allowances for sponsored nonprofit organizations. Some agencies and contractors did not agree. (See pp. 47 to 58.) Most of the agencies felt that consideration of the establishment of Government "Institutes" was warranted. Contractors in general did not comment on this. (See p. 59.)

ISSUES FOR FURTHER CONSIDERATION

In the 7 years since the executive branch policies on contracting for research and development were established, there have been major advances in the capability, as well as increases in the number, of educational, sponsored nonprofit, and industrial organizations to perform such work. At the same time, Federal Government capabilities have likewise increased through improvement in salaries and implementation of other steps envisioned in the 1962 report.

In view of these changes and the importance of the subject of the proper role of Government-sponsored nonprofit organizations, GAO believes that a Presidential-directed interagency or commission study is warranted. As an alternative, GAO recommends:

- That the Bureau of the Budget prescribe Government-wide guidance to agencies in establishing and contracting with sponsored nonprofit organizations, designed to enable Government agencies to achieve a balance between the flexibility needed by the organization to perform capably and the amount of Government supervision required. The guidelines should limit the management allowance to the amount needed to enable the organizations to accumulate a reserve to provide operational stability during temporary reductions in contract work and to pay prudent business expenses not otherwise reimbursable.
- That the Bureau of the Budget and the Civil Service Commission conduct a follow-on study to consider what types of organizations could best assist the Government in fulfilling its research and development missions, including consideration as to the desirability and feasibility of establishing Government "Institutes."

LEGISLATIVE PROPOSALS

None.

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NEED FOR IMPROVED GUIDELINES IN CONTRACTING FOR
RESEARCH WITH GOVERNMENT-SPONSORED NONPROFIT
CONTRACTORS

Department of Defense, et al B-146810

SUMMARY

THE REVIEW WAS MADE

On April 30, 1962, the President transmitted to the Congress a report entitled "Government Contracting for Research and Development." Subsequently extensive hearings were held by the House Government Operations Committee. The subject was and continues to be highly important.

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GAO has reviewed one of the more difficult and controversial elements in the 1962 report: the purpose, amount, and use of the "fee" or management allowance provided for sponsored, nonprofit organizations. Total expenditures for fees--to the extent of about \$9 million annually--is less important than the question: have the purpose of the fee and the 1962 guidelines been carried out?

FINDINGS AND CONCLUSIONS

GAO concluded that the purpose established for the fee in 1962 has not been accomplished satisfactorily and the fee has not been administered in accordance with the 1962 guidelines.

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AGENCY AND CONTRACTOR RESPONSES

Many agencies agreed that there was a need for Government-wide guidelines concerning management allowances for sponsored nonprofit organizations. Some agencies and contractors did not agree. (See pp. 47 to 58.) Most of the agencies felt that consideration of the establishment of Government "Institutes" was warranted. Contractors in general did not comment on this. (See p. 59.)

ISSUES FOR FURTHER CONSIDERATION

In the 7 years since the executive branch policies on contracting for research and development were established, there have been major advances in the capability, as well as increases in the number, of educational, sponsored nonprofit, and industrial organizations to perform such work. At the same time, Federal Government capabilities have likewise increased through improvement in salaries and implementation of other steps envisioned in the 1962 report.

In view of these changes and the importance of the subject of the proper role of Government-sponsored nonprofit organizations, GAO believes that a Presidential-directed interagency or commission study is warranted. As an alternative, GAO recommends:

- That the Bureau of the Budget prescribe Government-wide guidance to agencies in establishing and contracting with sponsored nonprofit organizations, designed to enable Government agencies to achieve a balance between the flexibility needed by the organization to perform capably and the amount of Government supervision required. The guidelines should limit the management allowance to the amount needed to enable the organizations to accumulate a reserve to provide operational stability during temporary reductions in contract work and to pay prudent business expenses not otherwise reimbursable.
- That the Bureau of the Budget and the Civil Service Commission conduct a follow-on study to consider what types of organizations could best assist the Government in fulfilling its research and development missions, including consideration as to the desirability and feasibility of establishing Government "Institutes."

LEGISLATIVE PROPOSALS

None.

INTRODUCTION

The General Accounting Office has conducted a survey of the policies and practices within the Government pertaining to the payment of fees¹ to nonprofit organizations on contracts awarded for research and development. The examination was made pursuant to the Budget and Accounting Act, 1921 (31 U.S.C. 53); the Accounting and Auditing Act of 1950 (31 U.S.C. 67); and the contract clauses prescribed by 10 U.S.C. 2313(b).

On April 30, 1962, the President transmitted to the Congress a report entitled "Government Contracting for Research and Development," commonly called the "Bell Report" after David E. Bell, Chairman of the Presidential study committee and Director of the Bureau of the Budget. Subsequently extensive hearings were held by the House Government Operations Committee. The subject was and continues to be highly important.

Research and development expenditures in 1962 were approximately \$10.3 billion, of which 80 percent was administered through non-Federal Government organizations. In fiscal year 1969 the total increased to an estimated \$17.3 billion, and the ratio expended by non-Federal and Federal organizations is about the same.

The objective of our survey was to review one of the more difficult and controversial elements in the 1962 report; the purpose, amount and the use of the "fee" or management allowance provided for sponsored, nonprofit organizations. The total annual expenditure for fees of approximately \$9 million is less important than the question of whether the purpose of the fees and the guidelines established in 1962 have been carried out.

Our survey was directed primarily toward an examination of the practices of the Department of Defense (DOD) in contracting with certain sponsored nonprofit organizations known as Federal Contract Research Centers; however, we also examined into contractual arrangements entered into by other Government agencies with other selected sponsored nonprofit organizations and by DOD and other Government agencies with three nonprofit institutions which are independently organized and do not have a Government sponsor.² We identified differences in policies and practices and considered justifications for the allowance of fees in each instance.

Our examination was limited to obtaining information on the bases used for the determination of the amounts of fees allowed to the various types

¹In this report the term "fee" with respect to nonprofit organizations is used synonymously with "general support" or "management" allowances.

²Unless specifically identified, the term "nonprofit" is used in this report to identify both sponsored and independent organizations. A sponsored nonprofit organization is defined for purposes of this report as one for which a Government agency has assumed responsibility for providing sufficient work and revenues to ensure retention of acquired capabilities to meet Government needs.

of nonprofit organizations and to inquiring into the uses made of fees by the selected nonprofit organizations. We did not review other aspects of the operations or management of the nonprofit organizations and did not look into the efficiency with which the nonprofit organizations carried out their research contracts with the Government.

The scope of our survey is described in more detail on page 65. A list of the nonprofit organizations covered in the survey is included as appendix I of this report.

HIGHLIGHTS

SIGNIFICANT VARIANCES IN AGENCY POLICIES ON FEES FOR NONPROFITS

The fees paid to nonprofit organizations and the bases used for the determination of such management allowances vary significantly among Government agencies. (See p. 21.)

DOD, in December 1966, adopted a weighted guidelines approach for fee negotiations on contracts with sponsored and nonsponsored nonprofit organizations. This approach included a special provision for adjustment in rate applicable to sponsored nonprofit organizations, to recognize their continuing financial support by the sponsoring Department or agency.

Before weighted guidelines were used, the Air Force policy provided for paying fees to sponsored nonprofit corporations, the negotiations of which took into consideration the corporations' special status and which tailored fees to meet the corporations' reasonable needs for independent research and limited working capital and facilities. This "needs" policy was not accepted by all the sponsored organizations, and fees were sometimes based on worth-of-task or other methods.

In the absence of DOD policy prior to the adoption of weighted guidelines, the Army, Navy and DOD components apparently based the fees on the stated needs of the nonprofit organization. We found that there was generally no statement setting forth the precise basis on which fees had been negotiated.

In contracts awarded to educational institutions for the operation of Government facilities, the agencies did not follow uniform practices in the determination of whether fees were allowable. We found examples where the Army and the Air Force allowed no fee, whereas the Navy, the Atomic Energy Commission (AEC), and the National Aeronautics and Space Administration (NASA) each allowed some fee to educational organizations for operating Government installations.

The National Science Foundation (NSF) policy concerning management fees paid to nonprofit corporations operating its national research centers is to determine fees on the basis of need, to cover such items as corporate expenses and a reasonable corporate reserve to give the contractors operational stability and flexibility.

FEES USED BY GOVERNMENT-SPONSORED NONPROFITS FOR VARIOUS PURPOSES

The Bell Report, "Report to the President on Government Contracting for Research and Development," issued April 30, 1962, advocated the payment of fees to nonprofit organizations for the following reasons: (1) to provide some degree of operational stability and flexibility to organizations otherwise bound to the precise limitations of cost financing of specific tasks, the fees to be used to even out variations in the income resulting from variations in the level of contract work, and (2) to conduct some

independent, self-initiated research in order to obtain and hold highly competent scientists and engineers.

Our survey showed that, depending on the financing arrangements agreed to between the sponsoring agency and the sponsored nonprofit organization and the amount of fees that the organization had been able to accumulate during its existence, fees had been used by management for various financial aspects of operations. Our survey showed also that many nonprofits did not use fees to an appreciable degree to conduct independent research.

Fees used in some instances
to provide working capital

There were 12 nonprofit organizations included in our survey that are considered to be Government-sponsored, that is, one or two agencies have assumed responsibility for the financial support of these organizations. We found that the requirements for working capital during periods of normal operation were being met in different ways for these organizations. (See p. 26.)

Three of the organizations had received Government advances in the past, but were at the time of our review using their own funds, accumulated primarily out of fees. Two were using a combination of Government advances and fee accumulations. Five were financed primarily by the Government, either through the use of advance payments or letters-of-credit arrangements. In two cases, operating capital was furnished entirely by the contractor-operator and Government funds were provided only on a reimbursement basis.

On the basis of the experience of the five nonprofits included in our survey that were being financed primarily by the Government, we believe that the financing of the operations of Government-sponsored nonprofit organizations can be accomplished without furnishing large amounts of fees to accumulate reserves for this purpose. There are economic advantages to the Government's furnishing working capital, through advance payments or arrangement for the use of letters of credit, instead of allowing the nonprofit to accumulate fees.

Fee accumulations used at times
of delay in renewal of Government
contracts or temporary reductions
in contract effort

We found that limited amounts of fee accumulations had been used by some of the nonprofits to maintain normal operating levels during periods of delay in contract renewal. Fees had also been used to accumulate reserves for use in case of reductions in the level of contract support (See p. 28.)

We believe that it might be necessary for sponsored nonprofits to retain fees for a limited reserve to provide stability of operation during short periods of time when Government program funds have been reduced or are not available. Where contract renewal is not doubtful, the incidence of need for funds for renewal delays could be kept at a minimum by the

sponsoring agency's working with the nonprofit's management to plan funding and contract negotiation in an orderly and timely manner, and by the use of letter contracts when necessary.

Contractual provisions for
termination liabilities
reduce need for reserves

In our opinion the DOD-sponsored nonprofits would not have to accumulate fees to cover costs in the event of contract termination. We saw no indication that the Government planned to dispense with the services of these organizations in the near future. Also, we found that the Air Force had included a clause in its contracts with MITRE to reimburse it for all reasonable and allocable personnel severance and other related windup costs if the Air Force contract with MITRE was not renewed. We believe that similar provisions could contractually cover such possibilities for other sponsored organizations and thus reduce the need for an accumulation of fee for this purpose. (See p. 29 .)

Fees being accumulated to
permit diversification and
continuity of operations

We examined into the reserves being accumulated by the various DOD-sponsored nonprofits receiving fees. Some of the organizations had instituted programs of setting up reserves to ensure stability in the event of reductions in the level of contract support. The stated purposes of some of these reserves seem to indicate that they are intended not so much as a cushion against temporary fluctuations in the financial support of the sponsor agency, but rather as a fund with which to seek other clients at such time as the nonprofits' services may no longer be required by their sponsors. (See p. 31 .)

We question whether fees should be provided to a Government-sponsored nonprofit organization for the purpose of creating a reserve to finance a shift of the organization's operations to other fields of endeavor or to enable it to compete in the private sector for non-Government business. Also, should the organization not discontinue operation after the sponsoring agency no longer requires its services but go into other activities, any claims which the Government may have established on the assets of the organization would tend to be negated since such claims are effective only upon the dissolution of the organization.

Fees used to pay for
nonreimbursable
business costs

We found that fees were being used by DOD-sponsored nonprofit organizations to finance expenses of operation that were not reimbursed under Government contracts because they are deemed by the Armed Services Procurement Regulation (ASPR) to be unallowable in whole or in part. (See p. 36 .) Many of these expenses are of the type customarily incurred by commercial firms operating in a competitive environment and are paid from funds obtained from contract profits or other sources of income.

We believe that, in order to enable the nonprofit to pay an appropriate amount of such expenses and, at the same time, ensure that the expenses are confined to necessary and prudent costs of doing business, the agency should base the amount of fees negotiated for this purpose on the reasonable needs of the organization. Consequently, although fees, once they have been provided, are to be used at the discretion of the management of the nonprofit organization, the uses made of the fees should be a factor in the determination of the amount of fees to be allowed in subsequent years.

Fees generally not used
for independent research

The Bell Report supported the payment to nonprofit organizations of fees for the conduct of some independent, self-initiated research in order to obtain and hold highly competent scientists and engineers. However, our survey showed that some nonprofit organizations have not conducted any independent research, others have performed some research of this type but have funded it principally through direct or indirect charges to contracts, and relatively few have funded an appreciable portion of their independent research from fee income. Evidently there is little recognizable difference between the type of research funded as fee-sponsored and that funded as reimbursable contract costs.

It appears that the overall research effort of these organizations is what attracts and holds scientific and engineering personnel. Although independent research is desirable, there is no necessity to furnish fees for such purpose to accomplish the objectives set forth in the Bell Report. (See p. 39.)

Fees used in some instances
for acquisition of facilities

We found that DOD-sponsored nonprofit organizations have used substantial amounts of fees for the purpose of acquiring capital assets. (See p. 41.)

In the cases we reviewed, the facilities had been acquired, in many instances, prior to the issuance of the Bell Report. The Bell Report stated that, where the Government furnished funds for nonprofit organizations to obtain facilities, it was equitable that rights be given to the Government to determine the disposition of the assets upon dissolution of the organizations. Certain residual rights to these assets have been acquired by DOD. It appears that the Government's claims upon dissolution of the organizations may be jeopardized should they elect to seek other clients, rather than dissolve, at the time their services are no longer required by their Government sponsors.

Some Government-sponsored nonprofit institutions operate in Government-furnished facilities and have utilized no fees for acquiring capital assets. It appears to us that it is in the best interests of the Government to furnish required facilities to nonprofit organizations instead of furnishing funds through fees to enable the organizations to acquire capital assets.

PROPOSED GOVERNMENT-WIDE GUIDELINES

We proposed that a statement of governmental policy be established to provide guidance in the negotiation of fees with Government-sponsored nonprofit organizations, along the lines outlined in the preceding paragraphs. (See p. 45.) The proposal was contained in a draft report submitted to the organizations included in our survey and to Government agencies expected to have an interest in such a policy.

All the 15 nonprofit organizations commented on the draft report. Although several of the organizations did not comment directly on our proposal, most of those which responded expressed the opinion that our proposal would restrict fees and such restriction would curtail the usefulness of the nonprofits to the Government.

These contractors contended that a limited fee policy would take away the financial resources with which they evidence their independence and flexibility and thus restrict their activities. Fees were considered necessary in order that, among other activities, these organizations could (1) maintain an objective approach to sponsors' needs, (2) attract and retain high-caliber talent to carry out sponsors' missions, (3) diversify operations to better anticipate sponsors' needs, and (4) conduct research independently of sponsors' approval.

However, the nonprofit organizations included in our survey that utilize Government-owned facilities and Government capital and perform independent research on a cost-reimbursable basis apparently were able to perform their sponsors' missions satisfactorily without any fees or with minimum amounts of fees.

We believe that nonprofit organizations that are established to serve continuing Government needs and are supported predominantly by the Government should be subject to a certain amount of Government supervision. On the other hand, the flexibility of these organizations should not be restricted to the extent that the characteristics which make it possible for them to perform capably would be destroyed.

In our opinion, the proposed guidelines should enable Government agencies to achieve a balance between these two objectives and thereby to obtain the services of these nonprofit organizations at the lowest possible cost that would permit them to function competently.

The Government agencies differed in their reactions to the proposed guidelines. DOD does not concur that guidelines should be prescribed as proposed; it prefers its current approach of modified weighted guidelines.

AEC believes that there is no need for Government-wide guidelines for negotiating fees with Government-sponsored nonprofit organizations. AEC believes also that each agency should have sufficient flexibility to enable it to determine fees based on its individual needs, conditions, and experience.

NSF, the Office of Science and Technology, and the Department of Health, Education, and Welfare (HEW) generally expressed agreement that

there was need for a statement of Government policy. The Director of NSF informed us that NSF would be pleased to participate in any study leading to the establishment of such a policy.

The comments received from the nonprofit contractors are discussed in more detail, beginning on page 47, and replies received from Government agencies are discussed individually, beginning on page 52.

ESTABLISHMENT OF GOVERNMENT INSTITUTES

One of the conclusions of the Bell Report was that a new kind of Government research and development establishment was promising enough to warrant further study. The objective of establishing such an instrumentality, which might be called a Government Institute, would be to achieve in the administration of certain research and development programs the kind of flexibility obtained by Government corporations and yet retain effective public accountability and control.

In view of the continuing and growing use of nonprofit organizations to assist Government agencies in carrying out their missions, we suggested that consideration be given to establishing Government Institutes to meet future needs. (See p. 59.)

Six Government agencies and three nonprofit contractors commented on the proposal, generally expressing agreement. Some of these organizations withheld unqualified support in the absence of knowledge as to how the utilization of Government Institutes would affect the existing Government-sponsored nonprofit organizations. Concern was expressed that these organizations would be converted to or replaced by Government Institutes.

We recognize that, in the opinion of the sponsoring agencies, these organizations are performing essential functions, and we are not suggesting that they necessarily be replaced or converted. We are proposing that consideration be given to the creation of Government Institutes to meet future needs. If they are authorized and prove effective, some nonprofits could conceivably be converted to or replaced by Government Institutes.

The matter of establishing Government Institutes would require a study involving considerations beyond those involved in establishing guidelines on fees for nonprofits. We believe that a special follow-up study to the review that led to the 1962 Bell Report should be conducted for the following reasons: (1) the recent increased use of nonprofit organizations to serve nondefense needs of the Government, (2) steps that have been taken within the Department of Defense since the issuance of the Bell Report to strengthen the competence of in-house research laboratories, such as increases in salary levels of professional personnel, authorization of laboratory directors' funds to permit flexibility in the selection and pursuit of research activities, and the establishment of direct lines of communication between laboratory directors and departmental officials, and (3) the growing number of private companies with analytical competence.

This follow-up study should consider the Government's need for contractor assistance in performing its research and development missions and the types of organizations that would best accomplish these tasks and should include criteria as to the circumstances under which such tasks should be performed within the government, by a sponsored nonprofit organization or by other organizations. We believe that, in the evaluation of the various types of contractor relationships available to Government agencies, consideration should be given to the desirability and feasibility of establishing Government Institutes.

RECOMMENDATIONS

We believe that the subject of the proper role of Government-sponsored nonprofit organizations is of sufficient importance to warrant a Presidential-directed interagency or commission study. As an alternative we are recommending:

1. That the Bureau of the Budget prescribe Government-wide guidance to agencies in establishing and contracting with sponsored nonprofit organizations, designed to enable Government agencies to achieve a balance between the flexibility needed by the organization to perform capably and the amount of Government supervision required.

The guidelines should limit the management allowance to the amount needed to enable the organizations to accumulate a reserve to provide operational stability during temporary reductions in contract work and to pay prudent business expenses not otherwise reimbursable.

The allowance should not include any amount for independent research, since such research, when considered desirable, should be authorized as an allowable cost. Also, the allowance should not include any amount for acquisition of capital assets since they should be provided by the Government or covered in the contract as an allowable cost. Similarly, allowances should not be provided for accumulation of working capital since the sponsoring agency should furnish the working capital through use of an advance-payment plan or a letter-of-credit arrangement.

2. That the Bureau of the Budget and the Civil Service Commission conduct a follow-on study to consider what types of organizations could best assist the Government in fulfilling its research and development missions, including consideration as to the desirability and feasibility of establishing Government Institutes.

The study should include criteria as to the circumstances under which work should be performed in-house, by sponsored nonprofit organizations or by private organizations.

BACKGROUND

The expanded responsibility assumed in the past 20 years by the Federal Government in scientific research has led to increased reliance on contracting with nonprofit organizations. A substantial amount of Federally financed research and development work in many fields has been accomplished by means of (1) established nonprofit institutions' engaging in contract work for the Government, (2) grants and contracts with universities, (3) operation of Government-owned facilities by nonprofit contractors, including universities, and (4) the creation by the Government, principally the defense agencies, of nonprofit corporations to conduct studies or perform technical-managerial services.

It is nonprofit organizations of the last type that have attracted considerable attention both within and without the Government. A major question associated with the continued existence of these Government-sponsored nonprofits has been the propriety of the payment of fees to these organizations and the uses made by them of those fees.

Various Government approaches in obtaining research and development

Federally financed research and development work is accomplished through various approaches. About 20 percent is performed in-house by Government personnel, whereas the bulk of the research and development work is performed by industrial firms, educational institutions, and other nonprofit institutions.

From 1962 to 1969 annual Federal obligations for research and development increased from \$10.3 billion to an estimated \$17.3 billion. The following table shows the obligations for each year and the distribution by type of performer.

