FEDERALLY FUNDED R&D CENTERS

Use of Fee by the MITRE Corporation
National Security and International Affairs Division

B-259371

November 27, 1995

The Honorable Carl Levin
Ranking Minority Member
Subcommittee on Oversight of
Government Management
and the District of Columbia
Committee on Governmental Affairs
United States Senate

Dear Senator Levin:

The Department of Defense (DOD) spent about $1.25 billion in fiscal year 1995 for research, development, engineering, and analytical services from the 10 federally funded research and development centers (FFRDCs) it sponsors. The MITRE Corporation is one of the largest FFRDCs, with fiscal year 1995 DOD funding of about $374 million. A 1992 report by your Committee raised concerns about whether government agencies effectively managed the FFRDCs they sponsored. Among the concerns was whether the contract fees provided to FFRDCs—in addition to reimbursement of incurred costs—were adequately justified. As you requested, we examined DOD’s management of fees provided to MITRE. More specifically, we reviewed (1) the manner in which MITRE spends its DOD management fee, (2) the adequacy of federal guidance on how fees may be used, (3) opportunities to reduce management fees at MITRE, (4) ways to strengthen DOD management oversight of MITRE’s use of fees, and (5) DOD’s efforts to improve the fee management process for its FFRDCs. In September 1995, we issued a report on the use of management fees at The Aerospace Corporation.2

Results in Brief

Neither the Office of Management and Budget (OMB) nor DOD has prepared sufficient guidance on negotiating FFRDC contract fees. Consequently, recurring questions are raised about MITRE’s use of fees, as well as the use of fees by other DOD FFRDCs. For example, the Defense Contract Audit Agency (DCAA) recently questioned MITRE’s use of fees to pay for entertainment, personal expenses for company officers, and benefits for employees. MITRE plans to continue to use its management fee for some of these questioned expenses.

The services have delayed providing contract funding at the start of a fiscal year. Consequently, MITRE has needed large amounts of fee to cover interest expense. MITRE cannot bill the government for unfunded work and therefore borrows to pay the costs incurred until DOD funds are allotted to its contracts. Largely because of funding delays, MITRE borrowed $85.6 million at one point during fiscal year 1994—about 73 percent of the company's net worth—and incurred interest costs of $866,000 during the year.

DOD oversight of contract fees has not ensured that fee awards to MITRE are equitable and consistent. For example, Army and Air Force contracting officers have not noted that MITRE often underestimated the fee revenue it will receive from non-DOD customers, thus overstating the fees it will need from the Army and the Air Force. Further, Army and Air Force contracting officers provided MITRE widely differing fee rates for fiscal year 1995, indicating that DOD may need to further refine its fee-granting methodology.

DOD acknowledges the need for stronger oversight of FFRDC management fees. It recently reviewed its process for granting fees as required by the Conference Report of the DOD Appropriations Act for Fiscal Year 1995 and concluded that fee guidance should be clarified. DOD also recommended changes to provide stronger audit oversight of FFRDC's costs and to limit the discretionary funding provided FFRDCs through fees.

**Background**

FFRDCs are federally sponsored entities—operated by universities, nonprofit institutions, or industrial firms under contract with the federal government—that provide research, development, systems engineering, and analytical services to federal government agencies. In awarding these contracts, the government need not seek open competition, and it traditionally has undertaken a commitment to provide a sufficient, stable body of work to maintain the essential core of scientific and engineering talent at an FFRDC. The Director of Defense Research and Engineering oversees DOD's FFRDCs.

MITRE, a nonprofit company, operates an FFRDC for DOD under contracts with the Air Force and the Army. It also operates an FFRDC under a contract with the Federal Aviation Administration (FAA). In addition, through its non-FFRDC divisions, MITRE provides services to DOD agencies, federal civilian agencies, and state and foreign governments.
Payment of contract fees to organizations that operate FFRDCs is addressed in DOD regulations. The regulations instruct contracting officers to first examine an organization's retained earnings to determine whether a fee is needed. If a fee is needed, contracting officers must consider the organization's needs to purchase capital equipment, to rebuild working capital, and to pay certain ordinary and necessary business expenses that are not reimbursable under procurement regulations. The Air Force has expanded on this guidance by instructing contracting officers to consider such items as depreciation charges, investment earnings, and fees earned on non-DOD contracts as sources of funds to offset the need for fees, a process that the Army also follows. Once a fee is awarded, its use is left to an FFRDC's discretion.

