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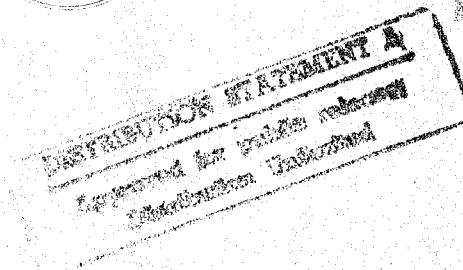
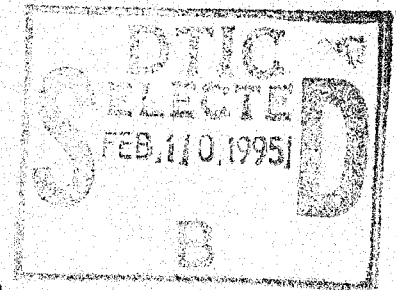
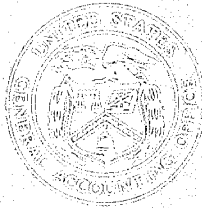
United States General Accounting Office

Report to the Chairman, Committee on
Government Operations, House of
Representatives

December 1994

OVERHEAD COSTS

Unallowable Costs Charged by Rockwell Corporation, Rocketdyne Division



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National Security and
International Affairs Division

B-257598

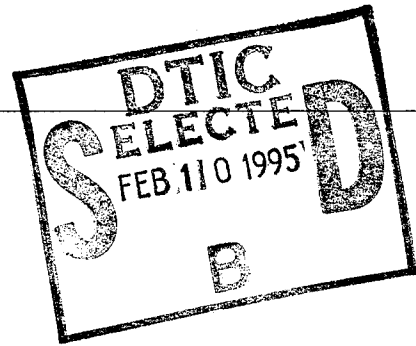
December 9, 1994

The Honorable John Conyers, Jr.
Chairman, Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

As you requested, we reviewed a major National Aeronautics and Space Administration (NASA) contractor's overhead cost submissions to determine whether they included unallowable costs. We also attempted to determine the extent to which questioned costs that the Defense Contract Audit Agency (DCAA) identified in its audit of the contractor's overhead submissions were sustained.

This report contains the results of our work at Rockwell International Corporation, Rocketdyne Division, Canoga Park, California. The results of a prior review of another major NASA contractor were reported to you in June 1994.¹



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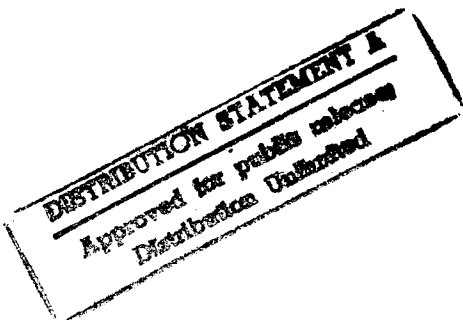
Overhead cost submissions are used to establish final overhead rates that determine reimbursements under cost-type contracts and to provide the historical cost basis for overhead rates that are used to negotiate fixed-price contracts. The Federal Acquisition Regulation (FAR) cost principles require government contractors to identify and exclude unallowable costs from overhead submissions.

The Department of Defense provides administrative contract support to NASA at Rocketdyne. The overhead submissions are reviewed by DCAA for allowability. About 80 percent of Rocketdyne's sales are under government cost reimbursable-type contracts.

Results in Brief

About \$222,000 of the costs we reviewed in Rocketdyne's fiscal year 1990 and 1992 overhead submissions was unallowable. This amount represents about 5 percent of the approximately \$4.8 million of costs reviewed and about 2.6 percent of the approximately \$8.6 million charged in total to the reviewed accounts. These percentages of unallowable costs cannot be generalized to the total overhead charges of \$866 million because we

¹Overhead Costs: Costs Charged By McDonnell Douglas Aerospace's Space Station Division (GAO/NSIAD-94-150, June 23, 1994).



reviewed only those accounts that we believed were more susceptible to unallowable charges. Rocketdyne included the unallowable costs in its overhead submissions primarily because accounting personnel did not have accurate instructions on allowable membership fees and because of weaknesses in Rockwell and Rocketdyne procedures for handling costs of outside legal services. Rocketdyne said it is implementing revised procedures to ensure that unallowable costs are properly recorded in the future.

