

October 1986

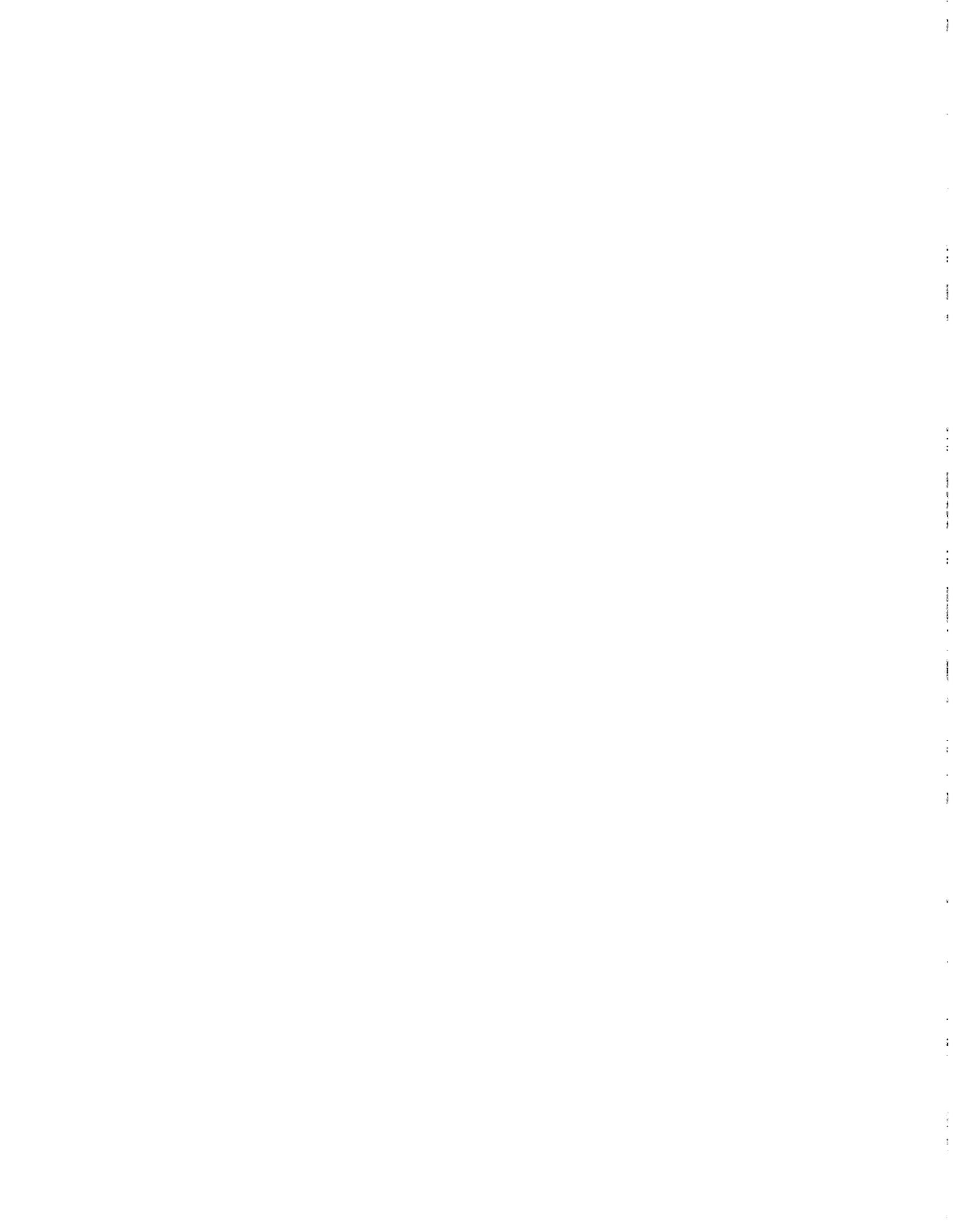
# UNALLOWABLE COSTS

## Improved Cost Principles Should Reduce Inconsistent Treatment of These Costs



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

Comptroller General  
of the United States

B-224782

October 10, 1986

The Honorable Barry M. Goldwater  
Chairman, Committee on Armed Services  
United States Senate

The Honorable William V. Roth, Jr.  
Chairman, Committee on Governmental  
Affairs  
United States Senate

The Honorable Les Aspin  
Chairman, Committee on Armed Services  
House of Representatives

The Honorable Jack Brooks  
Chairman, Committee on Government  
Operations  
House of Representatives

This is the initial report to the Committees under section 2324(j) of title 10, United States Code, as added by section 8112(a) of the Department of Defense (DOD) Appropriations Act, 1986, Public Law 99-190. Section 2324, which concerns allowable costs under defense contracts, requires us to evaluate DOD's implementation of the section to determine if the implementation is consistent with congressional intent, achieves the objective of eliminating unallowable costs charged to defense contracts, and could be improved or strengthened. This report will focus on changes made by DOD to the contract cost principles to implement section 2324.

