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CONTRACT PRICING

Unallowable Costs Charged to Defense Contracts



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National Security and
International Affairs Division

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November 20, 1992

The Honorable Jim Sasser
Chairman, Committee on the Budget
United States SenateThe Honorable Kent Conrad
United States Senate

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As you requested, we reviewed the overhead cost submissions of six defense contractors where the Defense Contract Audit Agency (DCAA) does not have a resident audit office. With government sales of between \$11 million and \$107 million each for the years we audited, the six contractors—and many other smaller contractors—do not have the volume of government business to justify the permanent resident office oversight that DCAA maintains at large defense contractors. Our objective was to determine whether these contractors were including in their overhead cost submissions costs that are expressly unallowable under the Federal Acquisition Regulation or are of questionable allowability.

Background

The Federal Acquisition Regulation cost principles require defense contractors to identify and exclude unallowable costs from their overhead submissions. Further, the Defense Federal Acquisition Regulation Supplement requires defense contractors to certify that to the best of their knowledge, these submissions do not include unallowable costs. Yet, DCAA's fiscal year 1991 audits questioned about \$1.3 billion in contractor direct and indirect costs allocated to government contracts. DCAA officials said that their data system does not separately identify the amount of direct and indirect costs questioned, but that the predominate amount would be for indirect costs—or overhead as it is commonly known. Contractor overhead submissions are used to establish overhead rates that are used in the settlement of contracts, such as cost and incentive-type contracts. They also provide the historical cost basis for overhead estimates used in the negotiation of fixed-price contracts.

Results in Brief

At all six contractors we reviewed, contractors did not identify and exclude all unallowable costs, as required by the Federal Acquisition Regulation. For example, in addition to almost \$1 million in costs questioned by DCAA at these six contractors, we identified about \$2 million

more in overhead costs that are either expressly unallowable or questionable.¹

The federal cost principles governing allowability for entertainment, employee morale and welfare, and business meeting costs lack sufficient clarity to assure consistent and appropriate application, and they are being interpreted broadly by some of the contractors we reviewed.

Limited transaction testing (tracing expenditures back to supporting documentation and evaluating their allowability) of contractor overhead cost submissions by DCAA may have also contributed to unallowable or questionable costs going undetected. Transaction testing is a key step to assure that contractor internal controls are excluding unallowable costs from contractor cost submissions.

Unallowable and Questionable Costs Included in Contractors' Submissions

At six contractors, we identified about \$2 million in overhead costs that are expressly unallowable or questionable. These costs were not excluded by the contractors from their overhead submissions or questioned in DCAA audits. At four of the six contractors, DCAA auditors did not question any overhead costs. Yet, our audit work identified \$1.3 million of unallowable or questionable costs. At the other two contractors, DCAA audits of either 1 or 2 years of overhead cost submissions questioned the allowability of almost \$1 million in overhead costs. Our audit work at these two contractors identified over \$700,000 in additional costs that are either unallowable or questionable.

Not all of the unallowable or questionable costs we identified represent overcharges to the government. These costs were included in the contractors overhead pool and, if not detected, a portion would have been allocated to its defense work. The actual amount of overcharges would depend on the amount of government versus commercial business performed by the contractor and the types of contracts with the government. In addition to being charged to government cost and incentive-type contracts, undetected unallowable costs may affect the negotiation of fixed-price contracts.

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

Expressly Unallowable Costs

Our review identified expressly unallowable costs that were included in contractors' overhead submissions. Some of our findings are discussed below.

Alcoholic Beverages

The Federal Acquisition Regulation expressly states that alcoholic beverage costs are unallowable as a charge against government contracts. Yet, at five of the six contractors we examined, we found almost \$24,000 of alcoholic beverages in the contractors' overhead submissions. For example, one contractor included in its overhead submission, \$1,621 for a Saturday evening "working" dinner attended by 21 employees and consultants at a cost of \$77 per person. The contractor included the entire bill, even though this amount included \$745 for a bar fee and alcoholic beverages, a cost of \$35 per person.

Personal Use of Automobiles

Although costs for the personal use of company automobiles are expressly unallowable under the Federal Acquisition Regulation, five of the six contractors we reviewed failed to exclude about \$173,000 of automobile expenses related to personal use from their overhead cost submissions. In addition, because these costs tend to be recurring, the contractors may have also included similar unallowable automobile charges in their cost submissions for years other than those we audited.