Rocketdyne would have been reimbursed for the fiscal year 1990 unallowable costs in part because DCAA did not review the company's legal expenses and did not follow up on information it did obtain on certain membership fees. At the time of our review, DCAA had not conducted its audit of Rocketdyne's fiscal year 1992 submission.

The extent to which DCAA-questioned costs were sustained was not an issue because DCAA did not question any costs in its reviews of Rocketdyne's overhead submissions for fiscal years 1988 and 1989—the most recent years for which final overhead rate negotiations were complete.

Unallowable Costs

At the time of our review, neither Rocketdyne's fiscal year 1990 nor 1992 overhead submissions had been settled. Rocketdyne has agreed to withdraw the approximately \$222,000 we identified as unallowable costs in its overhead submissions. The unallowable costs included costs for legal fees, lobbying, public relations, contributions, employee education, and training for consultants.

Legal Costs

According to FAR 31.205-47, costs incurred in connection with any proceeding brought by a state government alleging a violation of law or regulation that results in civil penalties are unallowable. Rocketdyne, however, paid civil penalties as a result of environmental lawsuits brought by the State of California in fiscal years 1990 and 1992 and included the outside legal expenses (\$59,600) incurred in connection with these lawsuits in its fiscal year 1990 and 1992 overhead submissions.

Also included in Rocketdyne's overhead submissions was a double payment of about \$25,400 to the law firm that represented Rocketdyne in one of the lawsuits. Rocketdyne has received a refund from the firm for

the double payment and has agreed to remove the \$25,400 from its overhead submission along with the \$59,600 in legal fees.

Lobbying

FAR 31.205-22 states that costs incurred in attempts to influence the introduction of legislation or the enactment or modification of pending federal legislation through communication with any Member or employee of Congress are unallowable. We identified about \$42,000 of lobbying costs that Rocketdyne included in its fiscal year 1990 and 1992 overhead submissions. Rocketdyne has agreed to remove the \$42,000 from its overhead submissions.

The lobbying costs were incurred primarily for outside professional services. For example, Rocketdyne paid a law firm about \$33,200 to lobby for Clean Air Act amendments. Rocketdyne has agreed to remove this payment from its overhead submission.

Most of the remaining lobbying cost concerned membership fees paid to an organization engaged in lobbying. Rocketdyne included \$6,300 for membership fees paid to the American Nuclear Energy Council in its fiscal year 1992 overhead submission. Rocketdyne has agreed to remove the \$6,300 from its overhead submission.

Public Relations

FAR 31.205-1 identifies unallowable public relations costs as those whose primary purpose is to promote the sale of products and services by stimulating interest in a product or product line or by enhancing a company's image. We identified about \$25,100 in unallowable public relations costs in Rocketdyne's fiscal year 1990 and 1992 overhead submissions. For example, Rocketdyne included in its fiscal year 1990 overhead submission \$25,000 for dues it paid to the U. S. Council for Energy Awareness. Representatives of Rocketdyne's Atomic International component, which conducts business in both the space and land-based nuclear power arena, justified this membership on the basis that the Council does "more than any other organization [sic] to educate Americans on the absolute necessity of a U. S. energy policy. . . leading to the construction and operation of many of these [nuclear] power plants as soon as possible." Furthermore, the Council's own literature shows that its mission is to foster public understanding of the advantages of nuclear power plants through advertising and public relations. Rocketdyne has agreed to remove \$25,100 from its overhead submissions.

Contributions

Except for costs of participation in community service activities such as blood bank or charity drives, contributions or donations, including cash, property, or services, regardless of the recipient, are unallowable under FAR 31.205-8. We identified contributions totaling about \$21,800 that Rocketdyne included in its fiscal year 1990 and 1992 overhead submissions.