Section 2324 specifies that 10 cost elements are unallowable under defense contracts. For an additional 16 cost elements, section 2324 requires DOD to amend its regulations, defining in detail and in specific terms those costs which are unallowable. The allowability of these 26 costs are determined by 14 cost principles. Section 2324 also requires DOD to amend the regulations governing the resolution of questioned costs.<sup>1</sup> DOD was required to prescribe these changes in regulations not later than April 7, 1986. A detailed statement on the requirements of section 2324 is included in appendix II.

<sup>1</sup>These are costs which the contractor has claimed are allowable, but which the contract auditor has questioned as unallowable. The contracting officer must resolve the question of allowability.

We found that DOD has taken significant strides to comply with the Congress' intent by prescribing new and amended cost principles within the directed time period. While we believe that the allowability criteria for all cost elements cannot be written in such a way as to remove all ambiguity, we found that DOD has directly addressed the allowability or unallowability of most of the costs listed in section 2324. The improved criteria for these costs and the amended resolution procedures prescribed by DOD through the Federal Acquisition Regulation (FAR)<sup>2</sup> should significantly improve overhead negotiations and reduce the inconsistent treatment of these costs.

However, we believe the contractor, contracting officer, and contract auditor could benefit if improvements were made in two cost principles. We recommend to the Secretary of Defense that the entertainment principle, FAR 31.205-14, and the executive lobbying principle, FAR 31.205-50, be amended in the following manner.

The entertainment principle states that costs of amusement, diversion, and social activities are unallowable, but refers the reader to the principles covering advertising and public relations, 31.205-1, and employee morale, 31.205-13. The reference to other principles has been interpreted by some contractors, contracting officers, and contract auditors to mean that entertainment costs incurred as a result of employee morale or public relations activities are allowable. Others have concluded that all entertainment costs are unallowable. For example, costs for tickets to sports events have been claimed by contractors as improving employee morale or performance. These costs could be classified as either entertainment, public relations, or employee morale. Because the objective of changing the principle is to remove ambiguities and ensure consistent treatment of the costs, we believe entertainment costs should be unallowable under all circumstances. Therefore, we recommend that the reference to other cost principles be removed from the entertainment principle and that a statement be inserted that costs made specifically unallowable under this subsection, 31.205-14, are not allowable under other subsections of FAR subpart 31.2.

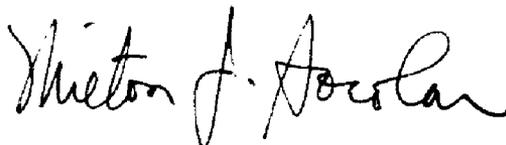
The executive lobbying principle specifies that costs incurred in attempting to improperly influence an executive branch employee are unallowable. The principle refers to FAR 3.401 which defines improper

<sup>2</sup>Although section 2324 directed DOD to amend its supplement to the FAR, in the interest of maintaining uniformity DOD opted to pursue amendments to the FAR, which applies to all government agencies.

influence, in essence, as an inducement to act regarding a contract on any basis other than the merits of the matter. The legislative lobbying principle, by contrast, lists specific costs that are unallowable without regard to whether the costs were incurred in connection with the merits of the matter. It also lists costs which are allowable and the circumstances under which they are allowable. To achieve consistency in the treatment of lobbying costs, we recommend that the executive lobbying principle be structured in a manner similar to the legislative lobbying principle.

A listing of the 26 cost elements in section 2324, the actions taken by DOD to comply with congressional intent, our analysis of DOD's actions, and the specific cost principles affected are found in appendixes II and III.

As arranged with the Subcommittee on Defense, House Committee on Appropriations, we did not obtain agency comments on this report. Unless you publicly announce the contents earlier, we plan no further distribution of this report until 5 days from the date of the report. At that time, we will send copies to the Secretary of Defense, the Administrator of General Services, and the Administrator, National Aeronautics and Space Administration, and other interested parties upon request.