Also, one contractor overstated its automobile account by about \$33,000 because of errors related to the replacement of company vehicles.

Personal Use of a Boat

The Federal Acquisition Regulation clearly states that entertainment expenses are unallowable. However, one contractor included in 2 years of overhead submissions about \$62,000 in expenses related to the personal use of the company's boat. The boat, a 46-foot sportfishing vessel, was used for both product testing and entertainment.

Advertising and Trade Shows

The Federal Acquisition Regulation provides that costs directly associated with unallowable costs are also unallowable. We found that four contractors failed to exclude about \$217,000 in unallowable trade show costs and costs directly associated with unallowable advertising and trade shows. One contractor included about \$178,000 in costs for its advertising and trade show departments in its overhead submission due to a cost analyst's failure to remove the costs, even though the analyst's cost records identified these costs as unallowable. An official of this contractor acknowledged that the same type of error may have been made in other years' submissions and in at least one of its estimates of future years' overhead rates. Accordingly, the contractor told us it is reviewing its most

recent overhead cost submission and plans to make adjustments for any errors.

Employee Dependent Scholarships

The Federal Acquisition Regulation generally disallows the costs of tuition, fees, textbooks, and similar or related benefits provided to persons other than company employees. Further, costs of college plans for employee dependents are expressly unallowable. Yet, one contractor had an employee dependent scholarship program that for each year provides up to five renewable \$2,000 scholarships to employee dependents. Over a 2-year period, this contractor included in its overhead cost submissions about \$31,000 for this scholarship program.

Although the contractor agrees that these costs are unallowable under the training and education cost principle, it nevertheless maintains that the costs are "...clearly allowable under the spirit and intent. . ." of the employee morale and welfare cost principle. We disagree. We believe that these costs are expressly unallowable under the training and education cost principle.

Questionable Costs

In addition to including costs in their overhead submissions that are expressly unallowable, the six contractors also included costs that we consider to be questionable. We questioned costs when the contractor could not provide the documentation required to support the costs, or when the purpose, nature, or reasonableness of the expenditure was in question.

Business Meetings

The Federal Acquisition Regulation provision allowing costs for business meetings was cited by contractor officials as justification for trips to resort locations, including those to foreign countries. For example, one contractor included about \$50,000 of travel expenses in its overhead submission for an annual management meeting held in Bermuda for 40 employees and a consultant. Thirty-six spouses and guests also went on the trip, but at their own expense.

Another contractor, over a 2-year period, included about \$333,000 in its overhead submission for travel to Puerto Vallarta, Mexico; Jamaica; the Grand Cayman Island; and Hawaii for its annual management and business meetings. For example, at a cost of about \$102,000, this contractor sent 151 employees (over one-third of its employees) to Montego Bay, Jamaica, to attend what the company calls its annual business meeting. The employees brought 112 spouses or guests. According to the contractor, the

purpose of this meeting was to review operating policy and marketing strategy and to serve as a stockholders meeting. Such meetings, according to the company, are "...intended to promote a corporate 'cohesiveness' via both social and business interaction. ..." and to "...combine business and fun via an opportunity to extend to a low cost vacation (at personal expense) in a resort area. Employees are encouraged to bring their spouses or families." The contractor claims that the additional costs of meetings in resort areas are a form of incentive compensation.

While we do not argue with the need to have legitimate business meetings, when the business trip takes on the character of a vacation, such as in the above instances, we question whether the government should pay for contractor employees to attend business meetings at resort locations, especially at tropical resort locations outside the United States.

Entertainment and Employee Morale

The Federal Acquisition Regulation expressly disallows entertainment costs for social activities and tickets to sporting events and shows. However, the regulation on entertainment costs refers, without any explanation, to the cost principle on employee morale and welfare costs, which are generally allowable. Because of this reference, some contractors we reviewed maintain that entertainment-type expenses for employees are an allowable cost of maintaining employee morale and welfare and include such costs in their overhead submissions. For example, over a 2-year period, one contractor's overhead submissions included \$14,000 for parking and tickets for professional sporting events (Boston Red Sox and Boston Celtics games), \$10,000 for schooner rentals for 40 employees and their guests, \$5,800 for running shoes for employees, and about \$12,000 for cable television charges for retirees.