Rocketdyne made the majority of these contributions, \$7,000 in fiscal year 1990 and \$9,000 in fiscal year 1992, to California State University, Northridge. As a result of our review, Rocketdyne has agreed to withdraw the \$16,000 from its overhead submissions.

Rocketdyne also included about \$3,800 in its overhead submissions for amounts it paid to a professional organization in excess of membership fees. Rocketdyne paid \$5,000 to the Institute for Space Nuclear Power Studies of the University of New Mexico, which was \$3,270 above the membership fee for that organization. DCAA audit guidelines identify such payments in excess of membership fees as contributions. Rocketdyne has agreed to withdraw \$3,800 from its overhead submissions.

Rocketdyne included about \$1,890 in its fiscal year 1992 overhead submission for food and beverage services provided to attendees of a Department of Energy (DOE) conference held at Florida International University. DOE held this conference to evaluate and monitor the progress of grantee universities under two DOE educational programs for minority students. Rocketdyne was under contract with DOE to help evaluate the progress of the universities under their grants. However, the contract did not require Rocketdyne to pay for food and beverage services for this conference. Consequently, we believe this \$1,890 is a contribution, since Rocketdyne had no contractual obligation with DOE to pay for the services and had no business interest with the DOE grantees. Rocketdyne has agreed to remove this cost from its submission.

Employee Education

Under FAR 31.205-44(d), costs associated with full-time education at the undergraduate level are unallowable. We identified about \$18,700 in the fiscal year 1990 overhead submission for one employee's full-time education at the undergraduate level and \$18,030 in the fiscal year 1992 overhead submission for another employee. Both of these employees were on leave of absence from Rocketdyne for about 36 months to obtain Bachelor of Science degrees. During this time, they attended school full-time, and Rocketdyne reimbursed one a total of \$18,700 and the other

\$30,220 (including \$12,190 for an earlier period) for educational expenses. Rocketdyne has agreed to remove these costs from its overhead submissions, and it said it is revising its educational policy to discontinue reimbursement of full-time education at the undergraduate level.

Training for Consultants

According to FAR 31.205-44(i), training or education costs for other than bona-fide employees are unallowable. However, Rocketdyne included about \$7,000 in its fiscal year 1992 overhead submission for costs associated with training two Rocketdyne consultants. Rocketdyne has agreed to withdraw the \$7,000 from its overhead submission.

Other Unallowable Costs

Rocketdyne agreed to remove other unallowable costs totaling about \$4,500 from its overhead submissions, including costs allocable to other Rockwell divisions and other erroneous billings.

Factors Contributing to Unallowable Costs in Overhead Claims

FAR requires contractors to identify unallowable costs in their accounting records and exclude them from any submission. Rocketdyne procedures require that unallowable costs be recorded in an unallowables account. However, Rocketdyne failed to identify certain costs as unallowable and, therefore, recorded them as allowable. Also, inattention by DCAA contributed to the unallowable costs going undetected.

Rocketdyne's failure to record expenses as unallowable was primarily due to erroneous instructions for recording the costs of membership fees and weaknesses in procedures for handling the costs of outside legal services. Improperly recorded membership fees totaled over \$54,500 and, as previously discussed, concerned lobbying, contributions, and public relations. Improperly recorded legal expenses totaled over \$118,000 and, as previously discussed, concerned legal costs for environmental lawsuits, lobbying, and duplicate payments.

The legal fees in question were paid by Rockwell International's corporate headquarters. For outside legal service fees, Rockwell sends each benefiting division (including Rocketdyne) information on its share of the cost. Each division then enters the cost in its accounting records, including unallowable accounts. However, for the costs we questioned, Rockwell did not advise Rocketdyne that the legal expenses were unallowable until about a year after sending the divisions the initial cost information, and then it did not identify how much was unallowable. As a

result of our review, Rockwell said it has revised its procedures and now provides information on unallowable legal costs at the time it advises its divisions of their share of the legal expenses.

Rocketdyne also failed to properly record certain membership fees as unallowable costs. Rocketdyne relies on Rockwell instructions to decide which organization's fee is an allowable cost and which is not. These instructions stated that membership fees for the organizations we questioned were allowable. Rocketdyne stated that Rockwell was changing its instructions on the organizations we questioned as a result of our review.