*for*   
Charles A. Bowsher  
Comptroller General  
of the United States

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## Abbreviations

DOD	Department of Defense
FAR	Federal Acquisition Regulation
GAO	General Accounting Office



# Objective, Scope, and Methodology

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Our objective was to evaluate DOD's changes to the contract cost principles mandated by 10 U.S.C. 2324 to determine if the principles are consistent with congressional intent, will achieve the objective of eliminating unallowable costs charged to defense contracts, and could be improved or strengthened.

Our work consisted of analyzing 13 cost principles that covered the 10 cost elements which the Congress specified as unallowable, and 16 cost elements for which the Congress required additional clarifying definition and detail on allowability. We also reviewed amended regulations covering the roles of the contractor, contracting officer, and contract auditor in resolving the costs for which the allowability has been questioned.

We met with representatives of the Defense Acquisition Regulatory Council and officials of the Defense Contract Audit Agency to discuss the cost principles. We questioned several contracting officers, contract auditors, and procurement officials to obtain their comments on the probable effectiveness of the 13 cost principles.

We reviewed two new cost principles on executive lobbying and alcoholic beverages to determine the clarity and distinction of the allowability or unallowability of the specific cost elements. We compared the previous edition of the other 11 cost principles to the new version published in the Federal Register during April and May 1986. We analyzed the amendments to determine whether or not clarity and specificity were added to the principles.

We also reviewed the new and amended principles and cost resolution procedures to determine if they contained sufficient definitions to effectively enable a contractor to remove unallowable costs from its overhead and aid the contracting officer, contract auditor, and contractor in resolving the costs for which the allowability has been questioned.

We performed our review from April to August 1986 in accordance with generally accepted government auditing standards.

# Tasks Required of DOD and Our Office by 10 U.S.C. 2324

The Congress held hearings in 1984 and 1985 which disclosed that millions of dollars which were classified by DOD's regulations as unallowable costs were charged by contractors to government contracts and were accepted as allowable costs by some government contracting officers. Other government contracting officers reviewing the same costs claimed by other contractors did not accept these costs as allowable. Testimony from several sources identified the cause of these inconsistencies as cost principles with ambiguous language which are interpreted differently by contractors, contracting officers, and contract auditors.

To remove any ambiguities, the Congress specified in section 2324 that the following 10 costs are unallowable:

- Costs of entertainment, including amusement, diversion, and social activities, and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities).
- Costs incurred to influence (directly or indirectly) legislative action on any matter pending before the Congress or a state legislature.
- Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of any false certification) brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).
- Payments of fines and penalties resulting from violations of, or failure to comply with, federal, state, local, or foreign laws and regulations, except when incurred as a result of compliance with specific terms and conditions of the contract or specific written instructions from the contracting officer authorizing in advance such payments in accordance with applicable regulations of the Secretary of Defense.
- Costs of membership in any social, dining, or country club or organization.
- Costs of alcoholic beverages.
- Contributions or donations, regardless of the recipient.
- Costs of advertising designed to promote the contractor or its products.
- Costs of promotional items and memorabilia, including models, gifts, and souvenirs.
- Costs for travel by commercial aircraft which exceed the amount of the standard commercial fare.

In addition, DOD was directed by the Congress to amend the cost principles that control the allowability of another 16 costs. The amendments

were to define in detail and in specific terms, the unallowability, in whole or in part, of the following costs:

- Air shows.
- Membership in civic, community, and professional organizations.
- Recruitment.
- Employee morale and welfare.
- Actions to influence (directly or indirectly) executive branch action on regulatory and contract matters (other than costs incurred in regard to contract proposals pursuant to solicited or unsolicited bids).
- Community relations.
- Dining facilities.
- Professional and consulting services, including legal services.
- Compensation.
- Selling and marketing.
- Travel.
- Public relations.
- Hotel and meal expenses.
- Expense of corporate aircraft.
- Company furnished automobiles.
- Advertising.

Beyond amendments to the cost principles, the Congress directed DOD to prescribe regulations that would define and clarify the roles of the contractor, contracting officer, and contract auditor in resolving questioned costs. These regulations were to require that:

- A contracting officer not resolve any questioned costs until adequate documentation is obtained on such costs.
- The opinion of the contract auditor be obtained on the allowability of such costs.
- To the maximum extent practicable, the contract auditor be present at any negotiation or meeting with the contractor regarding a determination of the allowability of indirect costs of the contractor.
- All categories of costs designated in the report of the contract auditor as questioned with respect to a proposal for settlement be resolved in such a manner that the amount of the individual questioned costs that are paid will be reflected in the settlement.