Federal Obligations for Research and Development, by Type of Performer

<u>Performer</u>	<u>Estimates</u>		<u>Actual obligation</u>					
	<u>1969</u>	<u>1968</u>	<u>1967</u>	<u>1966</u>	<u>1965</u>	<u>1964</u>	<u>1963</u>	<u>1962</u>
	(000,000 omitted)							
Federal Government	\$ 3,840	\$ 3,550	\$ 3,400	\$ 3,400	\$ 3,090	\$ 2,830	\$ 2,400	\$ 2,220
Industrial firms (note a)	9,730	9,300	9,880	8,880	8,670	8,570	7,620	5,900
Federal Contract Research Centers (FCRCs) administered by industrial firms	420	400	380	360	410	490	430	420
Universities and Colleges (note a)	1,700	1,510	1,450	1,330	1,190	1,060	850	800
FCRCs administered by universities	740	710	670	640	550	540	640	560
Other nonprofit institutions (note a)	450	400	400	390	350	300	220	160
FCRCs administered by other nonprofit institutions	250	230	220	170	230	230	210	150
Other	170	130	130	130	110	110	90	80
Total	\$17,300	\$16,230	\$16,530	\$15,300	\$14,600	\$14,130	\$12,460	\$10,290

^aExcluding Federal Contract Research Centers.

Source: National Science Foundation Reports entitled "Federal Funds For Research, Development and Other Scientific Activities," Volumes XII-XVII.

Creation of DOD-sponsored nonprofit corporations

In the years following World War II, DOD brought into being a number of quasi-private, nonprofit companies to augment the in-house capabilities of the military services. The Air Force pioneered in the use of these contract organizations. According to the Air Force, it had not had sufficient time to build competence within its own organization, and Civil Service regulations made it difficult to quickly recruit staffs possessing the capabilities required.

The first of these nonprofit corporations, managed by a group of private citizens constituting a board of trustees, was The RAND Corporation. A group was established at Douglas Aircraft Company in 1946, to provide systems analysis through a Project RAND contract with the Army Air Corps. From this group evolved The RAND Corporation in 1948. However, it was not until the late 1950's and early 1960's that the nonprofit corporations created by the defense agencies expanded greatly in numbers.

The increased need for strategic analysis led to the formation in 1956 of the Institute for Defense Analyses, used by the Joint Chiefs of Staff and the Director of Defense Research and Engineering; in 1958 of Analytic Services, Inc., to provide the Air Force a capability in analyzing immediate problems; in 1961 of the Logistics Management Institute, for long range studies primarily for the Assistant Secretary of Defense for Installations and Logistics; in 1961 of the Research Analysis Corporation for the Army; and in 1962 of the Center for Naval Analyses for the Navy. All these organizations are nonprofit corporations except the Center for Naval Analyses, which is a research organization operated by a nonprofit contractor.

During this period the Air Force's need for systems engineering and technical management brought into existence another group of nonprofits. The MITRE Corporation was formed in 1958, to serve in developing electronic command and control systems; the Aerospace Corporation was formed in 1960, to provide technical direction in missile and space programs; and the System Development Corporation was spun-off from RAND in 1956, to provide computer information programming and processing.

The Johns Hopkins University Applied Physics Laboratory, established in 1942, has been used by the Navy for technical advice on missile and space programs. The Laboratory is a Government-financed laboratory, operated as a division of the University.

In recent years congressional scrutiny, as well as self-examination by Government agencies, has resulted in a halt to the numbers and the individual growth in size of DOD nonprofit organizations.

Use of nonprofits by nondefense agencies

Nonprofit institutions also work exclusively for Government agencies, such as AEC, NASA, and NSF. Also, a recent compilation of Federally funded research and development centers shows that the Office of Education of HEW

is providing financial support for 23 nonprofit centers, eight of which are administered by colleges and universities and 15 of which are established as separate organizations. The creation of The Urban Institute was recently announced. The relationship of this nonprofit corporation will be to the Department of Housing and Urban Development somewhat like that of The RAND Corporation to the Air Force.

Independent nonprofit research institutes

Also involved in the Federal contract research effort are the independent nonprofit research institutes that contract in varying degrees with Government agencies. These organizations do not depend upon either the Federal Government or a single sponsoring Government agency for revenues and fees to provide funds for support and growth, but compete with universities, sponsored nonprofits, and profit-making companies, as well as other independent nonprofits, for contracts from many Government agencies and commercial firms.

The Bell Report

The 1962 Bell Report to the President on Government contracting for research and development pointed out that the rise in Federal research and development expenditures had altered the traditional patterns of organization of private industry and the universities and had resulted in the creation of entirely new kinds of organizations.

The report noted that new arrangements had been made with universities such as the Lincoln Laboratory of the Massachusetts Institute of Technology established by contract to respond to Air Force needs, and the Jet Propulsion Laboratory, established at the California Institute of Technology¹ to conduct research for the Army and later to supply services to NASA.

The report cited other research institutions, such as Stanford Research Institute, which were established to conduct research on contract for private or public customers, but which do the major share of their business with the Federal Government. Also mentioned was the creation of analytical service organizations, typified by RAND, and of companies furnishing systems engineering and technical direction, such as Aerospace and MITRE, and the organizational arrangements used by AEC, wherein laboratories are owned by the Government but operated under contract by either industrial companies or universities. These new types of organizations and arrangements had, according to the report, raised a number of criticisms and points of concern.

¹ According to the California Institute of Technology (Caltech), the Jet Propulsion Laboratory (JPL) is a division of the Institute and therefore is not organized separately. However, unlike other Caltech divisions, JPL is housed and operated primarily in a separate Government-owned facility.

The report pointed out the inability to apply the classical distinctions between what is public and what is private and questioned whether a corporation created to provide services to Government and receiving 100 percent of its financial support from Government is a "public" or "private" agency, and whether a business corporation doing nearly 100 percent of its business with Government is engaged in free enterprise. It was the opinion of the study committee that the complex partnership between Government and private institutions should continue, but one of the concerns of the study committee was the improvement of policies and procedures for contracting with these organizations.

Concerning the arrangements for contracting with nonprofit organizations other than universities, the report stated that the practice in contracting for research and development work with these organizations was to cover all allowable costs and, in addition, to provide what is commonly called a "fee." Although it points out that the term "fee" is misleading when the reasons for paying a "fee" to a profit corporation are considered, the report stated that, nevertheless, there are two sound reasons to justify payment of a "development" or "general support" allowance to nonprofit organizations, and it advocated continuation of these payments.

One stated reason for paying a fee is to provide some degree of operational stability and flexibility to organizations that otherwise would be tightly bound to the precise limitations of cost financing of specific tasks; the allowance can be used to even out variations in the income resulting from variations in the level of contract work. The second reason is that most nonprofits must conduct some independent, self-initiated research to obtain and hold highly competent scientists and engineers. But, according to the report, the amount of the fee or allowance in each instance still must be determined by bargaining between Government and contractor, in accordance with the independent relationship that is essential to successful contracting.

The Bell Report considered facilities and equipment another important question relating to contracting with nonprofit organizations other than universities. It was the judgment of the study committee that the normal rule should be that, where facilities and equipment are required to perform research and development work desired by the Government, the Government should either provide the facilities and the equipment or cover their cost on the contract. However, two special problems were recognized with respect to nonprofit organizations.

First, the committee felt that it was generally not desirable to furnish funds through fees for the purpose of enabling a contractor to acquire major capital assets. On the other hand, the Government should not attempt to dictate what a contractor does with his fee, provided it has been established on a sound and equitable basis. The committee saw no objection to a contractor's using part of his fee for facilities for use in his self-initiated research if he should so choose.

Second, the study concluded that it was equitable, where the Government had provided facilities, funds to obtain facilities, substantial working capital, or other resources to a contractor, that the Government should, upon dissolution of the organization, be entitled to a first claim upon such

resources. This matter should be governed, insofar as possible, by the terms of the contract or, in the case of a newly established organization, should be covered in the provisions of the organization's charter.

The Bell Report was approved by the President and transmitted to the heads of Departments and agencies for their guidance and action. The President noted that the report pointed the way to a number of improvements in the conduct of the Government's research and development program, which could be undertaken by the executive branch under existing authority.

Air Force policy statement on fees to nonprofits

Before issuance of the Bell Report, the Air Force established basic policy guidelines concerning its relations with Air Force sponsored non-profit corporations. In September 1961 the Air Force issued policies governing its relations with Aerospace, Analytic Services, MITRE, RAND and System Development Corporation. (System Development Corporation was removed by policy letter in September 1964). Generally, the policy statement provided, among other things, for payment to the corporations of fees which took into consideration the corporations' special status and which were tailored to meet reasonable needs.

The policy statement pointed out that these organizations had a close and continuing relationship with the Air Force, unlike that of other organizations. Consequently, it was stated that the business aspects of the affairs of these nonprofits must be open to Air Force scrutiny, "much as an actual Air Force operation." Such accountability, according to the policy statement, "is not inconsistent with the freedom of thought and independence on technical matters" sought from such organizations.

The policy statement took the position that these organizations have legitimate needs that can be met only through a fee. So that their stability would be ensured, fees were deemed as the proper source of assistance for conducting independent research programs within reasonable bounds and as a reserve for limited working capital requirements. The Air Force was to provide working capital, in the form of an advance payment pool, and facilities in which to operate. In the event of dissolution of a corporation the assets of the corporation were to revert to the Government.

This policy statement was issued unilaterally by the Air Force and met varying degrees of acceptance by the nonprofit corporations affected.

Congressional hearings on the Aerospace Corporation

In May 1965 the Subcommittee for Special Investigations of the House Committee on Armed Services held hearings on the Aerospace Corporation. The Subcommittee reported that Aerospace had rejected the Air Force policy of a fee based on need and had insisted that its fee be determined on a worth-of-task basis as provided by ASPR for commercial firms. Also, the Subcommittee found that Aerospace had consistently refused to disclose its

fee expenditures¹ and that fees based on presumed need had been awarded by the Air Force. Thus, fees were provided for purposes for which they were never used and were used for purposes never intended by the Air Force. The Subcommittee recommended that steps be taken to eliminate the use of a fee for Aerospace.

The Subcommittee considered the limited number of reasons for which a nonprofit corporation might need fees--independent research, operating capital, acquisition of facilities and a margin to cover honest error. In regard to facilities, the Subcommittee believed that the Bell Report and the Air Force policy statement of September 1961 should be the Government policy in all cases, and that nonprofits, such as Aerospace, should be provided with needed facilities. Recommendation was made that title to facilities and real property owned by Aerospace be vested in the Government of the United States.

The Subcommittee saw no reason why all independent research could not be provided for under contract reimbursement. The Subcommittee felt that there was no real necessity for a fee and that Aerospace's needs could be met through a combination of reimbursement and an advance payment pool. The Subcommittee believed that, in the event that, contrary to its recommendation, the fee was not abolished, at a very minimum Aerospace should be required to make regular, complete, and detailed disclosure to the Air Force of its fee expenditures.

The Subcommittee also recommended that the management concept of using outside organizations to help carry out the basic planning and subsequent managing of military missile/space programs be reappraised.

Air Force Ad Hoc Group study

The Air Force responded by directing a special eight-man committee composed of members of the Air Force Systems Command Board of Visitors to review the roles of three Air Force-sponsored corporations, two of which (MITRE and Aerospace) are included in our survey. This Ad Hoc Group of prominent citizens examined the requirements for the services of these specialized organizations, the environment in which the organizations operate, and the problems associated with their use. The Group also made extensive interviews of key management officials in the Government, industry, and universities.

A report by the Group, dated December 1, 1965, stated that the continuing use of MITRE and Aerospace was justified but that it was recognized that problems had arisen because of the unusual relationship of these organizations with the Air Force.

In regard to fees, the Ad Hoc Group report stated that a fee should be related to legitimate requirements that cannot be met within the contract. The report stated also that there was no need for MITRE and

¹ Aerospace Corporation informed us that it started disclosing its fee expenditures in December 1960.

Aerospace to accumulate capital that would eventually make them financially independent.

According to the report the fee should encompass, at a minimum, two items--small amounts of legitimate normal business expenses that cannot be reimbursed as costs under ASPR and sufficient funds to enable the corporations to meet termination liabilities. The report stated that no fee is required if funds accumulated for termination liability are sufficient to meet requirements and are invested with a return equal to or exceeding reasonable operating expenses that are not reimbursable. The report stated further that the corporations have no reason to accumulate assets except for funds required to meet those termination liabilities not covered by their contracts.

The Ad Hoc Group reported that, under Air Force policy, the facility needs of both Aerospace and MITRE had been recognized through "need" fee negotiations and the Air Force had financed the facilities without taking title, but, if the facilities were to represent convertible assets to be applied to termination obligations, they were probably in excess of corporate needs. The Group concluded that acceptance and appreciation of the vital roles of these corporations was the only key to assuring their stability and that other symbols of stability, such as buildings and accumulated assets, were at best a facade.

The Group felt that the Air Force must assume responsibility for reasonable stability since these organizations are dependent on the Air Force. This does not imply that the levels of funding may not vary, depending on the Air Force's requirement for services, but rather that the Air Force, in working with the corporate management, should see that funding variations are anticipated and planned in an orderly manner.

The Ad Hoc Group recommended that the Air Force should either obtain title to the facilities of Aerospace and MITRE or include in the contracts a clause which would provide that the corporations could not mortgage, lease, sell, or purchase any real property without the written consent of the Air Force.

In regard to independent research, the Ad Hoc Group report stated that all the corporations' research programs should be related to the fields of interest of their customers so that they could be paid for directly or indirectly under the contracts.

ASPR revision applicable
to nonprofits

On April 14, 1966, commenting on the Ad Hoc Group's report, the Secretary of the Air Force noted that the Group's recommendations on asset accumulation and the financing of research had derived from the basic recommendation of working toward a minimum-fee position. The Secretary stated that the Air Force policy of negotiating on the basis of the "needs" formula had not produced the lower fee levels envisioned and had made the Air Force

rather than the Boards of Trustees the arbiter of how the fee was to be allocated among corporate demands. It was his desire to try out the weighted guidelines of ASPR as a general framework for fee negotiations.

On June 15, 1966, an ASPR Subcommittee proposed a revision to ASPR--to apply the weighted guidelines method of fee determination to all contractors, appropriately adjusted to yield rational fee objectives for nonprofit organizations, sponsored and unsponsored. The revision stipulated a special negative factor for all nonprofit organizations in recognition of the exemption of nonprofits from Federal income taxation. In addition, the revision provided for a reduction in the fee for sponsored nonprofit organizations, in view of the continuing financial support provided by the sponsoring department or agency. The proposal became DOD policy with the issuance of Defense Procurement Circular No. 50 on December 30, 1966. The provisions were incorporated into ASPR 3-808.4(f) on June 1, 1967.

Defense Science Board studies

On October 27, 1966, DOD received a report from a task force appointed by the Defense Science Board Chairman to study the Federal Contract Research Centers. The task force reviewed 6 research centers, and the conclusion from the study was that a management fee was the only proven method of giving these organizations a desirable measure of independence and managerial flexibility. The report did not elaborate on what the task force considered necessary for achievement of independence or the method for determining the amount of fees needed to reach these goals.

The task force, in a memorandum approved by the Defense Science Board on January 10, 1968, reiterated its position that a management fee is the only proven method of giving the Federal Contract Research Centers a desirable measure of independence and managerial flexibility.

The task force stated that appropriate uses of fees include:

1. The accumulation of reasonable reserves, to assure stability in the event of major fluctuations in the level of research support or sudden shifts in programs calling for changes in personnel.
2. The need for funds to cover disallowable but justifiable costs, and to make managerial decisions without prior approval by auditing officials unfamiliar with administrative practices in modern research laboratories.
3. For certain research projects which are clearly in the long-range public interest, but possibly outside the current mission definition of the principal sponsor.

The task force found it difficult to establish a recommended level for the total amount of fees or for a balance among the uses to which the fees are committed. They felt that the fees should be large enough to make a significant and meaningful impact on the style and culture of the laboratory, and be typically smaller than the net fees (after taxes) to profit-making corporations for defense research and development activities. As to

a balance among various uses, the task force concluded that the policies should be left largely to the discretion of the boards of trustees and reviewed at a policy level in the course of periodic reviews by the client-agency.

Federal Procurement Regulations

Other Government agencies, in awarding contracts to nonprofit organizations for research and development work, are subject to the Federal Procurement Regulations (FPR) issued by the General Services Administration. FPR identifies certain factors for contracting officers to consider in negotiating fees, but does not specify weight ranges for assignment to the various factors. FPR does not provide special modifications applicable to the determination of fees allowed to nonprofit organizations.

* * * * *

The principal officials of DOD, AEC, and NASA responsible for the administration of activities included in this survey are shown in appendix II

FINDINGS AND RECOMMENDATIONS

SIGNIFICANT VARIANCES IN AGENCY POLICIES ON ALLOWING FEES TO NONPROFITS

As shown below, the fees paid to nonprofit organizations and the bases used for determining such fees vary significantly among Government agencies.

Special DOD policies have evolved

When DOD undertook to sponsor nonprofit organizations, policy statements or specific instructions were not promulgated to guide procuring agencies in negotiating contracts with nonprofit organizations. Government procurement officials and officials of the nonprofit organizations utilized the ASPR provisions, which until recently, made no specific provision for negotiating contracts with nonprofit organizations for research and development work. As a result, there was a lack of uniformity in the contractual arrangements entered into, including the payment of fees.

In December 1966, DOD adopted a weighted guideline approach for determining fees to be included in contracts with both sponsored and nonsponsored nonprofit organizations. This approach included a special provision for adjustment in rate, applicable to sponsored nonprofit organizations to recognize the continuing financial support provided by the sponsoring Department or agency.

Air Force practices varied

In September 1961 the Secretary of the Air Force issued a policy statement applicable to the Air Force-sponsored nonprofit corporations, including The RAND Corporation, The MITRE Corporation and the Aerospace Corporation. Broadly, the policy statement provided for payment of fees which took into consideration the special status of these corporations and which were tailored to meet the corporations' reasonable needs for independent research and limited working capital and facilities.

At the Air Force-sponsored corporations included in our survey, we found that this policy statement was not applied uniformly. Fees were negotiated with Aerospace and MITRE on a need basis, from 1962 through 1966. However, Aerospace favored the "worth of task" basis and refused to provide information as to its needs. As a result, the Air Force made its own evaluation of Aerospace's "presumed needs" in arriving at the amount of the fees.

We were informed that, from 1961 until 1966, the Air Force negotiated fees with RAND on a needs basis. RAND, however, informed us that from its standpoint the fees had been arrived at on the basis of worth-of-task.

Army, Navy, and DOD components generally used "need" basis

Before weighted guidelines were adopted the nonprofits sponsored by departments or agencies of DOD, other than the Air Force, apparently received fees based on their stated needs. However, at the organizations

included in our survey, we generally could find no statement or documentation that set forth the precise basis on which fees had been negotiated.

The Institute for Defense Analyses (IDA), in its contracts with various components of DOD, has justified its request for fees as being needed to maintain a productive environment and assure corporate independence and stability.

The Logistic Management Institute's (LMI) basic contract is with the Office of the Secretary of Defense. LMI has requested fees on the basis of need for funds to cover costs not reimbursable as contract costs and for working capital to provide operational stability and flexibility.

Fees negotiated by the Army with Research Analysis Corporation (RAC) and by the Navy with Johns Hopkins University for operation of the Applied Physics Laboratory (APL) apparently were based on the needs established by the individual organizations and negotiated with the respective services. RAC's fees have been used principally to accumulate working capital; APL's fees have been utilized primarily for the acquisition of facilities and investments.

Weighted guidelines for fees for nonprofits

In April 1966 the Secretary of the Air Force noted that the needs basis for negotiating fees with the Air Force-sponsored nonprofit corporations had not produced the low fee levels that he had hoped for and had made the Air Force rather than the Boards of Trustees the arbiter of how the fee was to be allocated among corporate demands. The Secretary, therefore, instructed that the weighted guidelines of ASPR be tried as a general framework for fee negotiations.

In June 1966 an ASPR Subcommittee proposed the application of weighted guidelines, suitably modified, for determination of fees to sponsored and unsponsored nonprofit organizations. The proposal became DOD policy on December 30, 1966, the first specific guidance given to DOD procurement agencies in negotiating with nonprofit organizations.

Contractor-operated Government facilities

The Government-sponsored institutions included in our survey that were non-DOD affiliated organizations included the Brookhaven National Laboratory (BNL), operated for AEC by Associated Universities, Inc. (AUI), and the Jet Propulsion Laboratory (JPL), operated for NASA by Caltech.

AUI is a nonprofit corporation chartered under State education law and sponsored by nine universities. AEC contracts with AUI for operation of BNL, a Government-owned laboratory. A fixed fee is negotiated to provide funds necessary to meet the direct corporate needs of AUI. The contracts do not provide for payment of a rate of fee, and the fee is not related to operating costs of BNL. On the basis of the amounts of operating costs, however, fees have averaged about 1 percent.

NASA's contracts with Caltech, a nonprofit educational institution, have, beginning with fiscal year 1961, contained a provision for a fixed

amount of fee for operating JPL. Also, for fiscal years 1961 through 1964, Caltech received a fixed amount for estimated allowable overhead cost. Beginning with fiscal year 1965, allocable indirect costs have been reimbursed through the use of a postdetermined negotiated overhead rate. Fees have averaged less than 1 percent of estimated contract costs. This rate is much lower than the 4- to 6-percent rates, which generally have been paid to DOD-sponsored nonprofit organizations that, in varying degrees, have acquired their own facilities, their own working capital and have conducted independent research. All of JPL's facilities are Government-owned.

Included also in our survey were three DOD facilities operated by nonprofit contractors. The contractual arrangements of each differed from those entered into by NASA and AEC.