Each year, MITRE submits a fee proposal to the Army and the Air Force outlining its anticipated needs to purchase capital equipment, rebuild working capital, and pay nonreimbursable expenses for the coming year. The proposal includes estimates of the depreciation charges, investment earnings, and fees on non-DOD contracts that will provide sources of funds to meet these needs as well as a proposed fee for its DOD contracts. Generally, MITRE uses historical trends to estimate its anticipated funding needs and the sources of funds available to meet these needs.

For fiscal year 1994, the Army provided MITRE a fixed fee of $7.6 million, representing 4.4 percent of estimated contract costs, and the Air Force provided a fee of $10.2 million, or 4.5 percent of estimated contract costs. These amounts included a traditional 3 percent of estimated contract costs—$5.2 million for the Army and $7.2 million for the Air Force—to support MITRE's independent research program. Beginning in fiscal year 1995, both services are funding MITRE's independent research through charges to overhead—comparable to the treatment of independent research for commercial contractors. This change has allowed the Army and the Air Force to significantly reduce fees awarded MITRE.

Lack of Guidance on Payment of Nonreimbursable Costs Results in Recurring Disputes

Neither OMB nor DOD has issued guidance that specifies the nonreimbursable costs contracting officers should consider in negotiating contract fees, as we recommended in our 1989 report. In that report, we concluded that some fees were appropriate because some necessary business expenses may not be reimbursed under government procurement regulations but questioned whether some costs paid from fee were necessary. Thus, to assist contracting officers in negotiating fees, we

recommended that guidance be developed providing examples of costs that could appropriately be considered in negotiating fees. DOD's current guidance notes that FFRDCs may incur some necessary but nonreimbursable costs but provides no examples of costs contracting officers may consider as ordinary and necessary.

In the absence of specific guidelines, the use of a fee for nonreimbursable costs has stimulated continuing controversy. During the late 1980s, the Air Force became concerned that MITRE used its contract fees for excessive and unnecessary expenditures and urged MITRE to reduce these expenses. MITRE agreed to various actions to reduce expenses. For example, MITRE agreed to limit the size of holiday parties and to reduce their costs. Further, MITRE instructed company officers to use first-class air travel only when they needed to perform work during a trip that could not be done in the coach cabin. Recognizing the potential for controversy regarding fee expenditures, Army and Air Force contracting officers said they have strengthened oversight of fee use and have challenged expenditures they considered inappropriate. For example, in fiscal year 1995, the Army and Air Force contracting officers began using detailed quarterly expenditure reports to monitor fee usage. Among the proposed expenses the contracting officers challenged during negotiations on fiscal year 1995 fees were costs for social functions and meals provided at business meetings.

DCAA has also raised questions about MITRE’s use of fees. During its review of MITRE’s fiscal year 1993 fee expenditures, DCAA concluded that fees were used to pay for lavish entertainment, personal expenses for company officers, and generous employee benefits. In addition, DCAA concluded that MITRE charged expenses to fees that would ordinarily be considered allowable, thereby avoiding the routine audit oversight normally accorded such costs. DCAA concluded that only 11 percent of the expenditures reviewed were “ordinary and necessary” business expenses. MITRE made similar expenditures during fiscal year 1994, and it plans to continue such expenditures—at a reduced level in some cases—during fiscal year 1995.

DCAA reported on numerous instances where MITRE used fees for entertainment expenses. For example, during fiscal year 1993, MITRE used fees to pay for a holiday party for company executives held in McLean, Virginia. This party cost $37,719, or about $110 for each of the 342 guests attending. During fiscal year 1994, MITRE held a similar holiday party at

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the McLean Hilton that cost $33,177. DCAA also cited use of fees to pay for a reception and dinners for the Board of Trustees during May 1993 at a cost of $21,208, or $118 per person, as well as $2,500 for a luncheon and tour of Washington, D.C., for spouses of the Trustees during the spring Trustees meeting. During fiscal year 1994, MITRE used fees to pay for a similar reception and dinners held in connection with the fall Trustees meeting, the cost was $18,778.