Another contractor included in its overhead submission about \$10,600 for a Christmas party buffet for its Washington, D.C., area-based employees and their guests. The party's cost, for the 104 persons in attendance, was \$102 per person, three times the maximum daily meals and incidental expenses allowance for contractor employees in a travel status. The 19-item menu was 3 pages long and included grilled whole Pacific salmon, tiny roasted potatoes filled with a julienne of smoked duck, and buckwheat blinis topped with American sturgeon caviar. The \$10,600 cost of the party included about \$1,500 for decorations and flowers, a disk jockey, and a magician. The contractor also included \$150 in state lottery tickets as Christmas party prizes in its overhead cost submission.

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

Pension Expenses

We also found that one contractor may have overstated pension expenses by about \$255,000 because, contrary to the Federal Acquisition Regulation, it failed to limit the amount of pension costs to those actually paid into the pension fund. In its fiscal year 1989 overhead submission, this contractor included \$324,000 for employee pension costs; yet, it only paid \$69,000 into the pension fund. While the contractor agreed that under a strict interpretation of the regulation the \$255,000 included in overhead above the amount actually paid into the fund was unallowable, it believes other issues could affect the allowability of these costs. These include (1) whether a prior year's payment into its pension fund in excess of expenses could be considered a prefunding of later years' expenses and (2) whether a possible waiver to the pension regulation could be obtained from the Department of Defense (DOD). The contractor said that it intended to pursue these matters with the government contracting officer.

Inadequately Supported Costs

The Federal Acquisition Regulation places the responsibility for supporting overhead costs on the contractor. Three of the six contractors did not adequately support the nature and scope of about \$152,000 in consultant service expenses. For example, one contractor submitted about \$16,000 for travel costs without documenting the purpose of the travel expense. Adequate support is required to justify the allowability of these costs.

We also questioned \$210,000 of contractor automobile expenses because three contractors failed to collect the data needed to show the extent of personal use. For example, one company included about \$127,500 of such automobile costs in its overhead rate submission.

Various Factors Are Responsible for Unallowable and Questionable Costs in Overhead Submissions

Federal regulations require defense contractors to identify and exclude unallowable costs from their overhead submissions and to certify that to the best of their knowledge, these submissions do not include unallowable costs. Each of the six contractors we reviewed excluded some unallowable costs from its overhead cost submission. Yet, our work indicates that these six contractors' internal control systems are not identifying and excluding significant amounts of unallowable or questionable costs from their overhead cost submissions. Standards for

internal controls require that control systems provide reasonable assurance that the objectives of the system will be accomplished. The internal control systems for identifying and excluding unallowable costs at the six contractors we reviewed need to be strengthened.

The Federal Acquisition Regulation governing allowability for entertainment, employee morale and welfare, and business meeting costs lack sufficient clarity to assure consistent and appropriate application, and they are being interpreted broadly by some of the contractors we reviewed. The cost principles need to be clarified.

Limited DCAA transaction testing of contractor overhead cost submissions may have also contributed to DCAA's failing to identify unallowable costs at the contractors we reviewed. At one contractor, for example, DCAA spent 155 hours reviewing the contractor's overhead submission, but only 26 hours on transaction testing. At another contractor, DCAA's audit involved 233 hours of which only 48 hours were spent on transaction testing.

The Government Auditing Standards provide that in determining the nature, timing, and extent of the audit steps and procedures to test for compliance, the auditor should assess the risk of noncompliance. Based on that assessment, the auditor should design steps and procedures to provide reasonable assurance of detecting material instances on intentional or nonintentional noncompliance. DCAA's Mandatory Annual Audit Requirements provide the basic criteria and procedures necessary to comply with government auditing standards in the contract audit environment. DCAA's policy requires that the reason for omission of any mandatory requirement must be documented in the working papers.

DOD acknowledged that the two audits described above were not done in full compliance with DCAA policy related to audit planning and evidential matter. DOD informed us that the Director, DCAA, has tasked the Regional Director responsible for these two audits to review not only that field office but all field offices in the region to determine compliance with DCAA policy. With regard to other locations, DOD stated that DCAA's testing of transactions was proper. However, the fact that our audit work identified substantial unallowable or questionable costs that were not detected by DCAA at all six contractors suggests that increased transaction testing by DCAA would have resulted in the identification of additional unallowable costs. It also would have provided DCAA more reasonable assurance that the contractors were in compliance with the federal regulations.