At the time of our survey, the Navy was contracting with Franklin Institute, a private nonprofit organization, for operation of the Center for Naval Analyses (CNA). Until 1967, contract estimates called for Franklin to receive fees of 6 percent. Franklin provided CNA's working capital. CNA operates in leased facilities, utilizing Government-furnished equipment. Franklin held no interest in CNA's assets. At July 31, 1967, the contract was terminated and operation of CNA was assumed by the University of Rochester.

Lincoln Laboratory is operated by the Massachusetts Institute of Technology (MIT) under a cost reimbursable contract with the Air Force. MIT receives no fee. Facilities and operating capital are provided by the Government; allocable MIT overhead expenses are allowable as indirect contract costs.

The Army has contracted with George Washington University (GWU) for operation of the Human Resources Research Office (HumRRO) under cost-reimbursement contracts with no fee.¹ The current operating contract provides GWU with a fixed amount in lieu of overhead. HumRRO occupies leased facilities; the Government has provided the equipment required by HumRRO.

Contracts with educational institutions

In contracts awarded to educational institutions for the operation of Government facilities, procurement regulations were not uniformly applied in determining whether fees were allowable.

In contracting with MIT and GWU for operation of Lincoln Laboratory and HumRRO,¹ respectively, contracting officers have applied the cost principles of ASPR relating to contracts with educational institutions and have provided no payment for a profit or a fee. However, the Navy has negotiated cost-plus-a-fixed-fee contracts with Johns Hopkins University for operation of the Applied Physics Laboratory. As noted above, NASA pays a management fee to an educational institution for operation of JPL, and AEC pays a fee to a nonprofit corporation chartered under a State educational law.

¹See page 34 for recent changes in HumRRO's contractual arrangements.

National Science Foundation
fee policy

NSF recently expressed the following philosophy concerning the management fees paid to the nonprofit corporations that operate its national research centers:¹

"The research center contractors are not commercial organizations with the risk and profit requirements of a private company. Therefore, they do not require fees for such items as taxes, payment of dividends, and the like. The research center contractors are special types of nonprofit corporations utilized by the Foundation to construct, operate and maintain unique kinds of national research facilities.

"In keeping with the foregoing, the fixed fees paid the research center contractors should be determined on a need basis to cover such items as corporate expenses and a reasonable corporate reserve to give the contractors operational stability and flexibility."

Contracts with private
nonprofit institutions

We included in our survey of nonprofit organizations three independent institutes that contract extensively with the Government but are not under the sponsorship of a single Government agency--that is they are not primarily funded by inclusion as a line item in a governmental agency budget. We surveyed these institutes for the purpose of contrasting the needs of these organizations for fees with those of the Government-sponsored nonprofits, recognizing that the independent institutes were established with private funds, often compete for Government contracts as opposed to Government-sponsored nonprofits which operate under sole-source contracts, furnish their own working capital, and accumulate funds for financial stability, acquisition of facilities, and expansion of operations.

The Woods Hole Oceanographic Institution is a private, nonprofit eleemosynary organization, established in 1930 as a result of a recommendation by the National Academy of Sciences. A \$3 million grant from the Rockefeller Foundation provided initial funds. During the 3-year period ended December 31, 1966, Woods Hole performed 99 percent of its research for the Government; the remainder was devoted to Institution-supported research. In addition to fees from Government contracts, Woods Hole receives endowment fund income, donations, and membership fees.

Woods Hole received contracts and grants from 12 Federal agencies. Ten agencies, both defense and civil, awarded contracts allowing fees up to 5 percent of the estimated costs of the contract. NSF and the National Institutes of Health (NIH) awarded grants that did not include a fee.

¹GAO report to the Congress, B-133338, September 1967.

Furthermore, since 1965 these two agencies have required Woods Hole to share the cost of research projects sponsored by them.

Woods Hole officials advised us that it is their policy to request a fee if there is no statutory prohibition and the agency is agreeable. After funding costs not recoverable under Government contracts, Woods Hole uses most of its remaining fees for plant expansion, independent research, education of oceanographers, and scientific publications.

Stanford Research Institute (SRI) is a nonendowed, nonprofit organization, engaged in basic and applied research for industry, Government, and various nonprofit organizations. Founded in 1946 by business and industrial leaders in cooperation with the Trustees of Stanford University, SRI in 1966 expended about 80 percent of its direct labor on Government contracts, most of which were of a cost-plus-a-fixed-fee type. SRI's fee policy is to charge fees consistent with regulations and practices of the negotiating agency. SRI's sources of revenue also include Government grants, which, according to SRI, are performed at less than full recovery.

According to SRI, fees from Government contracts constituted about 60 percent of SRI's total gross fees for 1964. We estimated that such fees amounted to 78 percent for 1965 and 64 percent for 1966. Rates of fees on Government prime contracts ranged substantially in 1966, averaging about 6.67 percent of estimated cost. We found that SRI uses its net fees primarily to further its growth and development.

The Franklin Institute of the State of Pennsylvania for the Promotion of the Mechanic Arts is a private, nonprofit organization founded in 1824. In support of its two major activities of science education and research, Franklin operates a science teaching museum, conducts seminars and workshops, publishes a scientific journal, and operates research laboratories. Its research laboratories were formally organized in 1946. About 80 percent of Franklin's research activity is performed for the Government under cost-plus-a-fixed-fee contracts. Franklin has generally attempted to obtain a 6-percent fee from Government agencies. Over the 3-1/2-year period ended June 30, 1967, negotiated fees have averaged about 5.6 percent.

Fees received by Franklin on Government contracts are commingled in the general operating fund with receipts from other activities, donations, and investment income and are used for the operation of the activities mentioned above.

FEES USED BY GOVERNMENT-SPONSORED
NONPROFITS FOR VARIOUS PURPOSES

The Bell Report advocated the payment of fees to nonprofit organizations for the following reasons: (1) to provide some degree of operational stability and flexibility to organizations otherwise bound to the precise limitations of cost financing of specific tasks, the allowance to be used to even out the variations in income resulting from variations in the level of contract work and (2) to conduct some independent, self-initiated research in order to obtain and hold highly competent scientists and engineers.

Our survey showed that, depending on the financing arrangements agreed to by the sponsoring agency and the nonprofit and the amount of fees that the nonprofit had been able to accumulate during its existence, fees have been used by management for various financial aspects of operations.

Fee accumulations have been used for working capital in day-to-day operations, for reserves to finance operations during a temporary reduction in contract work or delay in contract renewal, and for establishing funds to ensure continuity at such times as the services of the organizations may no longer be required by their principal sponsor. Fees were also used for expenses that were not reimbursed under Government contracts. In some instances, the organizations had not met the cash reserve goals set by them, because they had used fees for the acquisition of capital assets.

Our survey also showed that many nonprofits did not use fees to an appreciable degree to conduct independent research.

Fees used in some instances
to provide working capital

There were 12 nonprofit organizations included in our survey that are considered to be Government-sponsored; that is, one or two Departments or agencies have assumed responsibility for the substantial portion of the financial support of these organizations. (See app. I.) We found that the requirements for working capital during periods of normal operation were being met in different ways for these organizations.

Three of the organizations had received Government advances in the past, but were at the time of our review using their own funds, accumulated primarily out of fees. Two were using a combination of Government advances and fee accumulations. Five were being financed primarily by the Government either through the use of advance payments or letters-of-credit arrangements. In two cases, operating capital was being furnished entirely by the contractor-operator and Government funds were provided only on a reimbursement basis.

We found that Aerospace had retained funds of more than \$2 million dollars, primarily out of fees, and no longer required advance payments from the Government for working capital.

Although RAND initially received a grant of \$1 million from The Ford Foundation, most of its funds have since been obtained through Government

contracts, including fees and reimbursed depreciation and use charges. RAND's accumulated working capital at December 31, 1966, exceeded \$3 million, and RAND has had no advances from the Government.

When Research Analysis Corporation was organized in 1961, the Army provided it with a \$1 million advance fund. RAC repaid the advance in 1965, and at June 30, 1967, had accumulated, largely from fee income, working capital in excess of \$1.7 million.

On the other hand, five of the organizations were being financed primarily by the Government, either through advance payments or letters of credit. We found that these organizations had experienced no financial difficulties in operating under one or the other of these arrangements.

The Assistant Director for Administration at Lincoln Laboratory, which utilizes funds from an advance payment pool established by DOD for the Massachusetts Institute of Technology, informed us that funding arrangements had been adequate. Officials of the California Institute of Technology advised us that they had not experienced any difficulty in obtaining sufficient working capital for operating the Jet Propulsion Laboratory. NASA provides working capital to Caltech through letters of credit. Associated Universities, Inc. (AUI) has been supplied working capital for the Brookhaven National Laboratory by AEC through letters of credit, and AUI reserves are not used.

The Johns Hopkins University Applied Physics Laboratory's (APL) working capital requirements have been primarily met by an advance payment arrangement with the Navy, and an advance payment pool provided by the Air Force has been the primary source of MITRE's working capital. However, APL and MITRE have made limited use of accumulated reserves for working capital. The need for cash reserves to finance operations during periods when the Government has not contractually assumed financing responsibility, such as during a delay in contract renewal, is discussed in the following section of this report.

Treasury Department Circular No. 1075, revised February 13, 1967, states that cash advances to organizations outside the Federal Government constitute a significant portion of the Federal budget. For example, letter-of-credit advances during fiscal year 1968 exceeded \$18 billion. Because of the effect that the timing of advance payments has on the public debt and financing costs, the circular stipulates that everything possible should be done to preclude withdrawals from the Treasury sooner than necessary to finance the operations of the recipients of advances. According to the circular, advances should approximate the amount of daily needs for large organizations and should not exceed 1 month's needs for relatively small operations.

The Treasury Department policy states that, whenever these objectives cannot be met by advances, the letter-of-credit arrangement should be considered.

We believe that making advance payments or letters-of-credit arrangements offers advantages to the Government over allowing the nonprofit organization to accumulate working capital from fees. When either of the

first two methods are used, funds are tied up over shorter periods of time the result being lower financing costs, and, in addition, the Government retains greater control over the use of these funds, since contracting officers authorize withdrawals of funds.

Some of the organizations included in our survey interpreted Circular No. 1075 as favoring the elimination of advance payments and, therefore, indirectly advocating the accumulation of fees for working capital. The Treasury Department policy stated in the circular is that cash advances shall be limited to the minimum amounts possible, and be timed to meet only the actual cash requirements of the recipient to carry out an approved program or project. Therefore, making such short-term, minimum advances seems to be a more economical method of financing than either allowing the organization to accumulate fees, which results in the Treasury Department's relinquishing the funds on a permanent basis, or allowing the organization to borrow the funds at commercial rates.

Fee accumulations used at times of
delay in renewal of Government contracts or
temporary reductions in contract effort

We found that limited amounts of fee accumulations have been used by some of the nonprofits to maintain normal operating levels during periods of delay in contract renewal. The use of letter contracts has kept the needs in some cases to a minimum. Fees have also been used to accumulate reserves for use in case of reductions in the level of contract support.

At The MITRE Corporation, we found that, even though contract renewal was not doubtful, there were contract renewal delays during which funds were not made available by Federal agencies. For example, MITRE experienced Air Force contract renewal lags of 23, 20, and 7 days in 1964, 1965 and 1966, respectively, and had to use its own funds to finance current operations. MITRE for the most part has invested its fee reserve money in Treasury and commercial bills. On the occasions when MITRE has needed funds to finance operations, it has used employee vacation reserve funds and, to some extent, fee reserves.

At the Aerospace Corporation, contract renewal delays are covered by letter contracts. The letter contracts provide for the same reimbursement cost features as the definitized contract, and allowable contract costs are therefore reimbursable. However, no provisions are made under the letter contracts for partial fee payments. Aerospace officials informed us that operating costs not reimbursable under the letter contracts must be funded from Aerospace working capital previously accumulated from fees and accruals.

According to officials at The RAND Corporation, because of periodic delays in contract renewals, RAND's normal cash balances have not been adequate to meet operating expenses during these delays. As a result, RAND has had to borrow capital to meet its current liabilities during these periods of delay. For example, RAND borrowed \$725,000 and \$300,000, respectively, during the contract renewal periods in 1965 and 1966. Our examination of the Project RAND contract renewal during 1966 showed that

A letter contract having an effective date of September 1, 1966, was not signed until November 17, 1966.

The Research Analysis Corporation has requested fees to provide, among other things, for periods of interruption in Government contracts. We noted during our examination that, on one occasion when negotiations for the Army contract had been prolonged and thus Army funding had been delayed, RAC borrowed funds necessary for operations rather than utilize its accumulated cash reserves held in the form of short-term investments. We were informed by RAC that this was done because it was cheaper to borrow than to cash in the short-term investments, and that borrowing had been possible only because of the existence of accumulated reserves.

There have been a few occasions when contract renewal negotiations were not completed in time to keep Government funding procedures operative in financing the operations of the DOD-sponsored nonprofit organizations. The use of letter contracts in some instances has kept the need for reserve funds during renewal delays to a minimum. We believe that a more determined effort on the part of the sponsoring agency working with the nonprofit management to plan funding and effect contract negotiation in an orderly and timely manner, combined with the use of letter contracts when necessary, could reduce the need for reserves even further.

We recognize, however, that there may be short periods of time during which the Government is unable to provide financing to enable the nonprofit to continue a stable operation.¹ We therefore believe that fees should be available to the extent necessary to meet reasonable needs for maintaining the organization for a short period.

Contractual provisions for termination
liabilities reduce need for reserves

In our opinion, the DOD-sponsored nonprofit organizations included in our survey would not have to accumulate fees to cover liabilities arising from contract termination. We saw no indication that the Government planned to dispense with the services of these organizations in the near future. Also, we found that the agencies could mitigate the impact of contract termination by contractual provisions.

The Report of the Air Force Systems Command Board of Visitors' Ad Hoc Group, dated December 1, 1965, stated that the Air Force had a definite, continuing need for the services of MITRE and Aerospace. The report stated also that the Air Force must assume responsibility for reasonable stability of these organizations by working with the corporate management to see that funding variations are anticipated and planned in an orderly manner. The report stated further, in regard to termination protection, that fees should be paid to these organizations only if available assets were not sufficient to meet termination liabilities not covered by contracts.

¹Several of the nonprofits (Aerospace, IDA, MITRE) informed us that they have experienced unexpected reductions in level of program effort in one or more recent years.

We found that MITRE had been protected against all termination liabilities under its Government contracts, which contained specific clauses covering termination. MITRE had been further protected by inclusion of a clause in its Air Force contracts that provided that the Air Force would reimburse MITRE for all reasonable and allocable personnel severance and other related windup costs if the Air Force contract with MITRE was not renewed. MITRE's contract with the Air Force also provided that MITRE would be indemnified from liability on its bank loans in the event of contract termination or nonrenewal.¹

In responding to our draft report, Aerospace questioned whether the Air Force could cover all costs associated with termination, especially if termination occurred in the latter part of the contract period or was associated with nonrenewal of the contract. In our opinion, however, the contracts with Aerospace and other Government-sponsored nonprofit organizations could include provisions similar to those in the MITRE contract to cover termination costs and thus reduce the need for fee accumulations for this purpose.

¹MITRE has informed us that the bank loans liability indemnification clause in its Air Force contract was deleted in September 1967, subsequent to the loans' being fully paid.

Fees being accumulated to permit diversification and continuity of operations

We examined into the reserves being accumulated by the various DOD-sponsored nonprofits receiving fees. Some of the organizations had instituted programs of setting up reserves to ensure stability in the event of reductions in the level of contract support. The stated purposes of some of these reserves seem to indicate that they are intended not so much as a cushion against temporary fluctuations in the financial support of the sponsor agency, but rather as a fund with which to seek other clients at such time as the nonprofits' services may no longer be required by their sponsor.

The Bell Report recognized the issue of whether an organization that has been established to provide services to a Government agency should be permitted to seek contracts with other Government agencies or non-Government customers. The report stated that there was not a clear consensus among Government officials and officers of nonprofit organizations on the question. The Government officials participating in the study had considered the question far enough to have these tentative views:

1. In the case of organizations in the area of operations and research, such as The Rand Corporation, the principal advantages that they have to offer are the detached quality and objectivity of their work. Too close control by any Government agency may tend to limit objectivity. Organizations of this kind should not be discouraged from dealing with a variety of clients, both in and out of the Government.
2. A number of the organizations established to provide systems engineering and technical direction, such as Aerospace Corporation, were, at the time, of value principally because of their acting as agents of a single client. The report stated that, as programs change and new requirements arise, it might be possible for such organizations also to achieve a fully independent financial basis, resting on multiple clients, but this seemed (in 1962) to be a later rather than earlier development.

The Bell Report supports the payment of fees to be used to even out income variations resulting from variations in the level of contract work. The report does not indicate an intention to support the payment of fees to the extent sufficient to create a reserve to finance a transition by the nonprofit to other fields of endeavor or to enable it to compete in the private sector for non-Government business.

The Air Force Systems Command Board of Visitors' Ad Hoc Group examined the position of the sponsored nonprofit corporations providing systems engineering and technical direction capabilities to the Air Force. The Group found that, as special, sponsored organizations, the nonprofits' establishment for a specific purpose was encouraged by the Government and that, in order that satisfaction of that purpose be ensured, in practice nonprofits should remain contractually and financially dependent on their

sponsors. The Group found it inadvisable to allow the corporations to accumulate assets which could ultimately provide for complete independence.

Some of the DOD-sponsored nonprofits included in our survey appear to be accumulating fees to enable diversification and to ensure continuity of operation in the event of nonrenewal of contracts by the sponsoring agencies.

The RAND Corporation

The purpose of the RAND Corporation is to further and promote scientific, educational, and charitable purposes for the public welfare and national security. A RAND official has stated that, to fulfill its charter, RAND will undoubtedly engage in a wider range of work, including more of a nondefense nature. RAND officials believe that fees are needed, among other purposes, to establish and maintain a continuity fund.

In 1951 RAND's Board of Trustees recommended that a continuity reserve fund be built up by setting aside each year one third of RAND's net income until a reserve approximating 25 percent of the annual rate of effort was established. We were advised that such a fund would be used at times when RAND might experience a sharp reduction in its level of effort by reason of reduction or termination of its Government contracts. RAND believes that only by having such a continuity fund would it be able to retain a small cadre of scientific skills during the period that it would take for RAND to secure other sponsors.

We were informed, however, that RAND's building construction and certain of its RAND-sponsored projects had precluded establishing such a continuity fund. According to RAND, had this fund been established, it would have grown to slightly in excess of \$5 million as of mid-1967.

Upon the formation of RAND, the Air Force did not furnish buildings for RAND to operate in. RAND received a \$1 million grant from The Ford Foundation which enabled it to obtain commercial financing and construct its own facility. For this reason, RAND has not given the Government rights to its assets upon its dissolution, although the principal sources of funds used by RAND to acquire property and repay long-term loans relating to property acquisition have been fees and building-use charges and depreciation expense reimbursed under Government contracts.

The Aerospace Corporation

Aerospace's Articles of Incorporation state that Aerospace's purpose is to engage in, assist, and support scientific activities of the United States Government.

During fiscal year 1964 Air Force and Aerospace officials discussed the financial goals that would permit Aerospace to achieve the objectives of financial independence and stability. On March 3, 1964, the Secretary of the Air Force accepted the financial goals of Aerospace, which included working capital accumulation of \$4.5 million by the end of fiscal year 1967 and the overall "stability" goal of \$12.5 million in Aerospace cumulative

funds by fiscal year 1969. The \$12.5 million represents approximately 4 months' operating cost at an operational level of \$75 million a year.

Aerospace still performs almost all its effort for the Air Force. Aerospace's contract provides that the Government will receive any remaining assets upon Aerospace's dissolution.

Logistics Management Institute (LMI)

LMI's Certificate of Incorporation provides that LMI may perform services for any Government unit as well as any nonprofit corporation, but to date LMI has contracted exclusively with DOD. In late 1965 the LMI Trustees instituted a policy aimed at accumulating through fees an increased amount of working capital to provide a reserve for contingencies and to permit LMI to continue operation should DOD discontinue its support.

According to LMI estimates it will take a period of 3 to 4 months following discontinuance of the DOD contract to determine whether other governmental units that previously asked for LMI assistance still have a need for LMI's services. Its estimated working capital requirement would be about \$70,000 a month for the determination period, for a total requirement of about \$250,000. LMI has estimated that this level will be achieved by the end of fiscal year 1969.

LMI does not own any real property. Its charter provides that assets provided directly or indirectly by the Government shall, upon dissolution of LMI, be tendered to the Government.

Applied Physics Laboratory (APL)

One of APL's stated purposes for fees is the establishment of the APL Stabilization and Contingency Fund. The first objective of the Fund is to provide an environment of stability and permanence in an atmosphere conducive to creative thinking and sound engineering. The other objective is "to provide a measure of protection in the form of real and liquid assets to ensure the staff of a reasonable continuity or orderly transition in the event of a sudden or unforeseen change of policy on the part of the Government."

A formula has been devised through agreement between APL and the Navy to set a ceiling on accumulations of liquid assets in the APL Stabilization and Contingency Fund. The formula is based on routine operating costs for a 4-month period. APL calculated 4 months' operating costs at June 30, 1967 to be \$10,475,402. Liquid funds, represented by the market value of investments and operational capital as shown by the balance sheet, totaled \$6,998,257 on June 30, 1967. This left \$3,477,145 for APL to accumulate before reaching the fund ceiling.