DCAA had reviewed membership fees but not legal expenses in its last two audits of Rocketdyne's overhead submissions. It also raised questions about Rocketdyne's failure to record certain membership fees as unallowable. However, it dropped the questioned costs from its final report on Rocketdyne's overhead submissions because DCAA believed that it would not be "cost effective" to settle "such subjective" issues.

Sustention of DCAA Findings

NASA has delegated the authority for negotiating final overhead rates at Rocketdyne to the resident administrative contracting officer. Since DCAA questioned no costs in 1990, and for the previous 2 years, the sustention rate on DCAA-questioned costs during the negotiation of final overhead rates was not an issue.

DCAA Report on Rocketdyne's Noncompliance

On September 26, 1994, subsequent to our review, DCAA issued a report on its review of Rocketdyne's compliance with Cost Accounting Standard 405. This standard, in part, requires a contractor to identify and exclude from any billing, claim, or proposal applicable to a government contract those costs that are expressly unallowable under FAR or mutually agreed to be unallowable.

DCAA concluded that audits of Rocketdyne's overhead claims for fiscal year's 1990 and 1993 disclosed that Rocketdyne's failure to comply with the standard resulted in an increased cost to the government. Thus, according to DCAA, Rocketdyne was in noncompliance with the standard and FAR.

DCAA recommended that Rocketdyne reassess the adequacy of its screening process for unallowable costs and ensure that individuals

responsible for the screening are fully trained. While Rocketdyne believes it has an effective system to comply with the Cost Accounting Standards and FAR, it has agreed to strengthen its screening process.

Scope and Methodology

We selected Rocketdyne because about 80 percent of its sales are to NASA under cost-reimbursable contracts. To select the overhead cost accounts for review, we considered the sensitivity of the accounts—high probability of unallowable charges—and the significance of expenditures, including increases from year to year. In reviewing the accounts, we examined source documents to determine the nature and purpose of the expenses in relation to FAR's cost principles in effect at the time.

The accounts selected had a total value of about \$8.6 million, and we examined transactions with a total value of about \$4.8 million. Our findings, however, cannot be generalized to the total fiscal year 1990 and 1992 overhead submissions (about \$866 million) because we used a judgmental sample selecting accounts that we believed were more susceptible to unallowable charges.

We reviewed DCAA audit reports on overhead costs and related working papers to determine the scope and depth of coverage and the adequacy of transaction testing² necessary to establish allowability, allocability, and reasonableness of expenses included in the overhead submissions. We also reviewed Rocketdyne audits and related working papers to assess the adequacy of Rocketdyne's internal controls for preparing accurate overhead submissions. In addition, we reviewed overhead negotiation records the government contract administration office provided to determine the extent to which DCAA-questioned costs were sustained in the final indirect rate settlements.

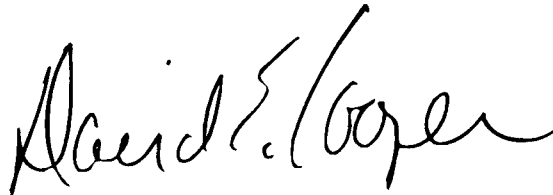
We performed our review between July 1993 and June 1994 in accordance with generally accepted government auditing standards. As agreed with your office, we did not obtain written agency comments on a draft of this report. However, we discussed our results with officials from DCAA, NASA, and Rocketdyne and incorporated their comments where appropriate.

²Transaction testing is a process that traces expenditures to supporting documentation to determine whether the expenditures are allowable. It also assesses the adequacy of a contractor's internal controls.

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 NASA Administrator; the Secretary of Defense; the Directors, Defense Logistics Agency, DCAA, and 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) 512-4587 if you or your staff have any questions concerning this report. Other major contributors to this report are listed in appendix I.

Sincerely yours,

A handwritten signature in cursive script that reads "David E. Cooper". The signature is written in black ink and is positioned centrally on the page.

David E. Cooper
Director, Acquisition Policy, Technology,
and Competitiveness Issues

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