To ensure a timely implementation of the regulations, the Congress required DOD to prescribe the regulations not later than April 7, 1986. The Congress required us to evaluate DOD's compliance by October 6, 1986.

# Analysis of Actions Taken by DOD to Improve and Strengthen Cost Principles

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## Improved Cost Principles

DOD completed the regulatory changes directed by the Congress within the specified 150 day period. The changes, which affected 13 cost principles, are shown in table III.1. Some of the changes are notable because the cost principles were either rewritten or a new concept for determining allowability or unallowability of costs was added.

For example, the advertising principle was expanded to include public relations costs. This principle contains definitions for the two terms, the specific advertising and public relations costs which are allowable, a declaration that all other advertising costs are unallowable, and a listing of numerous public relations costs that are unallowable. In addition, DOD added a new and important concept. This principle includes a declaration that costs which are unallowable under this principle cannot be allowable under other cost principles and vice versa.

In another example, the selling costs principle was rewritten to include a definition which lists the broad categories of activities performed by contractors to sell their products, such as advertising, public relations, entertainment, and market planning. The allowability of costs for these activities is controlled by the provisions of other cost principles. The fact that costs that are unallowable under these other cost principles may have been incurred in connection with allowable selling activities does not make them allowable.

Another notable change involves the compensation cost principle under which the contracting officer may challenge the reasonableness of any individual compensation element or the sum of the elements paid or accrued to particular employees or classes of employees. Once the compensation element is challenged, the contractor has the burden to demonstrate the reasonableness of that element.

In our analysis of changes to the regulations governing the resolution of costs submitted by a contractor but questioned by the contract auditor, we noted a related change made earlier by DOD. On August 5, 1985, DOD assigned responsibility for determining final overhead rates for all contractors, except educational or similar institutions, to the Defense Contract Audit Agency. The final overhead rates for large contractors were previously established through procurement negotiation.

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## Improvements Needed in Two Cost Principles

We found that two cost principles could be further strengthened if specific details and terms or clarifying language was added. The entertainment principle, FAR 31.205-14, specifies that costs of amusement,

diversion, social activities, and any directly associated costs such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities are unallowable, but refers the reader to the cost principles on advertising and public relations, and employee morale and welfare. Some of these entertainment costs could be classified as allowable under the other two principles. We believe this reference to the other principles could result in inconsistent treatment of these costs.

The executive lobbying principle specifies that costs incurred in attempting to improperly influence an executive branch employee are unallowable. The principle refers to FAR 3.401 which defines improper influence, in essence, as an inducement to act regarding a contract on any basis other than the merits of the matter. The legislative lobbying principle, by contrast, lists specific costs that are unallowable without regard to whether the costs were incurred in connection with the merits of the matter. It also lists costs which are allowable and the circumstances under which they are allowable. To achieve consistency in the treatment of lobbying costs, we recommend that the executive lobbying principle be structured in a manner similar to the legislative lobbying principle.

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## **Conclusions**

The changes made by DOD to the cost principles and its cost determination procedures should remove the majority of ambiguities previously associated with contract settlements. However, we believe two of the cost principles, entertainment and executive branch lobbying, could be improved.

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## **Recommendations**

We recommend to the Secretary of Defense that the reference in the entertainment principle to other cost principles be removed, and a statement be inserted in the principle that costs specifically unallowable under this subsection, 31.205-14, are not allowable under other subsections of FAR subpart 31.2. Also, the executive lobbying principle should be structured in a manner similar to the legislative lobbying principle, 31.205-22.