The University has stated that, "*** when liquid funds in the APL Stabilization and Contingency Fund equal an amount as from time to time may represent the Laboratory's routine operating cost for a period of four months, the rate of fee payable under the above contract [Navy] may be appropriately adjusted." However, APL has withdrawn funds to finance the

acquisition of land and buildings. Consequently, although APL has recognized that funds should be accumulated for stabilization and contingencies, the use of such funds for facilities, in effect, defeats that purpose.

The Navy contract with APL does not contain a clause covering the disposition of assets in the event of dissolution of APL. The University policy in this regard is that any material and financial assets remaining after the discharge of obligations will be held in a special fund to be utilized or disposed of for such purposes as may be deemed appropriate and satisfactory by representatives of the Navy and the University.

Research Analysis Corporation (RAC)

In addition to serving its principal client--the Army--RAC has undertaken a diversified program of independent research and studies for the Advanced Research Projects Agency of the Office of the Secretary of Defense, defense agencies, and nondefense sectors of the Government that demand the type of skills that RAC has developed.

RAC officials consider that RAC requires fees, to accumulate a reserve for corporate growth, development, and stability. RAC has not acquired real property as a stabilization factor, but has accumulated working capital in excess of \$1.7 million, of which about \$1.6 million is from fee income. RAC's monthly reimbursable costs amount to about \$1 million.

Human Resources Research Office (HumRRO)

Since its inception in 1951, HumRRO has been operated by the George Washington University (GWU) under sole sponsorship of the Army. On July 1, 1967, a modification to the Army contract with GWU provided for multi-sponsorship of HumRRO and made provision for the sharing of indirect costs among sponsors. On the same date HumRRO entered into a 5-year research contract with the Post Office Department. Although the Army will continue to be the principal sponsor of HumRRO work, HumRRO, under its Diversification Program, is seeking to perform work for other sponsors, both within and without the Government.

HumRRO has operated under cost-reimbursement-type contracts with no fee. GWU currently receives an annually fixed amount to cover overhead and indirect costs of the University. All of HumRRO's capital assets have been leased or Government-furnished.

In anticipation of the diversification of HumRRO work, GWU requested that, in accordance with the provisions of ASPR 4-116.4, title to all accountable Government property presently in the possession of HumRRO be transferred to the University for the benefit of HumRRO. On June 27, 1967, the contracting officer gave his approval. We were informed that the acquisition value of the property transferred was approximately \$500,000 and that this property has been acquired since HumRRO's inception in 1951. The transfer was brought about largely in order that the segregation of property and the keeping of separate inventory records, required under HumRRO's multisponsorship program, would be avoided. This is one of the reasons stated in ASPR 4-116.4 for transferring Government-owned equipment to non-profit educational or research institutions.

In HumRRO's proposal for allocation of costs under multisponsorship of HumRRO research, a management fee of 6 percent was proposed. The fee was to be determined on the basis of need for funds for independent research, acquisition of facilities, and operational flexibility. However, the Army did not want to give an educational institution a fee. Instead of a fee, HumRRO receives an amount approximating 1 percent of estimated costs on its Army and Post Office contracts for a HumRRO Director's Fund.

The Director's Fund is to be used for operational flexibility and minor capital facilities, the type of expenditures which, because of the multiple sponsorship arrangement, can no longer be identified with a specific contract or a particular sponsor. The fund is to be administered by the Director of HumRRO at his sole discretion and is to provide him with "a degree of operational flexibility which otherwise would be difficult to achieve without direct Government involvement in the process of HumRRO internal management."

Also, we have been informed that HumRRO has the right under its Army and Post Office contracts to devote not more than 5 percent of the estimated annual funding for the performance of independent research.

* * * * *

It appears that it would be somewhat incongruous to provide fees to a nonprofit organization to enable it to shift to other fields of endeavor when the organization has received the bulk of its financing from a Government agency and has developed its capabilities through Government support under a sole-source arrangement. To the extent that the services of that organization were needed by the agency, the potential loss of such services would be detrimental to the interests of the agency.

If, on the other hand, the nonprofit organization were no longer essential to the agency, the nonprofit's shift to other fields of endeavor would result in competition with private industry, for Government or private business. Such competition would appear to be inequitable since the heretofore sponsored nonprofit organization would have an unfair advantage over an organization which has built up its own capital and facilities. Furthermore, under these conditions any claims that the Government might have on the net assets acquired by a nonprofit from fees might well be negated since such claims are effective only upon dissolution of the organization.

Fees used to pay for nonreimbursable
business costs

We found that fees were being used by DOD-sponsored nonprofit organizations to finance expenses of operation not reimbursed under Government contracts. These expenses are not reimbursed under Government contracts because they are deemed by ASPR to be unallowable in whole or in part.

ASPR contains cost-reimbursement principles for research contracts with commercial organizations and for research grants and contracts with educational institutions. Generally, we found that the commercial cost principles were applied to costs of nonprofits except in those few instances where the nonprofits were operated by educational institutions under no-fee contracts with the Government.

Some of the expenses that ASPR deems unallowable in whole or in part are advertising, except in certain circumstances, such as when the expense is incurred solely as part of a reasonable recruitment program; bad debts; compensation, bonuses and incentive compensation to the extent that overall compensation is not commensurate with the contractor's established policy and not in conformance with compensation paid by other firms in the same area for similar services; contributions and donations; employee food and dormitory services not operated on a break-even basis; entertainment costs, except when related to technical and professional meetings and conferences; fines and penalties; interest on borrowings and other financial costs; relocation costs in excess of prescribed limits; excessive recruiting costs; and the difference in cost between first-class and less than first-class air accommodations, except when less than first class is not reasonably available.

Commercial organizations having contracts with the Government frequently incur many of these costs and pay them out of funds obtained from contract profits or other sources of income. Sponsored nonprofit organizations, however, generally have only the fees received from the Government as a source of funds for paying any expenses unallowable under ASPR. The question arises, therefore, as to what extent the nonprofits should be provided fees to pay for such unallowable expenses.

The RAND Corporation, for example, has a policy of allowing its technical and professional employees to use first-class air travel in connection with company business where the trip exceeds 1-1/2 hours. This policy is currently costing RAND about \$50,000 a year from corporate fees. The possibility of limiting air travel to less than first class and allocating the saved funds to independent research, was considered at a RAND management committee meeting on May 10, 1967. Management felt that a change would have an undesirable effect on staff morale and left the policy in effect.

Bureau of the Budget Circular No. A-21, ASPR, and FPR restrict the use of first-class accommodations by Government employees and contractors except where less costly accommodations do not meet reasonable and adequate quality standards and requirements for meeting appointments, connections with other scheduled transportation, speed, comfort, safety, or similar

factors. Previous reviews conducted by this Office have shown that substantial savings have been realized by many major Government contractors through use of this policy. Thus, by the continuation of its air-travel policy, RAND is incurring costs beyond those recognized as reasonable by both Government and industry officials.

Also, we noted that Aerospace has used fees for executive salaries considered by the contracting officer to be excessive in relation to salaries received by persons furnishing comparable services. Aerospace charged \$50,835 against fees in fiscal year 1967 for that portion of salaries that the Air Force did not approve as reimbursable contract costs. Aerospace's expenditures from fees for excluded compensation in fiscal years 1964, 1965, and 1966 amounted to \$100,201, \$99,284, and \$82,361, respectively.¹ The \$82,361 for fiscal year 1966 represents disallowances by the Air Force of compensation of 32 Aerospace employees, after considering salaries and incentive compensation. These disallowances ranged in amount from \$240 to \$6,600.

The Bell Report considered the question of whether standards should be applied to salaries and to related benefits paid to persons employed on federally financed research and development work in nonprofit establishments doing work exclusively for the Government. The report concluded that, where there was no cost control through competition, the basic standard for reimbursement of salaries and related benefits should be one of comparability to the compensation of persons doing similar work in the private economy.

By using fees to pay to personnel salaries in excess of those paid to counterparts in industry and Government, some nonprofits are in effect bypassing the control contemplated by the agency review and the approval procedure.

The Defense Science Board Task Force on Federal Contract Research Centers has stated that, apart from the use of fees to assure stability in the face of unexpected financial crisis, the fee provides managerial flexibility, which is essential to the continuing operation of the organization. One such requirement, according to the task force, is the need for funds to cover disallowable but justifiable costs.

The Air Force Systems Command Board of Visitors' Ad Hoc Group recognized the benefits to be derived from providing management with a limited degree of flexibility, in that certain legitimate business expenses are not reimbursable under ASPR and, since no other funds are available, must be met out of a fee. The Ad Hoc Group recommended that the Air Force and the sponsored nonprofit corporations work toward a minimum-fee position by developing sound policies and practices that would allow reimbursement under ASPR of the majority of the expenses being funded out of fees. The Group

¹ Aerospace, in commenting on this report, pointed out that, in each of the above years, the salary disallowances represented less than one quarter of 1 percent of the total wages and salaries paid.

stated that, under such a practice, facilities, research, salaries, and consultant fees should be limited to expenses that can be appropriately recognized and reimbursed as costs under the contract.

We believe that the costs allowed by the principles contained in ASPR are sufficiently broad to cover most necessary expenses. Consequently, only limited amounts of fees would be needed to fund other necessary costs. These fees could justifiably be used by the sponsored nonprofits to cover costs, in reasonable amounts, of activities such as business lunches and limited entertaining, community relations, and interest expense.

We believe that, in order to enable the nonprofit to pay such expenses and, at the same time, ensure that the expenses are confined to necessary and prudent costs of doing business, the agency should base the amount of fees negotiated on the reasonable needs of the organization. Consequently, although the fees, once they have been provided, are to be used at the discretion of the management of the nonprofit organization, the uses made of fees should be a factor in the determination of the amount of fees to be allowed in subsequent years.

Fees generally not used
for independent research

The Bell Report supported the payment of fees to nonprofit organizations for the conduct of some independent, self-initiated research to enable the organizations to obtain and hold highly competent scientists and engineers. The study committee saw merit in the argument that these payments represent incentive to maintain the cohesiveness and the quality of the organization.

However, our survey showed that some nonprofit organizations had not conducted any independent research; others had performed some research of this type but had funded it principally through direct or indirect charges to contracts; and relatively few had funded an appreciable portion of their independent research from fee income. Evidently there is little recognizable difference between the type of research funded as fee-sponsored and that funded as reimbursable contract costs. It appears that the overall research effort of these organizations is the attraction to scientific and engineering personnel.

The Logistics Management Institute has not requested a fee for, or conducted, an independent research program. Officers stated that LMI had not reached the point where an internal study and research program was mandatory in order to keep up with the state-of-the-art.

MITRE officials stated that the purpose of its independent research program was to investigate ideas with high potential for future application within MITRE's mission without having to compete with contract projects for limited resources. However, MITRE has used less than 14 percent of its fees for independent research.¹ Furthermore, in fiscal year 1967 the Air Force negotiated an agreement that 90 percent of MITRE's independent research, up to \$360,000, would be an allowable contract cost.

Research Analysis Corporation has spent about \$2.7 million for independent research from its inception in 1961 through 1967. However, about 98 percent of this research has been included as either direct or indirect charges to Government contracts; only about 2 percent, or \$58,000, has been paid from fees.¹

Aerospace conducts three categories of research, one of which is funded from fee income. Aerospace officials stated that fee-sponsored research generally relates to the long-range aspects of Aerospace's mission to provide technical support to the Air Force, whereas the Air Force contracts for research for which there is a foreseeable need. In the 7 years from Aerospace's inception through June 30, 1967, the Aerospace Board of Trustees authorized \$2.5 million and Aerospace expended \$1.8 million on fee-sponsored research. Aerospace received fees of \$21.7 million from the

¹According to some of the organizations, notably MITRE and RAC, they plan to make increased use of fees for independent research but have been unable to do so because of the commitment of funds to building programs, financial stability reserves, etc.

Government during this period. During fiscal years 1961-64, Aerospace expended \$82,548 on fee-sponsored research.

The congressional hearing in May 1965 questioned the discrepancy between the amounts of the fee cited by Aerospace as needed for independent research and the amounts actually spent. Aerospace has informed us that, during this period from 1961 to 1964, it used fees for financing a large building program in San Bernardino and El Segundo rather than performing the independent research intended by the Board of Trustees. Aerospace expended more than \$1.7 million in fiscal years 1965-67 for independent research.

The Institute for Defense Analyses informed us that it undertook research with fees and grants in order to improve the capabilities of the organization and individual staff members and to contribute to the advancement of science or public policy. IDA has financed more than 75 percent of its independent research through overhead charges to contracts. IDA has used about 5 percent of its income from fees for independent research. According to IDA, it has been unable to perform all of its authorized contract research because of the demand for direct contract effort and the limited manpower available.

One of the four stated objectives of RAND's fee-supported research is to attract and retain professional employees with appropriate skills. RAND informed us that it has spent about 33 percent of its net income for independent research. However, in 1966 independent research represented less than 2 percent of RAND's total effort. RAND considers all its efforts to be research.

At the Applied Physics Laboratory and the Lincoln Laboratory, all independent research is funded as an allowable contract cost. At the Jet Propulsion Laboratory and the Brookhaven National Laboratory, all research efforts are performed under the respective contracts with NASA and AEC, and there is no independent research, as such, performed.

At the above organizations, independent research, whether funded from fees or as contract costs, is generally related to areas of interest of the Government. We found little or no indication that fee-sponsored research was more of an attraction for getting and holding scientific personnel than research funded as a direct contract cost.

The Ad Hoc Group, which made a detailed study of Aerospace and MITRE, found that a vigorous and balanced research program was essential for these corporations, part of which should be accomplished at company discretion. The Group's report recommended that the company-selected portion be reimbursed under accepted costs of the contract.

General B. A. Schriever, Commander of the Air Force Systems Command at the time of the Ad Hoc Group study, stated that the nature and content of about 10 percent of the research program should be decided solely by the corporation, although the results of the entire program should be available to the Air Force. He stated also that the independence of this part of the program was more important than the mechanism by which it was funded and, if it could be funded as a reimbursable without imposing

inhibiting restrictions on its content or conduct, he agreed with the recommendation. As a matter of practical experience, he doubted, however, that this would be the case.

It does not appear necessary to provide fees for independent research to accomplish the purposes set forth in the Bell Report. A stated amount for independent research, such as a percentage of the overall research program, could be provided for as a reimbursable contract cost. This amount could be utilized by the nonprofit for research in a manner similar to the in-house laboratory directors' funds used by DOD. These funds were established to provide laboratory directors with the ability to initiate work in areas that they judge to be important and promising. At the end of each year, the uses made of the funds could be reviewed and the results made one of the bases for determining the amount of funds to be allowed in the subsequent year.

Fees used in some instances for acquisition of facilities

The Bell Report issued to the President in May 1962 stated the position that, where nonprofit organizations require facilities and equipment in order to perform research and development work desired by the Government, the Government should either provide the facilities and the equipment or cover their cost as part of the contract. The Report recognized two problems.

First, it is generally not desirable for the Government to furnish funds through fees for the purpose of enabling a contractor to acquire major capital assets. Second, where the Government has provided facilities, funds for obtaining facilities, substantial working capital, or other resources to a contractor, it is equitable that the Government should, upon dissolution of the organization, be entitled to a first claim upon such resources.

Our survey showed that Government agencies did not follow a consistent practice in furnishing facilities to Government-sponsored nonprofit organizations, and, in those instances where agencies had furnished fees to permit Government-sponsored nonprofit organizations to acquire facilities, rights were not always given to the Government to determine the disposition of these assets upon dissolution of the nonprofits.

We found that many of the DOD-sponsored nonprofit organizations had used fees to acquire capital assets, although the use of fees for this purpose in recent years has declined as the requirements for facilities have been filled.

One of the nonprofit organizations cited the restrictions and delays that may occur in budgeting for and managing Government-owned property. More general was the feeling that capital assets are part of the attainment of financial independence and operational stability. On the other hand, the Lincoln Laboratory, Jet Propulsion Laboratory, and Brookhaven National Laboratory operate in Government-owned facilities.

The MITRE Corporation has acquired \$10.7 million in land and facilities from fee earnings and from loans that are repaid from fee earnings. MITRE has used 69 percent of its fees for this purpose. The Aerospace Corporation has applied 67 percent of its fees toward acquiring \$19.6 million of land, buildings, and other assets. RAND and the Applied Physics Laboratory have utilized 43 percent and 46 percent, respectively, of their fees and other income, including depreciation and use charges reimbursed under Government contracts, to acquire facilities.

The Institute for Defense Analyses, Logistics Management Institute, and Research Analysis Corporation have acquired no land or buildings, but have utilized 30, 27, and 18 percent, respectively, of their Government fees for equipment, furniture, and leasehold improvements.

As noted above, three institutions have operated satisfactorily in Government-furnished facilities. It appears to us that it is not necessary that, to maintain a creative and productive environment, the Government furnish fees to organizations for acquiring large amounts of real property.

Government's rights to capital
assets acquired with fees

As stated in the Bell Report, when the Government has provided facilities or funds to obtain facilities, the Government should upon dissolution of the organization be entitled to a first claim upon such resources. In the cases we reviewed, the facilities obtained through fees were in many instances acquired prior to the issuance of the Bell Report. These assets are not legally subject to retroactive recapture, except through voluntary action on the part of the titleholding nonprofit organization. Attempts have been made by DOD, with some success, to acquire certain residual rights to these assets. These rights are predicated upon the organizations' being dissolved. If an organization does not discontinue operation after the sponsoring agency no longer requires its services, but goes into other activities, the rights of the Government to the residual value of the assets may be jeopardized.

The Bell Report stated that the Government's claim on these facilities should be governed, insofar as possible, by the terms of the contracts or, in the case of any newly established organization, by the provisions of the organization's charter.

MITRE and Aerospace have had provisions inserted in their contracts with the Air Force, designed to protect the Government's interest upon dissolution of the organizations. The Government's rights are based upon the organizations' being dissolved when the Government no longer needs their services. However, rather than dissolve, the organization could, without approval of the Federal Government, elect to perform commercial work. It seems that the dissolution clause would then be inoperative and MITRE and Aerospace could retain indefinitely the land and facilities paid for entirely out of fees.

Logistics Management Institute has, by supplemental agreement, provided in its contract with the Office of the Secretary of Defense for the

remaining corporate assets to be tendered to the Government upon LMI's dissolution. LMI has acquired no real property and has expended \$76,800 for equipment and improvements.

The Navy's contract with Johns Hopkins University for operation of the Applied Physics Laboratory gives the Government an option to purchase certain land and buildings held in the name of the University, but acquired with fees and other Laboratory income. We were informed that the Navy considered obtaining funds in its fiscal year 1970 budget to exercise the option. Also, the Navy received an alternative proposal from APL that the Government remove the option in return for a pledge from APL to make the facilities available for use by the Government for as long as required in the national interest.

One of the disadvantages of Government-sponsored nonprofits' acquiring assets from fees is pointed up by the added cost that the Government would incur should the Navy exercise the option. The average cost to APL for 250 acres of land subject to option was about \$650 per acre when it was acquired in fiscal year 1963 and earlier. The valuation in the fiscal year 1970 budget estimate of the Navy is \$6,892 per acre.

The Air Force did not provide Rand Corporation with facilities at Government expense. RAND informed us that it had accumulated \$610,000 in gross fees from the Government when it received a \$1 million grant from The Ford Foundation, which enabled it to obtain commercial financing and undertake a building program. However, RAND had an understanding with the Government that RAND would receive a use charge and thereby recover its building construction costs on an accelerated basis, which would reduce the risk that it was taking.

In 1962 RAND rejected an Air Force request to consider amending the charter to provide that, in the event of RAND's dissolution, the Air Force distribute the assets. The RAND charter provides that, upon dissolution of the corporation, the assets are to be distributed in accordance with the direction of The Ford Foundation or, if The Ford Foundation does not exist, then by decree of the Superior Court of California. RAND has received funds of nearly \$20 million from fees and other income related to Government contracts, in contrast to receiving only \$1 million from The Ford Foundation.

The Institute for Defense Analyses and the Research Analysis Corporation have acquired no real property, but have used fees for equipment and leasehold improvements. The charter of RAC, and its contract with the Army, provide that remaining corporate assets be turned over to the Government. RAC has expended about \$446,000 for equipment and improvements. IDA has amended its charter to provide that any assets remaining from funds paid to IDA as management fees on Government contracts be transferred to the Government unless a successor organization assumes some of IDA's responsibilities. IDA has expended \$1.3 million from fees on equipment and leasehold improvements.

Limited use of capital assets
acquired with fees

At Aerospace we noted that 9.2 acres of land at Cocoa Beach, Florida, and 38.95 acres of land at San Bernardino, California, having book values of about \$266,000 and \$261,000, respectively, were not being utilized in normal operations. The land at Cocoa Beach and San Bernardino was originally purchased for possible future corporation expansion. Aerospace does not contemplate expansion in these areas in the foreseeable future. The Cocoa Beach land has been put up for public sale. At the time of our survey, no decision had been made as to the future use or disposition of the San Bernardino land.

During a previous survey at MITRE, we noted that MITRE owned about 50 acres of land that were not being used, nor were there any plans for future use of the land. We pointed out that, if the land were sold, proceeds from the sale, estimated to amount to about \$900,000, could be used to reduce the cost of financing certain of MITRE's expenditures now being financed through fees paid under Government contracts.

MITRE replied that the 50 acres were an integral part of its 104-acre tract, the land had been and would continue to be used in experiments and test activities, and its probable use and appreciation in value justified its retention.

During the current survey, the Treasurer of MITRE stated that there were still no permanent plans for using the land although temporary use had been made and would continue to be made. We were advised that two temporary antenna towers were being erected on the land for the purpose of performing certain experiments and a permanent structure (small observatory) had been built.