DCAA also reported that MITRE used fees to pay personal expenses for company officers. For example, MITRE used $5,547 in fees during fiscal year 1993 to install a home security system in the company president’s residence. During fiscal year 1994, MITRE used fees to pay the $22 monthly monitoring fee for the president’s home security system. Similarly, DCAA questioned the practice of paying for personal use of company-furnished automobiles with fees, which totaled $28,605 during fiscal year 1994.

DCAA also noted generous benefits for employees during its review. For example, DCAA noted that during fiscal year 1993 MITRE used fees to pay the company president a miscellaneous relocation allowance of $31,292. MITRE continued to use fees for these allowances during fiscal year 1994, charging $689,265 or an average of $5,696 per employee relocated.

In response to concerns raised by the services, and direction from the Congress, MITRE has reduced some fee expenditures. For example, MITRE has suspended the holiday party for executives. Consistent with restrictions in the Fiscal Year 1995 National Defense Authorization Act, MITRE no longer uses fees to match employees’ contributions to educational institutions and is not making corporate contributions to civic and service organizations. On the other hand, MITRE plans to continue using fees for some expenses DCAA criticized, such as providing officers company cars for personal use and generous miscellaneous allowances for employees who are relocated. MITRE maintains that its fee expenditures are comparable to the costs commercial concerns incur and are necessary to attract and retain top-quality technical and management personnel.

DOD Could Reduce Need to Fund Nonreimbursable Interest Costs

Because the Army and the Air Force delay providing contract funding at the start of a fiscal year, MITRE needs discretionary funding—provided through fees—to cover estimates of nonreimbursable interest costs. MITRE operates under a series of annual contract options awarded by the Army and the Air Force, and funds allotted to one fiscal year’s contract
may not be carried over to a following fiscal year. Further, funding comes from the various program offices for which MITRE does work, rather than from a single Army- or Air Force-wide source. Once the various program offices transfer funds to the contracting officer, the contracting officer issues contract changes to allot the funds. MITRE's contracts with the two services provide for reimbursement of allowable costs incurred, limited to the amount of funds allotted to the contracts. Thus, MITRE cannot submit bills for the cost of the work it has started until the funds have been allotted.

During fiscal year 1994, delays in providing funding for MITRE's Army and Air Force contracts were significant. The Army, for example, first allotted funds to MITRE's contract on November 30, 1993—2 months after work on the contract began. As of January 1994, allotments amounted to only 16 percent of estimated cost and did not reach 95 percent of estimated costs until August 1994. For several large projects, no funds were allotted until March 1994—almost 6 months after work started.

Funding delays affect MITRE's finances. MITRE records costs incurred for which no billings have been submitted as "unbilled costs." The level of unbilled costs carried on MITRE's books varied through fiscal year 1994 and reached $85.6 million at the end of January 1994—about 73 percent of the company's net worth. Unbilled costs on Army and Air Force contracts accounted for $66.6 million of the $85.6 million total. MITRE had $47.6 million in loans outstanding at the end of January 1994 and incurred $866,000 in interest costs during the year. We estimate that, if unbilled costs on Army and Air Force contracts had been due only to normal bill processing delays, average unbilled costs for the contracts would have been reduced from $38.2 million to $15.1 million during fiscal year 1994. Reducing average unbilled costs by $23.1 million would significantly reduce MITRE's financing burden. Since MITRE's average borrowings during fiscal year 1994 were $21.7 million, the need to provide fees to cover nonreimbursable interest costs would have been substantially reduced or eliminated.

Several military program management personnel cited a desire to retain funds to deal with contingencies as a reason for having delayed funding MITRE's work. One said that he was unaware that funding delays adversely affected the company. Another program management official, however, stated that they have a good idea of how much MITRE support they will use during a year; thus, there is no excuse for delaying funds. In fiscal year 1995, the Air Force placed a high priority on obtaining prompt
funding of MITRE projects. By January 1995, the Air Force had allotted funds representing about 85 percent of the estimated contract costs. Other options for reducing MITRE’s financing requirements include the advance payment pool mechanism that some university-sponsored FFRDCs use and the revolving budget authority account that the Air Force uses to provide advance funding to The Aerospace Corporation.