Recommendations

We recommend that the Secretary of Defense clarify the Federal Acquisition Regulation by (1) eliminating the reference to other cost principles in the entertainment cost principle and (2) adding a statement that costs made specifically unallowable under the entertainment cost principle are not allowable under other cost principles. We also recommend that the Secretary of Defense evaluate the cost principles to determine whether additional guidance is needed concerning the allowability of business meetings at resort locations, especially resort locations outside the United States.

We recommend that the Director, DCAA, evaluate the extent to which field offices need to spend more time in transaction testing, especially at nonmajor contractors. We recognize that DCAA does not have the resources to make in-depth reviews at small contractors each year. However, DCAA should consider detailed in-depth reviews of contractors' incurred costs every 3 or 4 years. The potential for an in-depth review would act as an incentive for contractors to ensure that unallowable costs are excluded from their indirect cost submissions.

Contractors' and DOD's Views and Our Evaluation

As requested, we did not obtain full coordinated DOD comments on this report. We did, however, obtain comments on our findings and conclusions from contractor officials and from DOD.

While the six contractors we reviewed disagree with some of our findings, three informed us that they will strengthen their internal controls to ensure that unallowable overhead costs are identified and excluded from their overhead submissions. Five contractors stated that they are reviewing their overhead submissions for fiscal years other than those we audited to remove any unallowable costs of the type we identified. We believe these are positive steps.

DOD stated that DCAA has taken recent actions to strengthen audit performance at contractor locations where it does not have resident offices. DOD cited a series of initiatives DCAA has taken or has in process, including an evaluation of audit planning and transaction testing, new audit guidance on transaction testing and contractor internal control structures, and new training on transaction testing. We have not evaluated the implementation of these recent initiatives, but believe they are steps in the right direction.

DOD also stated that the cost of oversight is an important review consideration. We recognize that DCAA has limited resources that must be allocated based on an assessment of risk. Nevertheless, our findings point out that the depth of DCAA's audits was not sufficient to identify significant amounts of unallowable or questionable costs at several contractors.

Scope and Methodology

We evaluated whether six defense contractors were including in overhead cost submissions costs which are unallowable or questionable under the Federal Acquisition Regulation. In selecting the contractors, we examined DCAA audit reports and related working papers for a larger group of contractors. We judgmentally selected the six contractors to obtain a mix of manufacturing and service-type companies. Since the contractors we reviewed were not selected on a random basis, our results are not necessarily representative of the universe of small contractors.

These six contractors are audited by non-resident DCAA offices. With government sales of between \$11 million and \$107 million each for the years we audited, none of the six contractors had a sufficient volume of government business to justify the permanent resident office oversight that DCAA maintains at large defense contractors. Appendix I lists the six contractors we reviewed.

In examining the overhead cost submissions at the six contractors, we concentrated on those areas that we believe to be most vulnerable to overbilling. These include the costs of business meetings, travel, entertainment, consultants, advertising, and costs justified under a Federal Acquisition Regulation section titled employee morale, health, welfare, food services, and dormitory costs. In examining selected costs, we traced the costs to documentation supporting their nature and purpose. From this examination, we made a determination as to whether the costs were allowable or questionable under the Federal Acquisition Regulation existing at the time.

We conducted our audit between November 1991 and October 1992 in accordance with generally accepted government auditing standards.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies to the Secretary of Defense; the Directors of the Defense Logistics Agency and DCAA; the Director, Office of Management and

Budget; and other interested congressional committees. Copies will also be made available to others upon request.

Please contact me at (202) 275-8400 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix II.

A handwritten signature in black ink, appearing to read "Paul F. Mat.1", with a stylized flourish at the end.

Paul F. Mat.1
Director, Research, Development, Acquisition,
and Procurement Issues

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Abbreviations

DCAA	Defense Contract Audit Agency
DOD	Department of Defense

Six Companies Included in GAO Review

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Sippican, Inc., Marion, Massachusetts
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