PROPOSED GOVERNMENT-WIDE GUIDELINES FOR USE
BY AGENCIES IN CONTRACTING WITH SPONSORED
NONPROFIT ORGANIZATIONS

The results of our survey showed that there were many nonprofits engaged primarily in Government work, operating for all practical purposes as extensions or adjuncts of the Government, in many cases performing for a single Government agency. Yet these organizations were operating under a variety of contractual arrangements, differing as to the allowances of fees and bases for determining the amount of fees. It appeared to us that there was a need for a Government-wide policy for the guidance of Federal agencies in negotiating contracts for the services of nonprofit organizations sponsored by these agencies.

The policy would be applicable to the so-called sponsored nonprofit organizations that work primarily for the Federal Government and receive the substantial portion of their support from one or two agencies, as distinguished from the private, independent nonprofit institutions.

Therefore, we proposed that governmental policy be established to provide guidance to agencies in establishing and contracting with Government-sponsored nonprofit organizations. Our proposals were contained in a draft report submitted to the 15 nonprofit organizations included in our survey and to Government agencies expected to have an interest in such a policy, in order that we might obtain their comments.

We proposed that the policy include guidelines covering those items that normally would or would not be included in the fee. The policy should provide that the fees, once they have been determined by negotiation, belong to the contractor. However, to ensure that appropriate use is made of the fee, we proposed that each year disclosure of the uses made of the fees should be required and used as a factor for consideration of the amount of fees to be negotiated in subsequent years.

We suggested that the Government-wide policy formulated to guide agencies in establishing and contracting with sponsored nonprofit organizations include consideration of the following:

1. The fee negotiated with sponsored nonprofit organizations should be designed to (a) enable accumulation of a reserve to provide operational stability during temporary reductions in contract work, and (b) permit appropriate flexibility in operations.

- a. On the basis of our examination of the incidence and length of contract renewal delays, the level of effort that the nonprofit organizations have maintained, and the evidence that the Government agencies will be continuing to arrange for the services of these organizations, the reserve generally should be limited to an amount required to maintain operations for a specified short period of time during which contract renewal is in negotiation or during temporary reductions in the level of programmed work. The agencies should, where timely negotiation cannot possibly be accomplished, provide

that letter contracts be used during periods of contract-renewal delays.

The reserve should not be available for purposes other than needs to temporarily stabilize operations. Once the agreed level of stability reserve has been reached, no further amount of fees should be negotiated for that purpose until the balance falls below the agreed-to limit. Income earned on such reserves should be considered in determining future fee allowances. The Government should be given residual rights to any balance remaining in the operational stability reserve upon dissolution of the organization.

b. For flexibility in operations, the fee should include a sufficient amount to enable the nonprofit to pay necessary business expenses that are not reimbursable under the procurement regulations. In view of the lack of competitive restraints, the amount of the fee negotiated for this purpose should be determined on a minimal basis.

For assistance to negotiators, the guidelines should include examples of the types of expenses intended to be included in the fee, such as reasonable business luncheon expenses.

The guidelines should include also examples of expenditures that are not considered appropriate for recognition in negotiating the fee. For example, the excess cost arising from the exclusive use of first-class air travel seems unnecessary in view of the general practice in industry, Government, and universities of normally using less than first-class transportation. Similarly, if a nonprofit firm were to consistently pay salaries in excess of those approved by the Government representative, the excess costs would appear inappropriate for recognition in negotiating fees, although there may be circumstances where exceptions might be considered necessary to permit managerial flexibility.

2. No amount should be included in the fee for independent research. Where it is considered desirable for the organization to conduct independent research, the contract should specify the amount allowable. The amount to be paid by the Government should not, however, exceed the actual costs incurred. The research should relate to the purposes of the organization, but the nonprofit should have independent authority in selecting the research to be performed, including the authority to acquire limited facilities needed for such research.

3. No amount should be included in the fee to enable sponsored nonprofit organizations to acquire capital assets. Where a nonprofit contractor requires such assets in order to perform research and development work for the Government, the Government should either provide them or cover their cost as part of the contract. As noted above, reimbursable funds could be utilized by the contractor to acquire limited facilities and equipment for use in its independent research.

In those exceptional instances where facilities or equipment are acquired by the contractor with fees or other resources provided by the Government, the Government should have contractual rights to these assets upon dissolution of the organization.

4. Fees should not be provided for the purpose of enabling the organization to accumulate its own working capital. Working capital should be furnished by the sponsoring agency to the nonprofit organization through use of an advance payment plan or a letter-of-credit arrangement.

5. Where the sponsored nonprofit organization performs services for more than one agency, one sponsoring agency should be designated to negotiate the fee arrangement. Such a practice would enable the Government to apply a uniform rate of fee allowance and give one agency the responsibility for determining and monitoring the limits of the fee reserve accumulations, a control which would be extremely difficult were the organization to negotiate the fee contracts individually with many different Government agencies.

Contractor comments and our evaluation thereof

Replies were received from all 15 of the nonprofit organizations in response to our request for comments on the draft report. Several of the organizations did not find it necessary to make significant comments whereas the others replied at considerable length. In all, the letters and attachments came to more than 100 pages. For this reason, contrary to our customary practice, we have not included the contractors' comments in the appendix to this report, but we have incorporated pertinent comments in specific sections of the report. The major comments received from the contractors are summarized in the following paragraphs, along with our position.

Sponsored nonprofit organizations need financial resources for independence

The sponsored nonprofit organizations which in the past have received the greater percentages of fees, primarily the DOD-sponsored nonprofit corporations, expressed the opinion that the proposed guidelines would limit fees to the point of restricting the organizations' independence and objectivity, and, thus, the opportunity for the Government to receive maximum benefit from these organizations would be jeopardized.

The comments pointed out that these organizations were purposely created in varying forms to meet the diverse needs of the agencies of the Government, needs that could not be fulfilled within the Government structure. These contractors contended that, if fees were limited to the extent contemplated in the draft report, such standardization would take away the financial flexibility which had enabled the contractors to maintain an independent, objective approach to their sponsors' needs and had allowed them to attract and retain high-caliber talent to carry out their sponsors' missions.

We found that many of the various uses to which fees had been put by these organizations in maintaining this independence--facilities, cash reserves, independent research, etc.--had been met by other sponsored nonprofit organizations by means other than a fee. Some of the research and

development organizations included in our survey are operated by universities or other nonprofit organizations, utilize Government-owned facilities and Government capital, and perform independent research on a cost-reimbursable basis. It does not appear that it was any more difficult for these organizations to obtain capable personnel and accomplish their contractual tasks, while receiving a minimal fee or no fee at all, than for those organizations that claim that their usefulness would be greatly impaired without an accumulation of assets from fees.

Sponsored nonprofit organizations need
freedom from Government control

In stating their need for financial resources to ensure meaningful independence, some of the sponsored nonprofit organizations objected to being classified as extensions or adjuncts of the Government for the purpose of setting fee guidelines. We believe that any organization that has been established to serve the Federal Government and is receiving substantially all of its support from the Government must be considered as quasi-public and, therefore, more subject to Government constraints than a profit-making organization.

It seems that, as long as the organization retains the status of a nonprofit whose purpose is to serve the public and does so exclusively through contracts with the Government, there is a justifiable basis for establishing guidelines on the purposes for which fees should be allowed, so that the resources accumulated or acquired through fees from Government contracts will be kept within limits reasonably required to fulfill the objectives of these organizations.

Some of the DOD-sponsored nonprofit corporations, maintaining that they are independent organizations, felt that any Government-wide guidelines should be applicable to all nonprofits, including the private nonprofit institutions. However, several of the private, independent nonprofit institutions contended just the opposite, holding that their differences were significant enough that they should not be treated contractually or otherwise in the same manner as the Government-controlled and financed nonprofits, which obtain their support through a line item in a governmental agency budget.

Sponsorship offers no assurance
of financial stability

Comments were raised to the effect that the different organizational structures of the sponsored nonprofits do not lend themselves to the establishment of uniform rules and, furthermore, the designation as "sponsored" is a label which carries with it no assurance of a stable level of support for an extended length of time.

We noted, however, that in May 1968 the Director of Defense Research and Engineering, testifying before the Senate Committee on Foreign Relations concerning the Federal Contract Research Centers (FCRC's), stated that DOD or the Services have made an agreement to provide long-term

support to these institutions. Later in his testimony the Director stated that:

"*** The assurances that the Government gives these organizations are that over the years, as we see ahead, the situation is not going to change much in these areas of competence. For example, we see difficulties in the area of strategic or tactical warfare and, therefore, feel that for at least several years we will have a need for their services, and for about a certain level of manpower and, therefore, provided they can continue to maintain competence and turn out first-class work, we make a commitment to attempt to fund them at about the same level of effort. It is a moral commitment that is made to the individuals in and for services of these organizations."

In defining the type of commitment made to the FCRC's, the Director stated:

"Because of their unique value, it has been the policy of DOD to recognize a responsibility for the stability of support of the FCRC's.

"In effect, this means an annual determination by DOD of the support level for that year based on the projected work for the organization, and informing the FCRC of the level. This is the level furnished to the Congress in support of the budget."

We also found that DOD and other agencies try to assure the sponsored nonprofits of long-term support by entering into long-term contracts with them. Although some of the organizations argued that this assurance was meaningless since actual funding must be furnished on an annual basis subject to congressional budget approval, we believe that the distinction between a reduction in funding and a complete termination of services should be recognized. The proposed guidelines would provide for the payment of fees to enable accumulation of reserves for use during periods of temporary reductions in funding.

We do not believe that fees should be accumulated on the basis that the efforts of the entire organization may suddenly be dispensed with and thus the organization will have to be 100-percent self-supporting. None of the public statements by Government officials have given any indication that the services of these organizations, individually or as a group, are in any less demand now than they were at the time they were established. Furthermore, contractual provisions could be used to indemnify sponsored nonprofits against possible costs of termination.

Diversification furthers independence
of sponsored nonprofit organizations

Our proposed policy would provide that fees not be allowed for the purpose of creating a reserve to enable the sponsored nonprofit organization to enter other fields of endeavor or to compete in the private sector for non-Government business. Comments against this proposal were

received from the DOD-sponsored corporations that have fee accumulations and/or own their own facilities and, therefore, are in a position to effect such a transition.

These organizations look upon diversification as another means of furthering their independence. In the main they felt that limited diversification would initially be of benefit to their principal sponsor by broadening their capabilities to deal with a wider range of the sponsor's problems, and ultimately would benefit the Nation as a whole if, when their services were no longer required by the principal sponsor, the organizations remained intact and the resources were applied to some other endeavor in the public good.

Generally, the replies indicated that, were there transitions, services would be furnished to other agencies of the Federal Government, and possibly, in some cases, to State and local governments. The Research Analysis Corporation, however, informed us that its Board of Trustees has amended its charter to provide that RAC can now work for non-Government agencies in the public interest. Such a change was made after a suggestion by the Army that RAC might wish to work more broadly for clients without, as well as within, the Government.

We foresee that there would be problems if these organizations that have operated on Government funds and acquired their capabilities with Government support were to be allowed to move freely into the private economy. It appears that were the heretofore sponsored nonprofit organization to enter into competition with private industry for Government or other business, it would have acquired an unfair advantage over an organization that had built up its own capital and facilities.

Another of the problems associated with diversification concerns the possible loss by the Government of claims to assets of these organizations that were to be effective upon dissolution of the organizations. Several organizations pointed out that, as long as the diversification consisted of obtaining other Government sponsors, the Government's claims would be merely postponed, not negated. It appears to us, however, that, the broader the range of clients of the nonprofit, the more difficult it would be for the Government to administer and account for the nonprofit's assets, and that as a result the ultimate trend would be to let ownership of the assets remain with the nonprofit. Should diversification ultimately lead to the nonprofit's having clients outside the Government, there is a possibility that these assets would be irretrievably lost to the Government.

Sponsored nonprofit organizations need to
conduct research independent of sponsor

The comments from the sponsored nonprofits that have used fees in varying degrees for independent research generally expressed two points: (1) the financing of independent research through fees rather than through reimbursement of contract costs is essential if research is to be truly independent and (2) the organizations plan to conduct more and more independent research as the demands on fee for financial stability decrease.

During our survey we found that some of the sponsored nonprofits conducted all their independent research as a reimbursable contract cost. In commenting on the draft report, none of these organizations expressed dissatisfaction with this arrangement. George Washington University, which operates HumRRO, specifically concurred that no fee should be provided, rather independent research should be authorized on a reimbursable basis. Other organizations conducted mixtures of fee-sponsored and cost-reimbursable independent research; in most cases both related to areas of interest of Government sponsors.

We found some indication that the declaration of the need for fees for conducting independent research was related to the objective of preparing for future diversification of activities, to include in some cases non-Government activities. In a previous section of this report, we pointed out the inequities that would result from a sponsored nonprofit organization's shifting its field of endeavor, and stated our belief that fees should not be provided to permit this to happen. Therefore, we see little need to conduct independent research of a nature which would be so unrelated to tasks for the benefit of the Government that it could not be charged to a Government contract.

Agency comments and our evaluation thereof

Comments were received from eight Government agencies concerning the proposed establishment of fee guidelines. The Chairman, Civil Service Commission, commented orally that he concurred generally in our findings and conclusions. The replies from the other seven agencies are summarized in this section, by agency, and the letter from each agency is included in its entirety as an appendix to this report.

Some of the objections raised by the nonprofit contractors, and discussed previously, were also voiced by one or more of the Federal agencies. In these instances, the positions of the agencies are presented without our further evaluation. Where new viewpoints are presented, we have added our comments.

Department of Defense

The Director of Defense Research and Engineering commented on the guidelines proposed in our draft report, by letter dated April 24, 1968. (See app. III.)

The Director prefaced his comments specifically related to the contents of the draft report by noting that there was no evidence in the report that DOD-sponsored nonprofit organizations were applying fees to unwarranted classes of use or were expending fees within these classes in unlawful or irregular ways. The Director also recognized in his comments that no GAO investigation had been specifically conducted in regard to these aspects of the payment of fees to nonprofits. In view of the limited scope of our survey, we cannot affirm that the DOD-sponsored nonprofits have, or have not, used their fees with the propriety implied by the terms used above.

DOD does not concur that the Congress should prescribe guidelines as proposed. DOD points out that, after extensive study, it adopted the modified weighted guidelines approach to the negotiation of fees and that this procedure has not been in effect for a sufficient period to assess its effectiveness. DOD states that the draft report implies that the needs approach to setting fees is the only acceptable one, in contrast to modified weighted guidelines which DOD adopted specifically to offset some of the weaknesses the needs method was considered to have.

DOD's primary objection to negotiation of a fee based on need is that it fails to give recognition to merit, excellence of effort, past achievements, and other such factors. We believe that these considerations should be recognized in the case of profit-making companies that have an obligation to their stockholders to try to command greater fees through excellence. We believe also that these considerations are pertinent to independent nonprofit organizations, whose existence and growth is dependent on doing a better job than the organizations with which they compete for their contracts.

As for Government-sponsored nonprofits, the reason for the existence of these organizations is usually attributed to their ability to attract a

body of high-caliber talent that would otherwise not be available within the Government. In our opinion, the prime prerequisites for attracting and maintaining a body of top talent are such factors as attractive salaries, an environment conducive to creative endeavor, challenging assignments, etc. We doubt that the employees generally have knowledge of the amount or rate of contract fees received by the employing organization. We doubt that, in fact, the employee is concerned whether the costs of these inducements are being funded from fees or reimbursed as contract costs.

Once it has been determined how much the Government-sponsored nonprofit requires in the way of funds to maintain a normal degree of stability, the requirement for a fee becomes the amount needed for those requirements that cannot be funded as contract costs. It seems that to pay a fee that is in excess of basic needs would not be the most economical use of Government funds and would result in the nonprofit's either spending unnecessarily or accumulating excess reserves.

DOD stated that it has a continuing concern with the accumulation of assets by sponsored nonprofit organizations and cited an instruction to DOD activities sponsoring such organizations to review their capital accumulations at least once every 3 years. The results of these reviews are to be forwarded to the Deputy Secretary of Defense, identifying any amounts that appear to be unreasonable or unwarranted and advising what action has been taken.

DOD issued this memorandum in connection with its approval of the use of modified weighted guidelines, apparently to minimize any accumulation of fees negotiated under this method. However, the memorandum issued by the Deputy Secretary provides no guidance as to what constitutes an "unreasonable or unwarranted" accumulation, or what action is expected of the agency identifying what it believes to be such an accumulation.

It seems that, since DOD follows the policy that a fee, once it has been negotiated, belongs to the contractor, the agency's action would be limited to adjusting fees in some subsequent year or years, which in turn would require an adjustment to the modified weighted guidelines negotiation for recognition of fees already allowed in excess of reasonable needs. We believe, however, that it would be better not to provide unneeded funds that would result in an accumulation of assets and require subsequent adjustment. In our opinion the needs approach to negotiating fees would accomplish this objective.

Atomic Energy Commission

The General Manager of AEC commented on our draft report, in a letter dated April 9, 1968. (See app. IV.) AEC did not agree that there is a need for Government-wide guidelines for Government agencies in negotiating fees with Government-sponsored nonprofit organizations. AEC states that sponsored nonprofit organizations provide a degree of independence in scientific and technical operations that contributes to the Government agencies' ability to carry out their programs and, as essentially separate entities, are entitled to a commensurate degree of independence and flexibility. AEC states also that, consistent with this concept, fees should be paid to

these organizations to permit them a certain amount of latitude regarding costs that may be incurred.

AEC feels that it would not be practical or feasible to develop a Government-wide fee policy which would be appropriate for all situations and that the considerations upon which fees are based will and should vary with the different types of nonprofit organizations and the different environments in which they operate. AEC is therefore concerned that such a policy may have the effect of reducing the nonprofits' independence and flexibility and would be inconsistent with the nature and purpose of these organizations.

AEC agrees with the objective of keeping fees reasonable but believes that the best way to attain this objective is for each agency to carefully review the details that the organizations submit in support of their requests for fee, to determine if the items included are reasonable in relation to such factors as the type of organization, mission, local conditions, and past experience. AEC urges that, if adoption of a Government-wide fee policy is recommended by GAO, such a policy be stated in broad terms that provide sufficient flexibility to meet the varying needs of the different nonprofit organizations and their sponsoring agencies.

We find that the AEC objectives are in consonance with the objectives sought through the use of the proposed Government-wide guidelines. However, AEC favors allowing each agency to set its own guidance by which to determine the reasonableness of requests for fees.

In AEC's case, the proposed guidelines may appear to be unnecessary, but, it seems that, Government-wide, the use of weighted guidelines, worth-of-task, historical, and other bases, with the resulting accumulations of land, buildings, and cash reserves, calls for setting forth guidelines limiting the extent to which the Government should participate in making these organizations financially independent.

National Aeronautics and Space Administration

NASA commented by letter dated April 5, 1968 (app. V) that it appeared desirable to evaluate the results obtained in relation to the various arrangements between agencies and nonprofits before attempting to establish statutory criteria on fees. NASA stated that, in carrying out its programs, it had established relationships with industrial, university, and Government institutions so that the capabilities of these established institutions to do NASA's work, as well as other work, had been simultaneously strengthened.

NASA observed that nonprofit organizations do not readily lend themselves to easy classification; for example, the California Institute of Technology cannot be considered a nonprofit organization sponsored by the Government. Also, Caltech informed us that, since there is but one corporate entity--the Jet Propulsion Laboratory is a division of the Institute--it was concerned about being subject to rules established for contractors that are not independent and are considered to be sponsored by the Government.

We believe that in actual operation the Caltech-JPL fee arrangement with NASA closely resembles the fee arrangements envisioned by the proposed guidelines. JPL is operated in Government facilities, and direct and indirect costs of operation are reimbursed under Caltech's contract with NASA. Although Caltech's management fee is not determined on the needs basis, its negotiation gives consideration to many pertinent factors that NASA personnel consider to be reasonable and justifiable in relation to Caltech's operation of the Laboratory. Consequently, it appears that the establishment of such guidelines would have little, if any, effect on the relationship between Caltech-JPL and NASA.

We have no comparative information on the results obtained from the various arrangements between nonprofits and agencies. We doubt that such data, if available, would show a correlation of the relative competence and achievements of each organization to the fees allowed. Many of the highly respected organizations included in our survey received little or no fee. Also, we believe that it would be nearly impossible to measure the relative difficulty of the tasks performed by the many Government nonprofit organizations.

As long as there are no uniform criteria for determining fees, each agency may award fees on its own bases, including incentives for excellence, which may or may not be justified in the light of work accomplished by other organizations for a minimum fee. In our opinion, fees for sponsored nonprofits should be based on the needs of the organizations and should include limited amounts to cover those necessary and prudent costs of doing business that are not allowable under their contracts.

National Science Foundation

The Director of NSF informed us by letter dated May 14, 1968 (see app. VI), that the Foundation agreed with the recommendation that a statement of governmental policy be enacted to provide guidance to Government agencies in negotiating fees with Government-sponsored nonprofit organizations. In his judgment, any such policy should be sufficiently flexible to recognize different contractual arrangements and corresponding differences in relationships and responsibilities between the Government agencies and each contractor organization.

It is the Director's further judgment that one of the primary considerations in the negotiation of fees with nonprofit organizations is the relationship existing between the Government and the nonprofit organization. This relationship is influenced by the extent to which the organization is dependent upon Government funding for its programs.

NSF believes that, if the organization is only incidentally engaged in work for the Government, the fee negotiations should be conducted within the policies presently established for negotiations with commercial organizations but, if the nonprofit organization derives essentially all of its revenues from programs supported by Government agencies, the fee negotiations should be conducted within the framework of a policy developed specifically for nonprofit organizations.