Oversight and Negotiation of Fees Could Be Improved

DOD’s oversight of MITRE’s fee expenditures does not ensure that negotiated fee awards are equitable and consistent. Army and Air Force contracting officers generally analyze past MITRE fee expenditures to estimate fee needs for future years. However, because MITRE has contracts with many other federal agencies and state and foreign governments, we believe it is important that each customer bear an equitable share of fee expenditures. Since contracting officers do not routinely screen fee expenditures for nonrecurring costs, we are concerned that estimates of future fee needs may be distorted. Finally, we noted that lack of clear guidance on using fee to provide financing led the Army to award MITRE a fee for fiscal year 1995 that was higher than the Air Force contracting officer’s.

Army and Air Force contracting officers have not determined if MITRE’s estimates of fees on non-DOD contracts, which reflect anticipated fee rates and volumes of business, are reasonable. As shown in table 1, in 3 of the last 4 years, MITRE underestimated non-DOD fee earnings.

Table 1: Estimated and Actual Fee Earnings on Non-DOD Contracts—Fiscal Years 1991-94

<table>
<thead>
<tr>
<th>Fiscal year&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Estimated</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>$8,251</td>
<td>$8,439</td>
</tr>
<tr>
<td>1992</td>
<td>9,778</td>
<td>10,151</td>
</tr>
<tr>
<td>1993</td>
<td>10,899</td>
<td>10,332</td>
</tr>
<tr>
<td>1994</td>
<td>9,882</td>
<td>11,043</td>
</tr>
</tbody>
</table>

<sup>a</sup>For fiscal years 1991 and 1992, data are for MITRE’s August 1 to July 31 fiscal year. In fiscal year 1993, MITRE changed its fiscal year to align with the federal fiscal year; 1993 and 1994 data are from October 1 to September 30.

In fiscal year 1994, the underestimate amounted to about $1.2 million, or almost 12 percent of estimated non-DOD fee earnings. Contracting officers, in some cases, have analyzed past trends in non-DOD fee earnings but have
not reviewed the reasonableness of estimates for future years. Thus, MITRE was able to obtain larger fees from combined DoD and non-DOD sources than contemplated in the Army and the Air Force fee negotiations.

Army and Air Force contracting officers have only occasionally determined whether fee expenditures related to DoD and non-DoD work were proportional to the work performed. This is partly due to MITRE's accounting system commingling fee expenditures, making it difficult to identify fee expenses that relate primarily to non-DoD customers. For example, in fiscal year 1994, MITRE recorded $79,181 in costs incurred for first-class airfare and similar nonreimbursable travel expenses in a single company account. One individual, the chief of the MITRE division that does air traffic control work for FAA, incurred $21,000, or about 27 percent, of these charges. In one instance, the chief spent $6,486 for a first-class flight to London, England, to attend an air traffic control conference. MITRE claimed reimbursement for the $2,471 cost of a coach ticket and charged the additional $4,015 cost of a first-class ticket to the commingled fee account even though MITRE acknowledged that these trips were related to MITRE's air traffic control system work for foreign governments. MITRE has recently changed its accounting system to account for fee expenditures by division—roughly representing major customers—providing an opportunity to more readily determine what customer benefits from particular expenses.

In addition, contracting officers have not analyzed the relative needs for working capital related to different customers. Payment cycles on MITRE's non-DoD contracts are typically longer than those on DoD contracts. Both the Army and the Air Force contracts provide for biweekly billings, and timeliness of payment is routinely discussed during fee negotiations. Many non-DoD contracts, however, provide for monthly, rather than biweekly, billings, and payments on these contracts are generally less prompt. Consequently, non-DoD customers have made proportionately heavier demands on MITRE's working capital than the Army and the Air Force. During fiscal year 1994, accounts receivable due from non-DoD customers represented an average of 60 days of revenue, compared to 12.7 days for the Army and the Air Force. The unbilled costs for both DoD and non-DoD customers each averaged roughly 35 days of revenue. Thus, the total financing burden for non-DoD customers of 94.3 days of revenue was almost twice the financing burden for the Army and the Air Force, which was 48.2 days.
Contracting officers did not routinely analyze MITRE fee expenditures to identify nonrecurring costs that would distort projections of future fee needs. Major categories of nonrecurring expenses have been occasionally identified. DCAA, for example, identified several nonrecurring items in its review of 1993 fee expenditures. We noted several expenditures that appeared to be nonrecurring in nature during our review of 1994 fee expenditures, as the following shows.