**Appendix III  
Analysis of Actions Taken by DOD to  
Improve and Strengthen Cost Principles**

**Table III.1: Amendments Made to Cost Principles to Clarify Allowability or Unallowability of 26 Cost Elements**

<b>Cost principle</b>	<b>Cost element</b>	<b>Congressional intent</b>	<b>Action taken</b>
Advertising and Public Relations 31.205-1	Advertising <sup>a</sup>	Clarify unallowable costs.	Cost principle expanded from 3 to 7 sections to include public relations costs, and to add the strength and detail Congress requested. Added language defines public relations and advertising and declares the types of costs which are allowable or unallowable. Costs made specifically unallowable under this subsection are not allowable under other subsections of 31.205.
	Public relations		
	Community relations		
	Membership in civic, community, and professional organizations		
	Air shows		
Compensation for personal services 31.205-6	Promotional items	Declare costs unallowable	Costs of promotional items such as models, gifts, brochures, handouts, and magazines and other media designed to enhance the company image, are unallowable.
	Compensation costs	Clarify unallowable costs	Cost principle amended to state that compensation is reasonable if each element of the compensation package is reasonable. The contractor must demonstrate that each element challenged by the government is reasonable. In addition, two new criteria for reasonableness were added. These include the compensation practices of firms primarily involved in nongovernment work and the cost of services which could be obtained from other sources.
Contributions or donations 31.205-8	Costs of company furnished automobiles	Declare costs unallowable	Cost principle revised to specifically disallow the costs associated with employee's personal use, even though such costs are included in the employee's taxable income.
	Contributions or donations		The cost principle was strengthened by the addition of "including cash, property and service, regardless of recipient, are unallowable . . . ."
Employee morale and welfare 31.205-13	Employee morale and welfare	Clarify unallowable costs	Cost principle expanded to allow losses on contractor provided cafeteria and lodging facilities, when the contractor can demonstrate an attempt to break-even. This includes time and money that would be lost if employees had to leave the work place for meals and lodgings.
	Dining facilities		

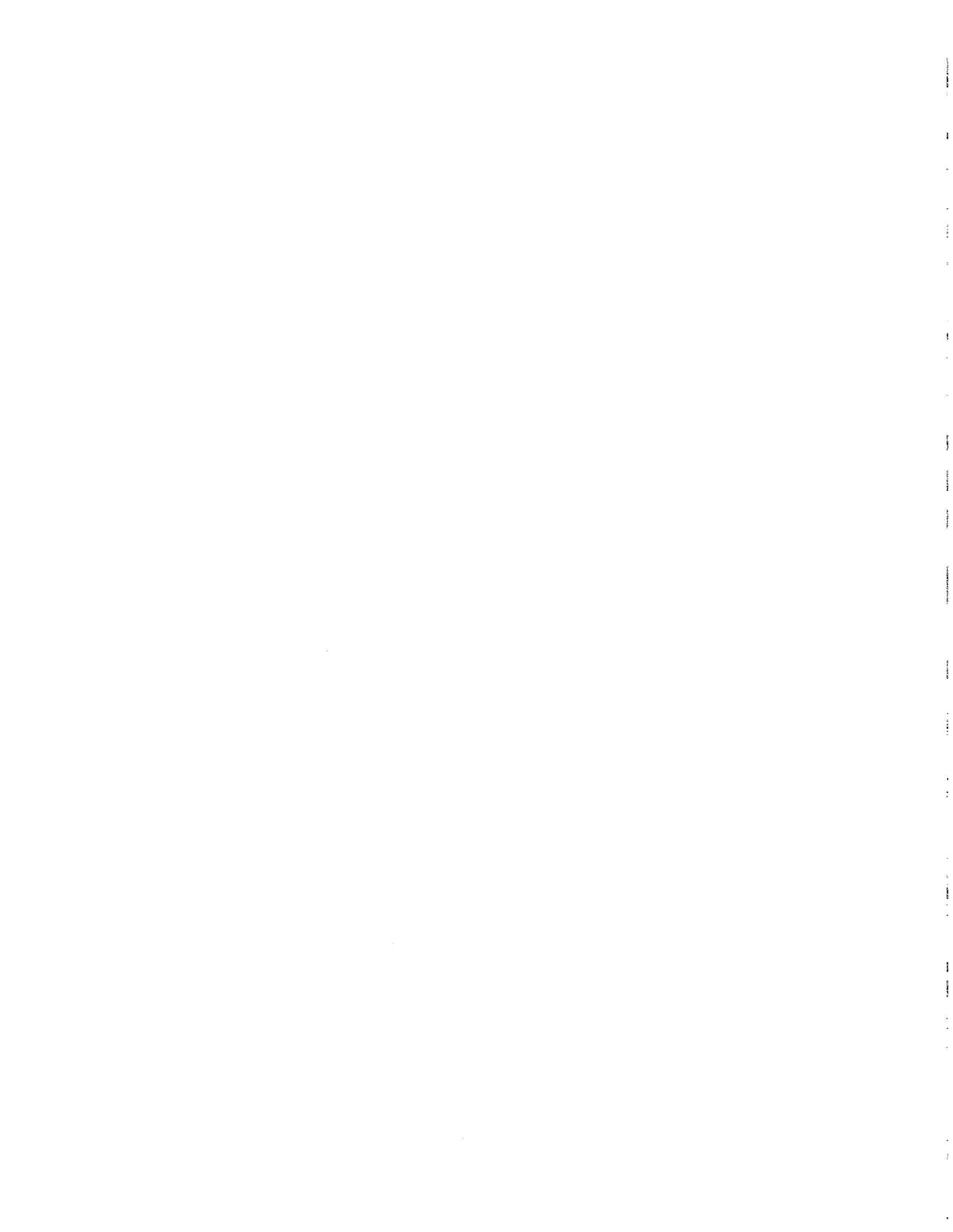
**Appendix III  
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<b>Cost principle</b>	<b>Cost element</b>	<b>Congressional intent</b>	<b>Action taken</b>
Entertainment costs 31.205-14	Entertainment  Membership in social, dining, or country club or organization.	Declare costs unallowable	Cost principle expanded to make memberships in social, dining, and country clubs or other organizations having the same purposes specifically unallowable.
Fines and penalties 31.205-15	Fines and penalties	Declare costs unallowable	Cost principle amended by adding the word foreign to the existing list of federal, state, and local laws and regulations.
Legislative lobbying costs 31.205-22	Legislative lobbying	Declare costs unallowable	Principle's title changed from lobbying costs to legislative lobbying costs. Amendment clarifies the need for documentation by the contractor to comply with this principle.
Professional and consulting service cost 31.205-33	Professional and consulting services, including legal services	Clarify unallowable costs	Declares unallowable those costs incurred in defending against government claims or appeals. Also unallowable are costs incurred in connection with the defense or prosecution of lawsuits or appeals between contractors, except when complying with specific terms of a contract or upon agreement with the contracting officer.
Costs of recruitment 31.205-34	Recruitment costs	Clarify unallowable costs	No change was made because the legislative history of Public Law 99-145 did not indicate the Congress' specific concern with this cost and DOD had received no complaints.
Selling costs 31.205-38	Selling and marketing	Clarify unallowable costs	Cost principle was expanded to provide a definition of general selling activities, and the cost principles that control the allowability of costs for these activities. Declares that the cost of activities correctly classified and disallowed under these principles cannot be reconsidered under this principle. Identifies which selling and marketing costs are allowable and requires the contractor to separate unallowable costs.