Therefore, NSF suggests that any policy guidance that is developed should be applicable to any nonprofit organization that derives essentially all of its revenues from programs supported by Government agencies and should not be limited to so-called sponsored nonprofit organizations. This would permit the policy to be used in negotiating fees with organizations that are primarily dependent upon Government funding, even though in this report they are identified as independent and do not fall within the category of a sponsored nonprofit organization.

NSF believes that any policy should be flexible, because the relationships with, and the responsibilities to, nonprofit organizations sponsored by, or primarily dependent upon, the Government differ within and between Government agencies. Where different relationships and responsibilities do exist, the basis upon which a fee should be determined and what constitutes the appropriate use of such a fee may differ significantly.

NSF's policy provides that fees under the contracts for the National Research Centers shall be determined on a need basis; a fee, once it has been paid to the contractor, becomes a corporate asset; and contractors are required to submit annually information on their fee expenditures, for review and use in determining fees prospectively. NSF recognized that strict application of such a policy could present problems to other Government funding agencies when faced with different circumstances, and would even present problems to the Foundation in attempting to negotiate fees under its cost-reimbursable contracts with nonprofit organizations.

NSF suggests that it might be advisable in any policy that may be developed to discontinue the term "fixed fee" and use some other title such as "corporate fee" or "management fee."

NSF concluded by endorsing our survey of fees of nonprofit organizations and stated the belief that the survey would be helpful in initiating a policy study and ultimately establishing guidelines beneficial to agencies concerned with such organizations. The Director informed us that NSF would be pleased to participate in any study which may be necessary to establish a Government-wide policy to provide guidance to Government agencies in negotiating fees with Government-sponsored nonprofit organizations.

Office of Science and Technology

The Director, in a letter dated June 3, 1968 (app. VII), informed us that the draft report in general came to sensible conclusions. He expressed particular agreement with recommendations that the negotiated fee should provide a financial reserve for operational stability and for flexibility by permitting payment of necessary business expenses not reimbursable; that the Government should have contractual rights, upon dissolution of organizations, to capital assets acquired with Government resources; and that fees should belong to the contractor but that the contractor be required to fully disclose its use of fees.

The Director stated that, he believed that if a uniform statement of Government policy was needed, it would be appropriate to make this a management issuance, along the lines of a Bureau of the Budget Circular,

rather than enact legislation for this purpose. Also, in any case, he hoped that any statement would avoid excessive inhibition of the flexibility which the concept of the Government-sponsored nonprofit organization is intended to provide.

Department of Health, Education, and Welfare

HEW informed us by letter dated April 3, 1968 (app. VIII), that it agreed that there was a need for Government-wide guidelines on establishing and contracting with sponsored nonprofit organizations. HEW has only a relatively small dollar volume of business with organizations such as those identified as the Federal Contract Research Centers. Also, HEW does not generally create corporations to carry out its programs, although some may be created as a result of program support which HEW provides. Nevertheless, HEW found that the report raises policy issues that have implications for and relevance to HEW's general relationships with nonprofit organizations and there is much in the report with which it concurs.

In fact, HEW would go further than the proposed guidelines and suggests that there is a necessity for establishing guidelines on dealing with all nonprofit organizations which derive the preponderance of their support from the Federal Government. Such guidelines might include standards for evaluating the financial responsibility of such organizations and a mechanism for a coordinated approach to such evaluation where support is derived from several Federal agencies.

HEW stated that it appeared inappropriate to base the amount of the fee on an analysis of how the fee was being or had been used; that this was inconsistent with normal fee concepts, which regard a fee as return on invested capital and reward for risk and enterprise; and that it would be unwise to create a potential for blurring the distinction between fees and costs.

As pointed out in the Bell Report, the reason for paying a "fee" to nonprofit organizations is quite different from the reason for paying a fee to profit-making contractors. In our opinion, there is a significant difference between the normal Government/contractor relationship and the relationship existing between the Government and its sponsored nonprofits. The sponsored nonprofit in most instances does not invest any capital of its own initially, and any subsequent investment is usually provided by the Government, although indirectly, through fees.

Recognizing that fees, once they have been negotiated, belong to the contractor and that it is the contractor's choice as to how the fees are spent, we believe that there must be some control over the amount of fees that the sponsored nonprofit receives. We question whether fees can be justified for purposes other than to stabilize operations on a short-term basis and to provide a limited amount of flexibility in operations. The Bell Report did not intend for the Government to lose claim to its investment in nonprofits; on the contrary its findings show that, where the Government has provided facilities, funds to obtain facilities, substantial working capital, or other resources to the contractor, it is equitable that the Government should be entitled to first claim to these resources upon dissolution of the organization.

We believe that it is just as important that these organizations not tie up the Government's resources over periods of time pending some indefinite dissolution date. Assets not essential to the performance of the organization's mission for its Government clients should be restricted, and the providing of fees on a needs basis tends to hold accumulations in check. It is obviously easier not to provide the resources in the first place than to prove them excessive and exercise a disputable claim at a later date.

Department of Housing and Urban Development

In a letter dated April 23, 1968 (app. IX), HUD replied to our request for comments on the draft report. HUD concurred with many of our recommendations, but suggested several matters for further consideration.

HUD believes that additional consideration should be given to the matter of flexibility in operations so that the negotiated fee would not be designed to reimburse the nonprofit organization for unreasonable costs not allowable under Government cost reimbursement contracts. Also, the guidelines should give careful consideration as to what items should be included in overhead costs as distinguished from nonallowable costs. HUD feels that use of either of the terms "development" or "general support" allowance would be preferable to the continued use of "fee."

HUD believes that the guidelines should also contain criteria that will define sponsored nonprofit organizations as distinguished from those that are not sponsored and under what conditions they would change from one category to another.

ADVISABILITY OF ESTABLISHING
GOVERNMENT INSTITUTES

One of the conclusions of the Bell Report was that a new kind of Government research and development establishment was promising enough to warrant further study. The establishment, which might be called a Government Institute, would provide a means of reproducing within the Government structure some of the most positive attributes of the nonprofit corporation. The objective of establishing such an instrumentality would be to achieve in the administration of certain research and development programs the kind of flexibility obtained by Government corporations and yet retain effective public accountability and control.

The Bell Report proposed that each Institute be created pursuant to authority granted by the Congress and be subject to the supervision of a Cabinet officer or agency head. It would, as a separate corporate entity directly managed by its own Board of Regents, enjoy a considerable degree of independence in the conduct of its internal affairs. An Institute would have authority to operate its own career merit system and to establish a compensation system based on the comparability principle, and would have broad authority to use funds and to acquire and dispose of property.

In view of the continuing and growing use of nonprofit organizations to assist Government agencies in carrying out their missions, we suggested in our draft report that consideration be given to establishing Government Institutes to meet future needs. Following is a summary of the comments received on the suggestion.

Contractor and agency comments

Seven government agencies and three nonprofit contractors offered comments on the proposal, generally agreeing that consideration of the establishment of Government Institutes seemed warranted. Some of these organizations withheld unqualified support in the absence of knowledge as to how the utilization of Government Institutes would affect the existing Government-sponsored nonprofit organizations.

One organization was concerned that the proposal might intend that the creation of Government Institutes be accomplished by converting the sponsored nonprofits to Government Institutes and felt that this should not be the approach to take until there had been opportunity for appropriate comparison. Several agencies, although supporting the idea of Government Institutes, did not wish to be restricted to the sole use of Institutes for their research efforts and opposed Institutes as a replacement for, or conversion from, sponsored nonprofit organizations.

We recognize that the existing Government-sponsored nonprofit organizations are, in the opinion of the sponsoring agencies, performing essential functions, and we are not suggesting that they necessarily be replaced by, or converted to, Government Institutes. Our proposal is directed toward the establishment of Government Institutes in lieu of the creation of additional sponsored Government nonprofits in the future. It is of course conceivable that, if Government Institutes are authorized and prove

effective, some of the present nonprofits will eventually be converted to or replaced by such Institutes.

Several of the Government agencies that conceivably could need the assistance of some type of nonprofit organization in the future were receptive to a study of the possibilities of using Government Institutes. Some felt that the matter should be handled separately from a study of nonprofit fees. We agree that the matter of establishing Government Institutes would require a study involving considerations beyond those involved in establishing guidelines on fees for nonprofits. In this connection, representatives of BOB and CSC stated orally that they believed such a study should be made as a follow-up to the Bell Report.

One contractor pointed out that, when the idea of a Government Institute was originally proposed in 1962, there was a feeling that this new type of organization might lead to new problems and existing conditions did not warrant their use. However, the recent increased use of nonprofit organizations to serve nondefense needs of the Government seems to indicate that conditions have changed.

Another indication of change in conditions involves the significant actions that have been taken since the issuance of the Bell Report to strengthen the competence of Government research and development laboratories. For example:

1. Salary levels of professional personnel have been raised substantially and are now more closely comparable to salary levels of outside organizations, and more flexibility has been provided to the laboratories, which enhances their ability to attract and hold first-class scientists and technicians.

2. Directors of Army, Navy, and Air Force research and development laboratories have been authorized to use a portion of their annual budgets for work they consider to be of promise or of importance. Unlike that of the regular laboratory programs, this work is exempt from prior approval or review at higher levels. Instead, the results of the work financed by the Laboratory Director's Fund are reviewed annually through presentations directly to the Assistant Secretary for Research and Development of the cognizant Military Department.

3. An office of laboratory management, headed by a competent scientist, was established within the office of the Director, Defense Research and Engineering, to act as a focal point for all DOD research and development activities. Also, in each Military Department a highly qualified scientist or engineer was appointed to represent the research and development laboratories at the Department level.

4. Laboratories have been reorganized into new weapon centers and now have major assignments in threat analysis and development of requirements, planning for future weapons, assessment of vulnerability of proposed major systems, and other important roles in the research and developing cycle.

A third factor indicating a change in conditions since the issuance of the Bell Report is the emergence of numerous profit-seeking companies

having analytical competence. There are now over 30 such organizations in the Washington area alone.

Therefore, we believe that a special follow-up study to the review which led to the 1962 Bell Report should be conducted. This study would consider what types of organizations could best assist the Government in fulfilling its research and development missions. The desirability and feasibility of establishing Government Institutes should be a part of this evaluation. Also, such study should include criteria as to the circumstances under which such work should be performed within the Government, by sponsored nonprofit organizations or by other organizations.

CONCLUSIONS

Nonprofit organizations created for continuing Government work and supported predominantly by the Government, are sometimes referred to as adjunct organizations, or in some instances, as captive corporations. Yet these organizations enjoy a flexibility and independence generally not possible in a Government organization and are free from many of the restrictions and limitations placed on Government agencies and personnel.

Widespread recognition has been given to the claim that this independence is necessary if these organizations are to serve their sponsoring agencies with objectivity. We found that the organizations claim that objectivity is achieved through financial independence, being able to accept or reject sponsors' assigned tasks and render decisions free from agency bias. Financial independence in this context means accumulated fees and other resources obtained through fees.

These organizations claim also that diversification of interests and endeavors furthers objectivity and thereby provides the nonprofit with a broader view and greater knowledge with which to meet the sponsors' problems. They contend that, fees should be looked upon as the source of funds to support such a program.

We believe that such organizations must of necessity be subject to a certain amount of Government supervision. It seems that the use of fees for diversification is one example of an area that requires control if the Government's interest is to be protected. On the other hand, the flexibility of these organizations should not be so restricted as to destroy the characteristics that make it possible to perform assignments capably. Otherwise, there would be no justification for their existence. We believe that there must be a reasonable balance between control in the Government's interest and flexibility of operations in order for the organization to capably serve to the ultimate benefit of the Government.

In our opinion, the proposed guidelines should enable Government agencies to achieve this balance and obtain the services of these nonprofits at the lowest possible cost that would permit them to function competently. The management allowances, of course, would continue to be determined through negotiations, in accordance with normal contract procedures.

The guidelines would provide for negotiation of management allowances in order to create limited reserves that would enable the sponsored nonprofit organizations to maintain a stable level of operation. Although they have experienced occasional fluctuations in workload, such as cutbacks caused by a reduction in the annual appropriation or shifts in particular tasks to be performed, over the long term these organizations have shown a marked degree of growth and stability.

We saw no indication in the statements of agency officials that the need for the services of these organizations would decline in the future. However, we see no reason why, in those instances where sponsored nonprofits are concerned about the possibility of contract terminations,

Government agencies should not mitigate the impact of such possible terminations by contractual provisions. Under the proposed guidelines, management allowances would not be provided for reserves sufficient to finance a complete reorientation upon an unexpected termination, since there is little likelihood that such an event would occur without ample notice and provision by the sponsoring agency.

Also management allowances would not be provided to the extent that would permit these organizations to accumulate reserves to finance a shift to other fields of endeavor and to compete in the private sector for non-Government business.

All costs allowable under applicable cost principles of Government procurement regulations would be reimbursed under Government contracts, and, under the proposed guidelines, allowances would be provided in limited amounts to meet necessary and prudent costs of doing business that are not allowable as contract costs.

In summary, we question whether management allowances should generally be provided to sponsored nonprofits for purposes other than stabilizing operations on a short-term basis and providing limited flexibility in operations.

RECOMMENDATIONS

We believe that the subject of the proper role of Government-sponsored nonprofit organizations is of sufficient importance to warrant a Presidential-directed interagency or commission study. As an alternative we recommend:

1. That the Bureau of the Budget prescribe Government-wide guidance to agencies in establishing and contracting with sponsored nonprofit organizations, designed to enable Government agencies to achieve a balance between the flexibility needed by the organization to perform capably and the amount of Government supervision required.

The guidelines should limit the management allowance to the amount needed to enable the organization to accumulate a reserve to provide operational stability during temporary reductions in contract work and to pay prudent business expenses not otherwise reimbursable. Income earned on such reserve should be considered in determining the amounts of future management allowances. Also, the guidelines should include samples of the types of business expenses to be paid from the reserve and examples of those expenses that are not allowable.

The allowance should not include any amount for independent research, since such research, when considered desirable, should be authorized as an allowable cost. Also, the allowance should not include any amount for acquisition of capital assets since they should be provided by the Government or covered in the contract as an allowable cost. Similarly, allowances should not be provided for accumulation of working capital since the sponsoring agency

should furnish the working capital through use of an advance-payment plan or a letter-of-credit arrangement.

The guidelines should provide, that, in those exceptional cases where facilities or equipment are acquired from fees or other resources provided by the Government, the Government have an enforceable equity in the assets. A similar provision should be made for assets held in the form of a stability reserve. The guidelines should also specify the circumstances under which the Government would exercise its rights to these assets, such as dissolution of the organization, discontinuance of sponsorship by the Government, or reduction of the Government's contracts to the point where they no longer represent the preponderance of the organization's sales.

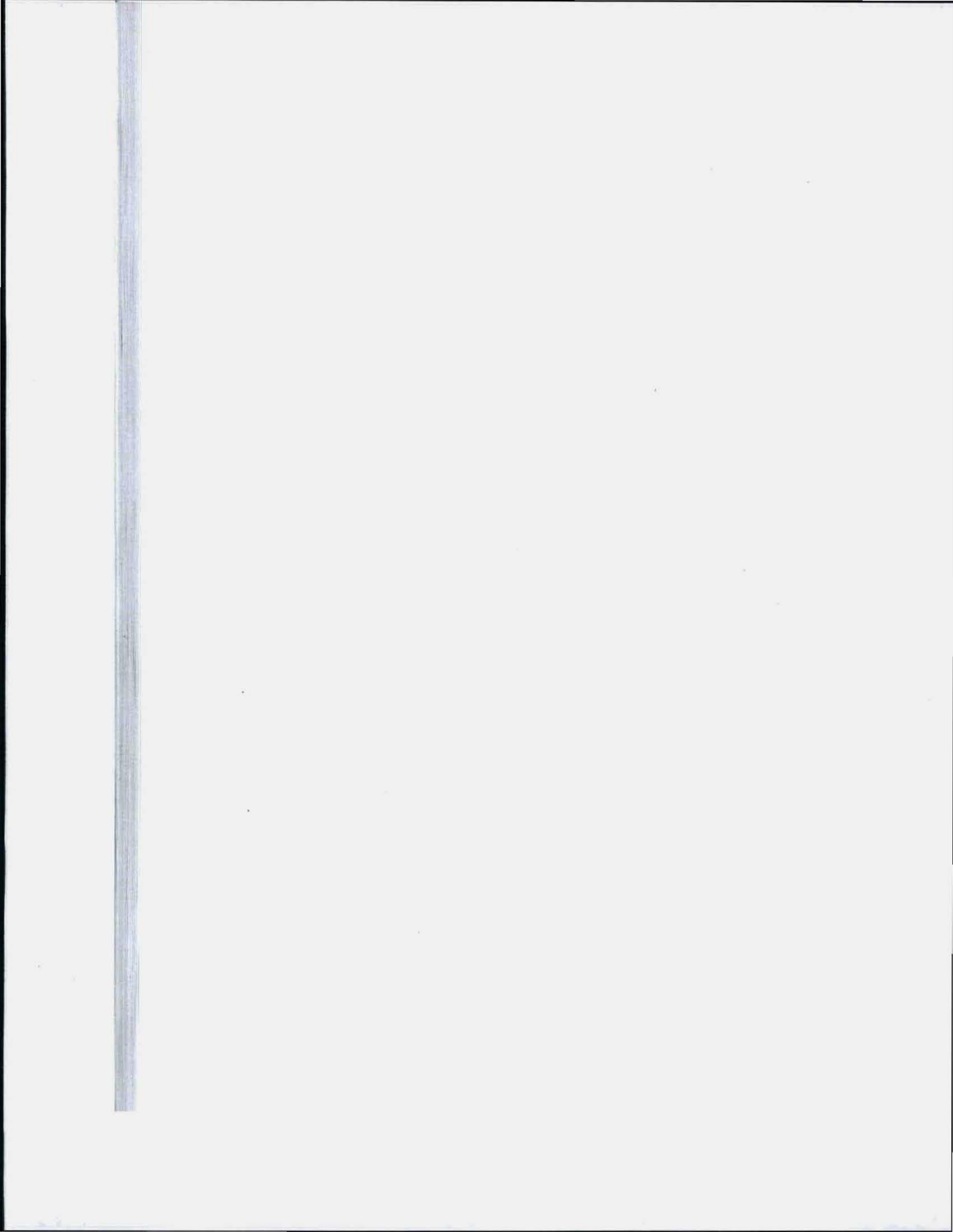
2. That the Bureau of the Budget and the Civil Service Commission conduct a study to follow up on the findings of the Bell Report with respect to what types of organizations could best assist the Government in fulfilling research and development missions.

This study should include consideration of the desirability and feasibility of establishing Government Institutes to meet future needs of Government agencies. Such study should include criteria as to the circumstances under which research tasks should be performed within the Government, by a sponsored nonprofit organization or by other organizations, such as independent nonprofit research institutions, educational institutions, and profit-seeking companies.

SCOPE OF SURVEY

Our survey was conducted at 15 nonprofit contractor locations: 12 nonprofit organizations sponsored by DOD, AEC, or NASA and three independent nonprofit institutions. A list of these nonprofit organizations is included as appendix I of this report. Also, we obtained information on the use of nonprofit organizations by other agencies, including HEW and NSF.

We inquired into the practices of Government agencies in the payment of fees to nonprofit organizations and the methods used to establish the amount of fee when fees were allowed; the uses made of fees by nonprofit organizations; the extent to which Government fees were used by nonprofit organizations to conduct independent research and the measures taken by the Government to direct the research into areas of interest to the Government; the extent to which fees have been provided by the Government in order for the nonprofit organizations to acquire facilities, and the rights the Government has to these assets upon contemplated disposition of the assets or dissolution of the nonprofit organizations; and the justification of the nonprofit organizations' need to retain fees and accumulate cash reserves for use as working capital and for financial stability in times of contract interruption or termination.



APPENDIXES



NONPROFIT ORGANIZATIONS AT WHICH INFORMATION
WAS OBTAINED FOR OUR SURVEY

	Organized	Annual operating level (in millions)	Sponsor	Effort for sponsor (note a)	Income from Government fees		
					Period	Amount (in millions)	Rates
GOVERNMENT SPONSORED NONPROFIT ORGANIZATIONS:							
Aerospace Corporation, El Segundo, California	1960	\$ 75	Air Force	99%	1961-67	\$21.7	3.5%-6.0%
Institute for Defense Analyses, Arlington, Virginia	1956	15	DOD	100	1963-67	2.8	4.1-5.4
Logistics Management Institute, Washington, D.C.	1961	1	DOD	100	1962-67	.3	4.3-6.0
Research Analysis Corporation, McLean, Virginia	1961	12	Army	83	1962-67	2.4	4.7-5.0
The MITRE Corporation, Bedford, Massachusetts	1958	38	Air Force	95	1958-67	14.2	3.0-6.6
The Rand Corporation, Santa Monica, California	1948	22	Air Force	70	1948-66	13.6	4.7-6.0
Applied Physics Laboratory, Silver Spring, Maryland (note b)	1942	50	Navy	90	1942-67	14.3	AVG. 3.1
Brookhaven National Laboratory, Upton, New York (note b)	1946	48	AEC	80	1963-67	2.3	1.0-1.3
Center For Naval Analyses, Arlington, Virginia (note b)	1962	9	Navy	100	1964-67	1.0	2.9-5.4
Human Resources Research Office, Alexandria, Virginia (note b)	1951	4	Army	90	-	No Fees (note c)	-
Jet Propulsion Laboratory, Pasadena, California (note b)	1939	210	NASA	99	1961-67	8.7	0.6-0.8
Lincoln Laboratory, Lexington, Massachusetts (note b)	1951	64	Air Force	50	-	No Fees	-

^aRepresents only the effort for the sponsor specified on this schedule. Most of these nonprofits perform all, or practically all, their work for Government agencies.