- A charge of $507,000 to reconcile MITRE's accounting records to its property management records. During fiscal year 1994, MITRE undertook a major effort to identify discrepancies between its property and accounting record-keeping systems because independent auditors had criticized it for not reconciling the two systems regularly.
- A charge of $270,000 to record anticipated costs of providing meals and refreshments at meetings. MITRE accounting staff told us that at the end of fiscal year 1994, costs incurred for meals and refreshments at meetings were substantially less than in previous years. This charge was recorded because the accounting staff anticipated that these costs would eventually equal those of previous years, but the anticipated costs did not materialize.
- A charge of $310,845 to write off losses on contracts with the German government. These losses were written off as part of an agreement to resolve payment disputes on work performed between 1979 and 1992.

Lack of sufficient guidance on use of fee to provide financing for FFRDCs led Army and Air Force contracting officers to award significantly different fee rates. In 1993, MITRE obtained a 3-year term loan to take advantage of favorable, fixed interest rates rather than the fluctuating rates on its short-term borrowing. In fee negotiations for fiscal year 1995, MITRE proposed that it obtain another term loan during 1995. The Air Force considered the proceeds of this loan as a source of cash, offset by a need to make principal payments on the term loan, and awarded a fee of $2 million, or about 0.9 percent of estimated contract costs. The Army, on the other hand, excluded both loan proceeds and principal payments from its analysis of 1995 fee requirements because it was unwilling to make a commitment to provide fee to cover principal payments in future years. Consequently, the Army awarded a fee of $3.7 million on its somewhat smaller contract, amounting to 2.3 percent of estimated costs. DOD guidance provides no suggestions on how contracting officers should treat financing transactions in analyzing fee needs.
DOD Recognizes Fee Guidance Should Be Strengthened

In the Conference Report of the DOD Appropriations Act for Fiscal Year 1995, the Congress directed DOD to review how its FFRDCs have used fees and provide recommendations for revising the DOD FFRDC fee structure. The results of that review, reported in May 1995,\(^5\) are consistent with the findings of our current work and recommendations we made in 1969 regarding fees granted sponsored nonprofit research organizations.

DOD's report identified a need for stronger guidance on FFRDC fees and more consistent fee awards. In its report, DOD concludes that because the Weighted Guidelines Method\(^6\) normally results in a fee greater than demonstrated need, some contracting officers have awarded unneeded fees. DOD recommended that the guidance be revised to (1) make it clear that need will be the criterion for awarding fees to FFRDCs, (2) avoid using undefined and ambiguous terms to describe fee needs, and (3) identify specific costs that are inappropriate to pay from fees. We found that Army and Air Force fee analysis procedures are intended to limit MITRE's fee to demonstrated need. The lack of a clear description of costs that fees can be used to cover, however, has complicated contracting officers' efforts to ascertain MITRE's fee needs.

DOD's report also identified a need for greater audit oversight of costs FFRDCs have historically paid from fees, such as the costs for independent research programs, contract termination, and capital equipment. In its report, DOD recommends, as we did in 1969, that independent research be treated as a reimbursable cost so that expenditures will be subject to routine audit oversight. The Army and the Air Force have implemented this treatment of independent research costs at MITRE.

DOD's report also recommended that termination costs should be audited and reimbursed directly when and if an FFRDC's contract is terminated; fees should not be provided for such costs. We have opposed using fees to build contingency reserves, and MITRE has not requested fees to build termination cost reserves.

As to financing capital equipment with fees, DOD recommends that the FFRDCs capital acquisition plans be thoroughly audited. We have recommended that FFRDC sponsors fund capital equipment purchases directly through contract charges rather than through fee. We noted that


\(^6\)This method is normally used to determine contract fees for commercial firms and is one test for determining reasonable FFRDC fees.
the capital equipment acquisition plan MITRE proposed during fiscal year 1994 fee negotiations differed markedly from MITRE’s actual purchases for the year.