**Appendix III**  
**Analysis of Actions Taken by DOD to**  
**Improve and Strengthen Cost Principles**

<b>Cost principle</b>	<b>Cost element</b>	<b>Congressional intent</b>	<b>Action taken</b>
Travel costs 31.205-46	Travel costs	Clarify unallowable costs	Travel costs which exceed the current federal per diem rates are unallowable, including the costs for corporate aircraft, except in extraordinary or temporary situations and when required by contract specification or an advance agreement. The contractor must document and justify the condition(s) requiring the excessive airfare and travel costs.
	Hotel and meal expenses		
	Expense of corporate aircraft	Declare costs unallowable	Airfare costs in excess of the lowest customary standard, coach, or equivalent airfare offered during normal business hours is unallowable, except when such travel would cause a physical hardship on the traveler, or result in excessive travel time, or offset savings. The contractor must document and justify these conditions for the cost to be allowable.
Cost greater than commercial airfares			
Defense of fraud proceedings 31.205-47	Defense of any civil or criminal fraud proceedings	Declare Costs unallowable	The principle was expanded to declare as unallowable the costs incurred to defend against fraud proceedings, "including filing of a false certification," and "including directly associated costs" of fraud proceedings.
Executive lobbying costs 31.205-50	Actions to influence executive branch action on regulatory or contract matters	Clarify unallowable costs	This new principle intends to disallow any costs incurred in attempting to improperly influence, either directly or indirectly, an executive branch employee to consider or act on a contractual or regulatory matter.
Cost of alcoholic beverages 31.205-51	Costs of alcoholic beverages	Declare costs unallowable	Costs of alcoholic beverages are specifically unallowable.

<sup>a</sup>The advertising cost element was included in both the 10 elements specified as unallowable and the 16 elements requiring clarifying language.



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