^bGovernment sponsoring agencies contract with educational organizations for the operation of these nonprofits.

^cBeginning July 1, 1967, contract provides for amount equal to about 1 percent of estimated overhead costs, to be used as a Director's fund. (See p. 35.)

NONPROFIT ORGANIZATIONS AT WHICH INFORMATION
WAS OBTAINED FOR OUR SURVEY

	Organized	Sales to Government		Fees on Government contracts			Average rate	
		Period	Amount (in millions)	Percent	Period	Amount		Of total income (note b)
INDEPENDENT NONPROFIT INSTITUTIONS:								
Stanford Research Institute Menlo Park, California	1946	1966	\$43	80%	1964-66	\$7.7 million	72%	6.67%
The Franklin Institute, Philadelphia, Pennsylvania (note a)	1824	1964-67	18	89	1964-67	898,000	87	5.2
Woods Hole Oceanographic Institution, Woods Hole, Massachusetts	1930	1964-66	25	100	1964-66	720,000	40	4.3

^a Figures represent Franklin's laboratory research contracts only; does not include fees from contract for operating CNA or income from activities in which the Government does not participate.

^b Total income includes, to the extent applicable, fees on Government and commercial contracts, endowment income, donations, membership fees, etc.

PRINCIPAL OFFICIALS OF
THE DEPARTMENT OF DEFENSE
THE UNITED STATES ATOMIC ENERGY COMMISSION, AND
THE NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
RESPONSIBLE FOR THE ADMINISTRATION
OF ACTIVITIES INCLUDED IN THIS SURVEY

	Tenure of office	
	From	To
<u>DEPARTMENT OF DEFENSE</u>		
SECRETARY OF DEFENSE:		
Clark M. Clifford	Mar. 1968	Jan. 1969
Robert S. McNamara	Jan. 1961	Mar. 1968
DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING:		
John S. Foster, Jr.	Oct. 1965	Present
Harold Brown	May 1961	Oct. 1965
ASSISTANT SECRETARY OF DEFENSE (INSTALLATIONS AND LOGISTICS) (formerly Supply and Logistics):		
Thomas D. Morris	Sept. 1967	Present
Paul R. Ignatius	Dec. 1964	Sept. 1967
<u>ATOMIC ENERGY COMMISSION</u>		
CHAIRMAN:		
Glenn T. Seaborg	Mar. 1961	Present
GENERAL MANAGER:		
R. E. Hollingsworth	Aug. 1964	Present
<u>NATIONAL AERONAUTICS AND SPACE ADMINISTRATION</u>		
ADMINISTRATOR:		
Thomas O. Paine (acting)	Oct. 1968	Present
James E. Webb	Feb. 1961	Oct. 1968
DEPUTY ADMINISTRATOR:		
Vacant	Oct. 1968	Present
Thomas O. Paine	Mar. 1968	Oct. 1968
Vacant	Jan. 1968	Mar. 1968
Robert C. Seamans, Jr.	Dec. 1965	Jan. 1968
Hugh L. Dryden	Oct. 1958	Dec. 1965
ASSOCIATE ADMINISTRATOR FOR ORGANIZATION AND MANAGEMENT:		
Harold B. Finger	Mar. 1967	Present



DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING
WASHINGTON, D. C. 20301

24 APR 1968

Mr. William A. Newman, Jr.
Director, Defense Division
U. S. General Accounting Office
Washington, D. C.

Subject: GAO Draft Report of February 12, 1968,
"Survey of Fees of Nonprofit Organizations"

Dear Mr. Newman:

We have reviewed the subject draft report and, although we recognize no GAO investigation was specifically conducted in regard to the following, we are pleased to note that there is no evidence in the report to suggest that:

- a. The various classes of use to which the DoD sponsored not-for-profit (FCRC) organizations are applying their fee monies are unwarranted, and
- b. Fees are being expended within these classes in unlawful or irregular ways.

We are also pleased to note that the GAO agrees that it is appropriate that those funds which are furnished to FCRC's as a "fee" be expended at the discretion of the FCRC managements, subject to disclosure of use and to some degree of consideration in subsequent contract negotiations.

Specific comments on the Report are as follows:

- a. The Report implies that the "needs" approach to setting fees is the only acceptable approach, in contrast to the modified weighted guidelines approach now in use throughout DoD under ASPR 3-808.2. Your attention is called to the fact that this latter approach was adopted in late 1966 specifically for the purpose of offsetting some of the weaknesses the "needs" approach was considered to have. Our primary objection to negotiation of fee based on need is that it fails to give recognition to merit, excellence of effort, past achievements, quality of effort, and other such factors.

We continue to be concerned with the accumulation of assets by "sponsored" nonprofit organizations. This concern has prompted

us to instruct DoD activities sponsoring such organizations to provide to the Deputy Secretary of Defense periodic reports identifying capital accumulations which appear to be unreasonable or unwarranted and advise him of the action taken to correct the condition. These reports will serve as a basis for reviewing the adequacy of our policies.

- b. DoD does not concur that the covering of certain designated classes of FCRC expenses on a cost-reimbursable basis rather than by fee automatically gives DoD better or more desirable control over these expenditures. Nor does it concur that FCRC management discretion regarding certain types of otherwise discretionary expenditures should not be permitted beyond some "modest amount."
- c. DoD concurs that advance payments and possibly letters of credit should be used wherever the specific circumstances indicate that such methods of financing are desirable.
- d. Your attention is called to the fact that it is DoD policy to encourage contractors to furnish their own facilities, rather than DoD do so, unless specific circumstances dictate to the contrary.
- e. DoD questions the implication that FCRC diversification per se is automatically bad. Properly controlled diversification seems to have been of benefit so far, in fact.

Government Institutes do warrant further study. However, it appears that this topic is outside of the scope of a review of nonprofit fees. It should probably be handled separately, therefore.

In summary, in view of the extensive study which led us to adopt the modified weighted guidelines approach and the fact that it has not been in effect for a sufficient period to assess its effectiveness, we do not concur in your proposal that the Congress prescribe guidance along the lines you suggested.

Sincerely,


John S. Foster, Jr.



UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

APR 9 1968

Mr. C. P. Pin
Associate Director
Civil Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Pin:

In accordance with the request in your February 12, 1968, letter, we have reviewed the draft of the proposed report to the Congress on the results of GAO's survey of fees of nonprofit organizations and offer the following comments for your consideration.

The only nonprofit organization referred to in the report with whom AEC has a contract is Associated Universities, Inc. (AUI) which operates the Brookhaven National Laboratory. The GAO statements relating to AUI are factual and we have no comments or suggestions to make.

The draft report concludes that the many different forms of nonprofit organizations being sponsored by agencies of the Federal Government, and the corresponding differences in the amount of fees allowed, indicate that there is a need to establish guidance to the agencies for use in negotiating fees with these organizations. To meet this need, the draft report recommends to Congress that a statement of governmental policy be enacted to provide guidance to Government agencies in negotiating fees with Government-sponsored nonprofit organizations. The draft report recommends five points for consideration in developing this Government-wide policy. Before commenting on the details of the report, we would like to make some general comments about the basic recommendation to establish a Government-wide policy.

Sponsored nonprofit organizations provide a degree of independence in scientific and technical operations, which contributes to the Government agencies' ability to carry out their programs. Most of these nonprofit organizations are not "adjuncts" or "extensions" of

Mr. C. P. Pin

the Government as suggested in the GAO draft report; they are essentially separate entities and, as such, entitled to a commensurate degree of independence and flexibility. Consistent with this concept the most important reason for paying "fees" to these organizations is to permit them a certain amount of latitude regarding costs that may be incurred.

As your report notes, the nonprofits vary considerably in organization, mission, and relationship to their respective sponsoring agencies. The use of nonprofit organizations enables the sponsoring agencies to tailor the organizations to their special programmatic needs. Even the nonprofits sponsored by the same agency will be different, depending on the mission and operating situation. The considerations upon which the fees are based will and should vary with the different types of nonprofit organizations and the different environments in which they operate. For example, in one case it may be appropriate for a nonprofit to acquire capital assets or perform independent research; in another case it may not be. In view of the foregoing, we do not feel that it would be practical or feasible to develop a Government-wide fee policy which would be appropriate for all these situations. We are therefore concerned that the detailed Government-wide fee policy proposed in the draft report may have the effect of reducing the independence and flexibility of the sponsored nonprofit organizations and would be inconsistent with the nature and purpose of these organizations.

We agree with the objective to keep fees reasonable. In our view, the best way to assure that fees are reasonable is not to establish detailed ground rules as proposed by GAO but rather for each agency to carefully review the details that the non-profit organizations submit in support of their requests for fee to determine if the items included are reasonable in relation to factors such as the type of organization, mission, local conditions, and past experience.

For the reasons discussed above, we do not agree that there is a need for Government-wide guidelines. In our opinion the draft report does not offer evidence that demonstrates there is such a need. However, if GAO should decide to recommend in its final report that a Government-wide fee policy be adopted, we would urge that such a policy be stated in broad terms that provide sufficient flexibility to meet the varying needs of the different nonprofit organizations and their sponsoring agencies.

Mr. C. P. Pin

Subject to the above general comments, we have the following comments on some of the specific points made in the draft report.

The draft report states that its proposed guidelines would be applicable to "sponsored nonprofits which perform work primarily for the Government, with one or two agencies agreeing to be responsible for providing the major financial support, as distinguished from private, independent nonprofit institutions". After reviewing the detailed comments in the draft report, it is not clear to us just what types of organizations are intended to be encompassed by this definition. For example, the RAND Corporation would not presently seem to meet this definition, but since it is discussed in the report as being a sponsored nonprofit organization, we assume GAO would intend any Government-wide policy to apply to RAND. In view of the many types of Government-sponsored nonprofit organizations that do exist, we believe the report should be very precise in defining the organizations it intends its recommendations to cover.

The draft report recommends five points for consideration in developing a Government-wide policy. While we recognize that any of these points might have merit in a given situation, we do not believe they are appropriate for uniform, Government-wide application. Only the individual agencies are in a position to realistically determine if these points should be applied in a particular situation and, if so, the extent and manner in which they should be applied. Our comments on the individual points are presented in the same order as they appear in the report.

Item No. 1. The draft report states that:

"The fee negotiated with sponsored nonprofit organizations should be designed to (a) enable accumulation of a reserve to provide operational stability during temporary reductions in contract work, and (b) permit appropriate flexibility in operations."

We agree that as a general rule it is appropriate that the reserve accumulated to provide operational stability should be limited to an amount required to maintain operations for a specified short period of time or to an amount required for some other legitimate reason, and that once the agreed level is reached no further amount should be negotiated for such purpose until the balance falls below the agreed-to limit. We also agree that as a general rule the

Mr. C. P. Pin

Government should be given residual right to balances remaining in the reserve. However, we do provide sometimes that a nonprofit contractor can retain a designated amount of the accumulated reserve upon dissolution. We would not want a rule that is so inflexible as to not permit this.

Regarding the use of the fee to permit appropriate flexibility in operations, the report states that the fee should be sufficient to pay necessary business expenses which are not reimbursable under the procurement regulations, such as entertainment, advertising, bad debts, contributions, and so on; but fee should not be used for the payment of expenses which are of an allowable nature but exceed the limits for such costs established in the contract, such as first-class air travel and salaries. We believe an unnecessary distinction is being made between these two types of costs. In our view, almost any type of business expense may be appropriate for inclusion in the fee, including direct or indirect allowable costs that are normally reimbursed under the contract. The key to control, as we see it, is not to attempt to list expenses that are not appropriate for inclusion, but rather to carefully review the details supporting the request for a particular fee when it is being negotiated, including a review of the contractor's past fee expenditures, and evaluate the merits of each item requested in terms of the particular situation.

Item No. 2. The draft report recommends that no amount for independent research should be included in the negotiated fee. The report further recommends that:

"To the extent feasible and desirable, funds should be provided for the organization to conduct independent research on a reimbursable basis. The research should relate to the purposes of the organization, but the nonprofit should have independent authority in selecting the research to be performed, including the authority to acquire limited facilities needed for such research."

Independent research which would be conducted on a reimbursable basis and which must "relate" to the purposes of the organization would not truly be "independent". We recognize however that there are legal and budgetary problems when programmatic funds provided for contract work are used to reimburse contractor costs which do not "relate" to the contract work, i.e., are not necessary or incident to the performance of the contract. Since the ability to conduct

Mr. C. P. Pin

truly independent research is an attribute of the independence of the nonprofit organization, we believe the solution is to permit the inclusion of a modest amount in the fee for such research when the circumstances warrant. If in a given case, as the draft report suggests, a contractor uses funds provided in the fee for independent research for some other purpose, this factor can be taken into consideration when negotiating a fee for a subsequent period.

Item No. 3. The draft report states that no amount should be included in the fee negotiated to enable sponsored nonprofit organizations to acquire capital assets. While we agree that as a general rule no significant amounts should be included in the fee for the purpose of acquiring capital assets, we believe this is an item that must be examined on a case-by-case basis. Furthermore, we consider it appropriate to permit the use of fee to acquire office furniture, office equipment, etc., so long as the amount is reasonable.

We agree that in those cases where significant capital assets are acquired with funds provided in the fees the Government should have contractual rights to the assets upon dissolution of the organization.

Item No. 4. The report states that fees should not be provided for the purpose of enabling the organization to accumulate its own working capital. We have no particular problem with this item, apart from our general comments made at the outset of this letter.

Item No. 5. It is recommended that where the nonprofit organization performs services for more than one agency, the sponsoring agency should be designated to negotiate the fee arrangements. This recommendation presupposes a degree of uniformity in various Government agency arrangements that does not exist. We believe it is preferable to allow each agency to conduct its own negotiations.

Use of Government Institutes

The draft report states:

"In view of the continuing and growing use of nonprofit organizations to assist Government agencies in carrying out their missions, we suggest that consideration be given to enacting enabling legislation for the establishment of Government institutes to meet future needs."

Mr. C. P. Pin

We assume this statement is only intended to reflect the proposal in the Bell Report that consideration be given to the establishment of Government institutes as a means of achieving the kind of flexibility desired in the administration of certain research and development programs. However, the statement could be interpreted as suggesting that Government institutes be substituted for sponsored nonprofit organizations. If this is the intent of the statement, we strongly disagree with any proposal that would make it mandatory for agencies to meet future needs through Government institutes rather than sponsored nonprofit organizations.

Sincerely yours,


General Manager



NATIONAL AERONAUTICS AND SPACE ADMINISTRATION
WASHINGTON, D.C. 20546

IN REPLY REFER TO:

D

APR 5 1968

Mr. Clerio P. Pin
Associate Director
Civil Division
U.S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Pin:

We appreciate the opportunity to comment on the GAO draft report to the Congress on "Survey of Fees of Nonprofit Organizations, DOD, AEC, and NASA."

The draft report presents data indicating significant differences in the business arrangements which characterize the Government's work with various nonprofit organizations. It would appear desirable to evaluate the results obtained in relation to the various arrangements before attempting to establish statutory criteria on fees. As NASA has carried out its programs, we have worked to establish relationships with industrial, university, and Government institutions so that the capabilities of these established institutions to do our work as well as other work were simultaneously strengthened. Our objective has been to use, develop, and adjust the capabilities of these institutions to meet current needs as well as the needs of evolving Government programs. Establishment of new types of organizations, such as the Government institutes referred to in the Bell report and suggested in the GAO draft report, may not be desirable or necessary in providing the capabilities needed.

We observe that nonprofit organizations do not readily lend themselves to easy classification and that the draft report does not resolve the definitional problems which exist. For example, the California Institute of Technology cannot be considered a nonprofit organization which is sponsored by the U.S. Government. The fact that the Institute operates the Jet Propulsion Laboratory for NASA and is paid a management fee

does not, in our opinion, justify the characterization of Caltech as a Government sponsored organization. It is our view that statutory criteria on fees for nonprofit organizations could cause an inflexibility of approach that is unwarranted at this time.

If you wish to discuss our views on any of the above matters in any further detail, we will be happy to do so.

Sincerely yours,

A handwritten signature in cursive script, reading "Harold B. Finger". The signature is written in dark ink and is positioned above the typed name and title.

Harold B. Finger
Associate Administrator for
Organization and Management

NATIONAL SCIENCE FOUNDATION
OFFICE OF THE DIRECTOR
WASHINGTON, D.C. 20550

May 14, 1968

Mr. Frederick K. Rabel
Assistant Director, Civil Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Rabel:

This is in reply to your letter of February 16, 1968, furnishing the Foundation copies of the draft of the GAO proposed report to the Congress entitled, "Survey of Fees of Nonprofit Organizations."

The following comments are presented for the consideration of the GAO in preparing the final report. The comments have been directed to the Recommendations to the Congress. Since the question of fees to nonprofit organizations is complicated somewhat when viewed on a Government-wide basis, we have also included some general observations which we believe are pertinent to the development of a policy for use in determining fees for nonprofit organizations. Our comments reflect primarily the relevant experience of the Foundation with university-sponsored nonprofit organizations, such as Associated Universities, Inc., who act as management contractors for the National Research Centers supported by the National Science Foundation.

One of the primary considerations in the negotiation of fees with nonprofit organizations, in our judgment, is the relationship existing between the Government and the nonprofit organization. This relationship is influenced by the extent to which the organization is dependent upon Government funding for carrying out its programs. We believe that if the organization is engaged primarily in work in the private sector of our economy and only incidentally is engaged in work for the Government, fee negotiations should be conducted within the policies presently established for negotiating fees with commercial organizations. If, on the other hand, the nonprofit organization derives essentially all of its revenues from programs supported by Government agencies, we believe fee negotiations should be conducted within the framework of a policy developed specifically for nonprofit organizations. Therefore, we suggest that any policy guidance that is developed for use in determining fees with nonprofit organizations should be applicable to any nonprofit organization which derives essentially all of its revenues from programs supported by Government agencies and not be limited to so-called sponsored nonprofit

organizations. This would permit the policy to be used in negotiating fees with organizations such as Stanford Research Institute (SRI) and Woods Hole Oceanographic Institution, both of which, as indicated in the report, are primarily dependent upon Government agencies for funding program activities even though neither falls into the category of a sponsored nonprofit organization as the term is used in the report.

In addition, we believe that any policy that may be developed should be flexible and recognize the different relationships existing between Government agencies and nonprofit organizations sponsored by or primarily dependent upon the Government. The Foundation believes that the relationships with and the responsibilities to nonprofit organizations primarily dependent upon Government funding differ significantly within and between Government agencies. To illustrate, the Foundation's relationships with and responsibilities to the contractors who manage the National Research Centers are not the same as the relationships with and responsibilities to organizations such as The RAND Corporation or SRI even though each is a nonprofit organization which derives either all or substantially all of its revenues from programs supported by Government agencies.

Likewise, the Foundation's relationships with and responsibilities to organizations such as The RAND Corporation or SRI differs from that of other Government funding agencies that have a predominant share of the workload or that may have been instrumental in the establishment of such organizations. Where different relationships and responsibilities do exist, the basis upon which a fee should be determined and what constitutes the appropriate use of such fee may differ significantly. The Foundation's policy, as indicated on page 30 of the report, provides that fees under the contracts for the National Research Centers shall be determined on a need basis. Once the fee is paid to the contractors, it becomes a corporate asset. The contractors, however, are required to submit information annually relating to fee expenditures. This information is reviewed and used to determine fees prospectively. While this policy works well with respect to the establishment of fees under contracts for the management of the National Research Centers, we recognize that the strict application of such a policy could present problems to other Government funding agencies when faced with circumstances different from those existing between the Foundation and contractors managing the National Research Centers, and would even present problems to the Foundation in attempting to negotiate fees under its cost-reimbursable contracts with nonprofit organizations such as The RAND Corporation and SRI.

We question whether the fees negotiated and paid to nonprofit organizations subject to the proposed policy should be referred to as fixed fees since the term, as used in contracts with such

organizations, has a different connotation than it has when used in contracts with commercial organizations. In the case of our contracts for the National Research Centers, fee payments are intended to cover corporate expenses and to permit the corporation to accumulate a reasonable reserve. The use of the term "fixed fee" to identify amounts negotiated and paid to cover such corporate needs may in our opinion be somewhat misleading and, therefore, we believe it might be advisable in any policy that may be developed to discontinue the term "fixed fee" and instead refer to the amounts negotiated and paid by some other title such as "corporate fee," or "management fee."

We endorse the suggestion made in the report that fees negotiated with so-called sponsored nonprofit organizations enable them to pay legitimate business expenses which are unallowable under the applicable cost principles of Government procurement regulations, recognizing that the amounts negotiated for such purposes should be based on the reasonable needs of the corporation.

Recommendation (Unnumbered)

A statement of governmental policy be enacted to provide guidance to Government agencies in negotiating fees with Government-sponsored nonprofit organizations.

Foundation Comment

The Foundation agrees with the recommendation. As indicated in the introductory comment, however, the enactment of any such statement of Government policy will present problems. In our judgment any such policy should be sufficiently flexible to recognize different contractual arrangements and corresponding differences in relationships and responsibilities between the Government agencies and each contractor organization.

We believe some clarification might be advisable with respect to the policy guidelines suggested by the GAO. The report states that "The policy should provide that the fees, once determined by negotiation, would belong to the contractor. However, to assure appropriate use is made of the fee, disclosure should be required and used as a factor for consideration of the amount of fees negotiated in the subsequent year." The Foundation has some question with respect to the type of policy guidance that might be required to

assure appropriate use is made of the fee. The Foundation's own policy provides that the fee payment becomes a corporate asset. Limitations are placed upon the expenditures of such fees, however, since no portion of the fees are to be used to support Center-related activities which, because of statutory or regulatory limitations, cannot be charged directly to the contract or would be contrary to the express wishes of the Congress. In addition, as a further means of reviewing such expenditures, the Foundation requires an annual accounting of fee expenditures and establishes fees for subsequent periods on a need basis. We feel the type of review we now exercise assures appropriate use of fees. In determining appropriate use, however, we concern ourselves with categories of cost and the overall reasonableness of expenditures within such cost categories and are not concerned with a detailed review of actual expenditures as is necessary with reimbursable cost. We would want any policy to cover this point so as to avoid any misunderstanding concerning the extent to which fee expenditures should be reviewed.

In addition, we note that the policy statement cited above indicates that fees will be negotiated each year. The Foundation, as you know after many years of experience negotiating fees on an annual basis negotiated a fee for a five-year period in one of its contracts for the National Research Centers. We believe, as we previously advised the GAO, that the time period to be used for fee negotiations is a matter of judgment. In some instances, in our opinion, the negotiation of fees for periods covering two or more years is advantageous and consequently we would want any policy developed to provide the agencies with some latitude in the selection of time periods and not be limited to one year.

Recommendation (1)

The fee negotiated with sponsored nonprofit organizations should be designed to (a) enable accumulation of a reserve to provide operational stability during temporary reductions in contract work, and (b) permit appropriate flexibility in operations. (Page 73)

Foundation Comment

The Foundation is in substantial agreement with the above recommendation as indicated in the NSF fee policy quoted on page 30 of the draft report. We believe, however, some clarification would be useful concerning policy provisions which permit the accumulation of a reserve to provide operational stability during temporary reduction in contract work. Operational

APPENDIX VI

Page 5

stability as used in the policy statement by the Foundation concerns primarily the operations of the corporate activity and not the operations of the research centers which are funded under contract.

The Foundation would be opposed to providing fee to contractors operating National Research Centers to accumulate a reserve for use during temporary reduction in contract work. It is the position of the Foundation that the costs of operating the facilities involved are properly a contract cost and should be provided for under the contract awarded for the operation of the facilities.

While the need to accumulate a reserve to provide operational stability during temporary reductions in contract work has not existed with respect to NSF contractors managing the National Research Centers, we recognize that the problem may exist with other nonprofit organizations who operate Government-owned facilities or are primarily dependent upon Government funding to support their programs. Where such a need exists we would favor policy provisions enabling nonprofit organizations to accumulate reserve money which would help cover the cost of operations during reductions in contract workload. This need, as we see it, would exist primarily where the costs of operations are funded under several contracts and the costs of operations are allocated thereto on a prorata basis, as opposed to our Center contracts where all costs of operations are charged direct to an NSF contract.

Recommendation (2)

No amount should be included in the fee negotiation for independent research. (Page 75)

Foundation Comment

The Foundation agrees with the recommendation and with the idea expressed that to the extent feasible and desirable, funds should be provided under contracts for independent research. We do not believe that special provisions are needed to achieve these objectives under contracts for the National Research Centers. The directors of the Foundation-supported National Research Centers play a significant role in the processes of determining the broad guidelines governing the programs of their respective centers and have sufficient flexibility in implementing these guidelines to achieve the objectives for which "independent research funds" are provided to other organizations.

Recommendation (3)

No amount should be included in the fee negotiation to enable sponsored nonprofit organizations to acquire capital assets. (Page 75)

Foundation Comment

The Foundation does not agree with the recommendation. We believe that nonprofit organizations, sponsored and nonsponsored, frequently have the need to acquire capital assets in conducting their corporate activities and should not be restricted in this area because their only source of such funds is from fees. With respect to nonprofit organizations, particularly so-called sponsored nonprofits, that derive either all or essentially all of their funds for corporate activities from fixed fees under Government contracts, however, we would recommend that any fee policy developed provide that any charges to the Government for the use of capital assets acquired from such funds be exclusive of depreciation or similar charges.

The Foundation does agree that where sponsored nonprofit organizations acquire physical assets from fees or other resources provided by the Government, the Government should have equitable contractual rights to such assets upon dissolution of the organizations. The Foundation, however, is concerned with many questions that might arise in connection with the rights to such assets under many different possible sets of circumstances. We believe, for example, that any policy covering such rights should include provisions limiting (i) the right of contractors to convert such assets to cash in connection with contract completion or termination, and (ii) the rights to transfer such assets to any closely affiliated organization. The policy also should include some provision covering rights of the Government to assets of a sponsored nonprofit organization where fees are derived from many Government agencies.

Recommendation (4)

Fees should not be provided for the purpose of enabling the organization to accumulate its own working capital. Working capital should be furnished by the sponsoring agency to the nonprofit organization through use of an advance payment plan or a letter of credit arrangement, as prescribed by Treasury Department Circular No. 1075. (Page 76)

Foundation Comment

The Foundation agrees with the recommendation. The Foundation employs the letter of credit to provide contract funds to contractors operating the National Research Centers.

Recommendation (5)

Where the sponsored nonprofit organization performs services for more than one agency, the sponsoring agency should be designated to negotiate the fee arrangements. (Page 16)

Foundation Comment

The Foundation does not concur in this recommendation. The differences which currently exist between the fees provided to the same organization by several agencies result from the differences in the relationship of the work under each contract to the programs and objectives of the organization and those of the agency supporting the work. An artificially imposed rigidity of fee structure would deny the existence of these very real differences. We believe that the establishment of general principles governing fee negotiations and a requirement for coordination among the agencies involved will achieve the basic objective of this recommendation while avoiding the undesirable effects which normally result from very rigid restrictions on administrative discretion.

Suggested Recommendation

In view of the continuing and growing use of nonprofit organizations to assist Government agencies in carrying out their missions, that consideration be given to enacting enabling legislation for the establishment of Government Institutes to meet future needs. (Page 77)

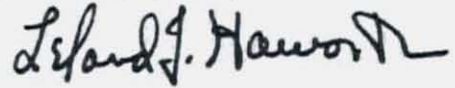
Foundation Comment

The Foundation believes it would be worthwhile to explore this idea further but would prefer to reserve comment on the establishment of Government Institutes. While the question of Government Institutes relates to sponsored nonprofit organizations, we believe it should be handled as a separate problem. The Foundation would be pleased to participate in a review within the Government of such Institutes and how they might be effectively employed in carrying out specific missions of Government agencies.

While we have limited our comments on the report to the Recommendations to the Congress, we endorse the survey of fees of nonprofit organizations and believe it will be helpful in initiating a policy study and ultimately establishing guidelines which will be beneficial.

to agencies concerned with such organizations. The Foundation would be pleased to participate in any study which may be necessary to establish a Government-wide policy to provide guidance to Government agencies in negotiating fees with Government-sponsored nonprofit organizations.

Sincerely yours,

A handwritten signature in cursive script that reads "Leland J. Haworth". The signature is written in dark ink and is positioned above the typed name.

Leland J. Haworth
Director

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF SCIENCE AND TECHNOLOGY
WASHINGTON, D.C. 20506

June 3, 1968

Dear Mr. Crawford:

I very much appreciate your providing me with an opportunity to comment on the draft report on the GAO survey of fees of Government-sponsored non-profit organizations. The report is thorough and in general comes to very sensible conclusions.

In particular, I am in agreement with the following recommendations in the report:

1. The negotiated fee should provide a financial reserve for operational stability, and should provide for flexibility by permitting payment of necessary business expenses which are not reimbursable.
2. The Government should have contractual rights, upon dissolution of a non-profit organization, to capital assets acquired with Government resources.
3. Fees should belong to the contractor, with full disclosure of use required.

On the questions of use of fee to acquire capital assets, or to accumulate working capital, I defer to the experienced judgment of the agencies involved. On the question of use of fee to conduct independent research, I understand that GAO is preparing a separate report on this subject, and would prefer to comment after having the benefit of that study. I tend to agree that it is preferable for independent research to be reimbursable, but this approach may in some cases limit the true independence of the research and corresponding decrease the organization's ability to attract the best people.

A primary recommendation of the report is that there be a statement of governmental policy to provide guidance to Government agencies in negotiating fees. If such a uniform policy statement is needed, I would think it appropriate to make this a management issuance along the lines of a Bureau of the Budget Circular, rather than to enact legislation for this purpose. The gravity of the problems cited in the draft report does not seem to me to justify legislative status. In any case, I would hope that any statement of policy would avoid excessive inhibition of the very flexibility which the concept of the Government-sponsored non-profit organization is intended to provide.

I was very pleased to see in the draft report a recommendation that consideration be given to enacting enabling legislation for the establishment of Government Institutes, along the lines recommended in the Bell Report, to meet future needs. This recommendation has my wholehearted support.

Sincerely,



Donald F. Hornig
Director

Mr. Irvine M. Crawford
Assistant Director
Civil Division
U.S. General Accounting Office
Washington, D.C.



DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
WASHINGTON, D.C. 20201

OFFICE OF THE SECRETARY

APR 3 1968

Dear Mr. Poskaitis:

The Secretary has asked that I reply to your draft report to the Congress covering your survey of fees of certain non-profit organizations sponsored by or doing business with the Department of Defense, the Atomic Energy Commission, and the National Aeronautics and Space Administration.

The report contains the findings of a survey conducted by GAO to determine whether fees paid to non-profit organizations sponsored by the government were in accordance with the purpose of the Report to the President on Government Contracting for Research and Development (The Bell Report).

The report is directed primarily toward an examination of Department of Defense contractors, now known as Federal Contract Research Centers. This Department has only a relatively small dollar volume of business with such organizations. Additionally, the Department does not generally create corporations to carry out its programs; although some may be created as a result of program support which we provide. Nevertheless the report raises policy issues that have implications for and relevance to our general relationships with non-profit organizations. Consequently, the report is of interest to us and we are grateful for the opportunity to review it.

There is much in the report with which we concur. We agree that there is a need for government-wide guidelines on establishing and contracting with sponsored non-profit organizations. We would go further and suggest that there is a necessity for establishing guidelines on dealing with non-profit organizations which derive the preponderance of their support from the Federal government. Such guidelines might well include standards for evaluating the financial responsibility of such organizations and a mechanism for a coordinated approach to such evaluation where support is derived from several Federal agencies.

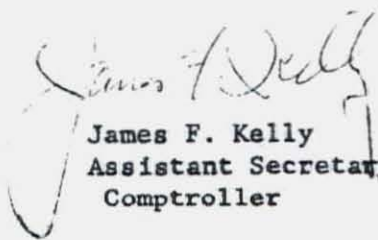
We also agree that, as a general rule, medicare being a notable exception, fees should not be used to fund the acquisition of facilities or be provided for working capital. But, we do not agree that fee should be used as a means of reimbursing unallowable costs.

As an alternative, we would support a reassessment of the concept of allowability that might perhaps bring it more into consonance with the normal costs of doing business. It also appears inappropriate to base the amount of fee on an analysis of how fee is being or has been used. This is inconsistent with normal fee concepts, which regard fee as a return on invested capital and a reward for risk and enterprise; and it would be unwise to create a potential for blurring the distinction between fee and cost.

The costs of independent or self-sponsored research create special problems for this Department. We sponsor research to a very substantial degree and employ study sections and advisory groups of outstanding researchers to assist us in identifying those projects which have sufficient scientific or technical merit to warrant our support. Accordingly it has seemed inappropriate to us to provide support indirectly, by reimbursing the costs of self-sponsored research, to projects which we may have rejected as ineligible for direct support.

We are endeavoring to develop policies which will guide us in our dealings with non-profit organizations and therefore appreciate the useful information and analysis which your report provides.

Sincerely yours,



James F. Kelly
Assistant Secretary,
Comptroller

Mr. R.J. Poskaitis
Assistant Director, Civil Accounting
and Auditing Division
U.S. General Accounting Office
Washington, D.C. 20548



DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D. C. 20410

OFFICE OF THE ASSISTANT SECRETARY
FOR ADMINISTRATION

IN REPLY REFER
ASA-3

APR 23 1968

Mr. Max Hirschhorn
Associate Director, Civil Division
United States General Accounting Office
Washington, D. C. 20548

Dear Mr. Hirschhorn:

At the request of Secretary Weaver, I am replying to the draft report to the Congress on the survey of fees of nonprofit organizations transmitted with your letter dated February 14, 1968.

This Department concurs with the recommendations pertaining to the exclusion of fee for independent research, acquisition of capital assets, accumulation of working capital and the designation of the sponsoring agency to negotiate fee arrangements where more than one agency is involved.

We believe additional consideration should be given to the matter of flexibility in operations so that the negotiated fee would not be designed to reimburse the nonprofit organization for unreasonable costs not allowable under Government cost reimbursement contracts. The guidelines should give careful consideration as to what items should be included in overhead costs as distinguished from nonallowable costs. The Bell Report recognized that the term "fee" as used in connection with nonprofit organizations was misleading, and used the terms "development" or "general support" allowance. We feel that either of these terms would be preferable to the continued use of "fee".

The guidelines should also contain criteria which will define sponsored nonprofit organizations as distinguished from those that are not sponsored and under what conditions they would change from one category to another.

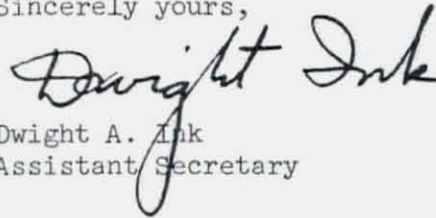
This Department also concurs with your recommendation that consideration be given to the establishment of Government institutes at sometime in the future. Such institutions may be organized as an additional or supplementary means of carrying out Government research and development, but not as a replacement for, or a conversion from nonprofit organizations.

The establishment of The Urban Institute will considerably strengthen the efforts of this Department. We now expect that the Institute will receive funds from the general research appropriations of this Department as well as from other Federal agencies and departments. Moreover, the Institute will develop a capacity to perform research for state and local governments as well as private bodies.

The establishment of Government institutes should in no way restrict the sponsoring governmental activity to the sole use of the institute for its research effort, but should provide for flexibility when selecting sources.

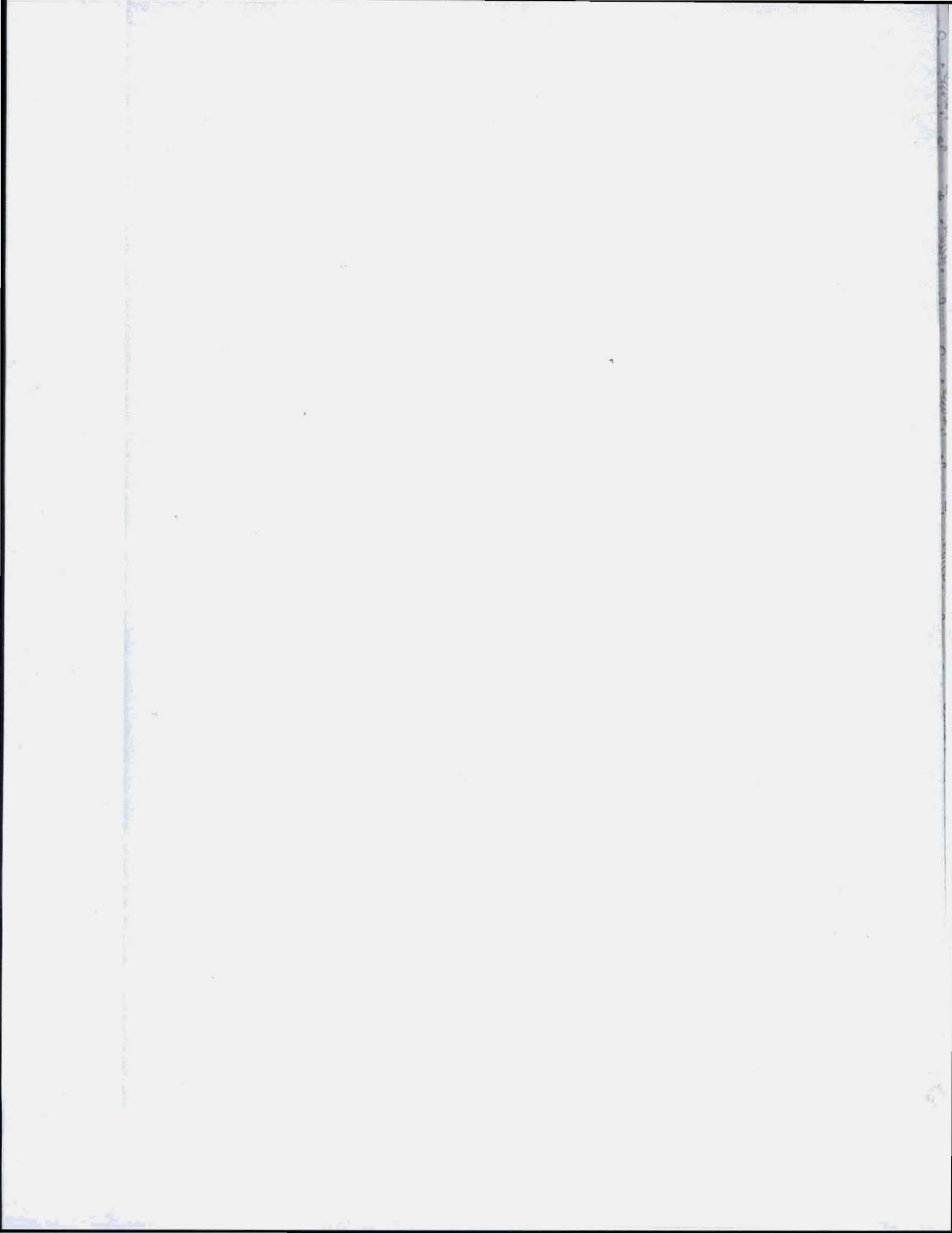
We appreciate the opportunity provided us to comment on the draft report.

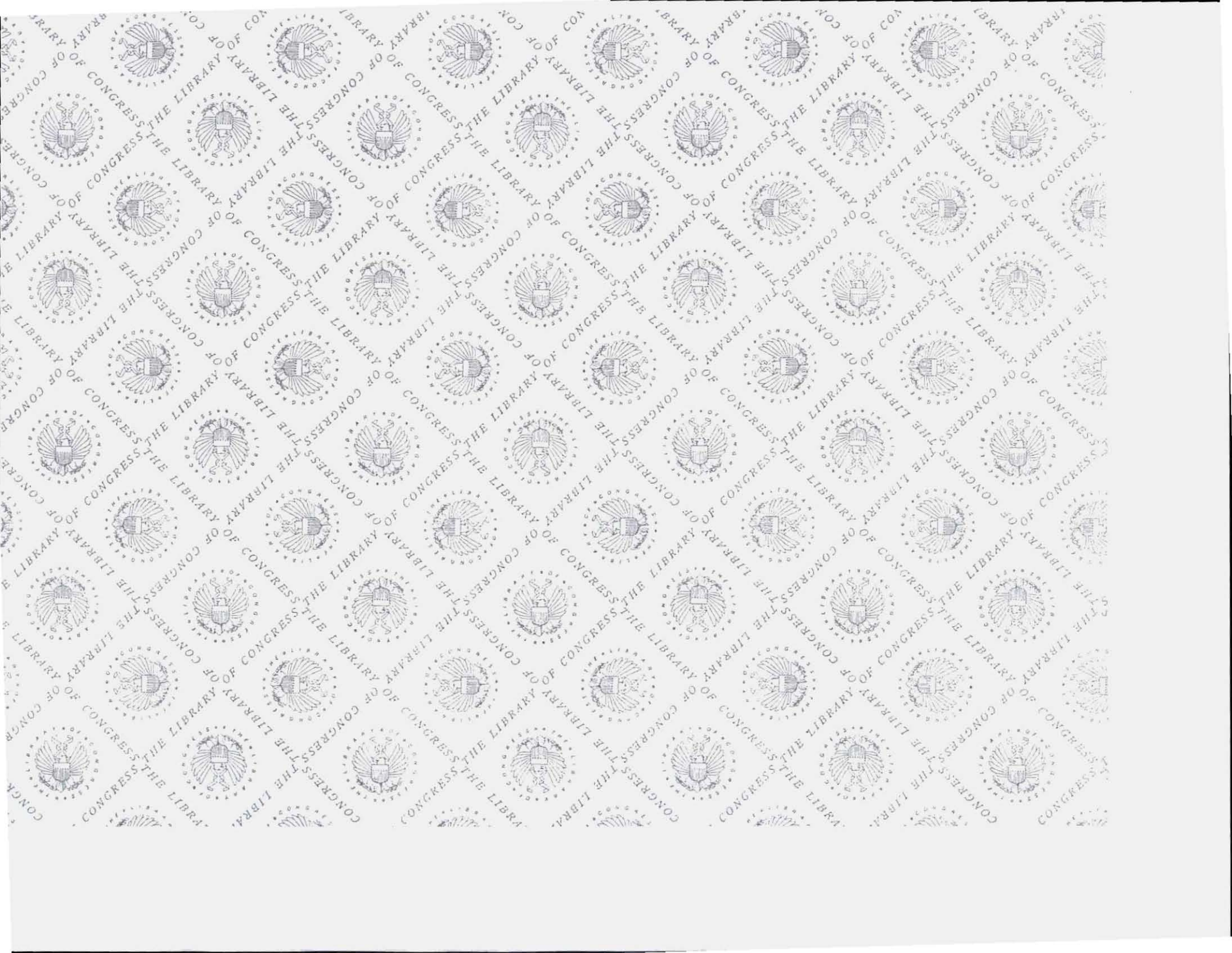
Sincerely yours,

A handwritten signature in cursive script that reads "Dwight Ink". The signature is written in dark ink and is positioned above the typed name and title.

Dwight A. Ink
Assistant Secretary

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MAY 71

N. MANCHESTER,
INDIANA