Recommendations to the Secretary of Defense

We recommend that the Secretary of Defense

- issue guidance that, to the extent practicable, specifically identifies the nature and extent of nonreimbursable costs that may be covered by fee and the costs for which fees should not be provided;
- consider the feasibility of issuing guidance specifying the circumstances in which each of the various funding and payment methods devised by the services should be used; and
- assign responsibility to the Director of Defense Research and Engineering for routinely surveying the services’ fee-granting processes for FFRDCs, identifying and promoting the use of effective or innovative analytical practices, and recommending needed changes to eliminate inconsistencies in awarding fees.

DOD and MITRE Comments

DOD generally concurred with a draft of this report. It stated that the report would be helpful to ongoing DOD efforts to strengthen its procedures for the oversight and use of management fees by DOD-sponsored FFRDCs. However, DOD pointed out that none of the data in the report represented improper activity, as currently defined by contract or regulation, on the part of either the Air Force, the Army, or the MITRE Corporation.

DOD also agreed with our recommendations and indicated it would take steps to address them. It added that (1) in fiscal year 1996 DOD will address inappropriate use of fees during the contract negotiation process and (2) beginning in fiscal year 1995, fee expenditures are being associated directly with the cost centers (i.e., contracts) benefiting from the expenses. DOD said that these steps will result in reductions in the amount of fee paid to an FFRDC and help ensure that it pays only its fair share of fee expenses. DOD’s comments are presented in their entirety in appendix I.

MITRE agreed with our recommendation on the need for strengthened guidance on the nature and extent of nonreimbursable costs that may be covered by fee and the costs for which fees should not be provided. It also agreed with our observation regarding interest costs incurred as a result of delays in funding, as well as in billing and payment cycles and said it
would welcome some form of advance funding/payment mechanism. MITRE's comments are presented in their entirety in appendix II.

Scope and Methodology

We reviewed documentation relating to company organization and management and interviewed MITRE officials at the company's Bedford, Massachusetts, and McLean, Virginia, locations. We also reviewed accounting records and supporting documentation relating to fee expenditures during fiscal year 1994. We selected fiscal year 1994 because it was the most recently competed fiscal year at the time of our review and because expenditures for fiscal year 1993 had been reviewed by DCAA.

We interviewed officials and reviewed documentation maintained at the Director of Defense Research and Engineering, the DOD Inspector General, and DCAA. We also interviewed officials and reviewed documentation relating to contract fee awards at the three agencies that contract with MITRE for FFRDC operations: the U.S. Army Communications-Electronics Command, Fort Monmouth, New Jersey; the Air Force Electronic Systems Center, Hanscom Air Force Base, Massachusetts; and FAA, Washington, D.C..

We conducted our review from October 1994 to August 1995 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 the date of this letter. At that time, we will send copies to other interested congressional committees, the Secretary of Defense, the Director of the Office of Management and Budget, and the President of the MITRE Corporation. We will also make copies available to others on 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 III.

Sincerely yours,

[Signature]

David E. Cooper
Director, Acquisition Policy,
Technology, and Competitiveness Issues
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Contracts—Fiscal Years 1991-94

Abbreviations

DCAA Defense Contract Audit Agency
DOD Department of Defense
FAA Federal Aviation Administration
FFRDC federally funded research and development center
OMB Office of Management and Budget
Mr. David E. Cooper  
Director, Acquisition Policy,  
Technology, and Competitiveness Issues  
National Security and International  
Affairs Division  
U.S. General Accounting Office  
Washington D.C. 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "FEDERALLY FUNDED R&D CENTERS: Use of Management Fee by the MITRE Corporation, " dated September 18, 1995 (GAO Code 705085/OSD Case 9977).

The DoD generally concurs with the draft report. The information presented in the report will be very helpful to the ongoing DoD effort to strengthen its procedures for the oversight and use of management fees by DoD sponsored Federally Funded Research and Development Centers (FFRDCs). However, the DoD would like to emphasize (and the report should so state) that none of the data presented in the report represents improper activity, as currently defined by contract or regulation, on the part of either the Air Force, the Army, or the MITRE Corporation.

Additionally, while the Department understands that the report highlights data from the FY 1993 and FY 1994 Air Force and Army contracts with the MITRE Corporation (as examples of problems related to the issue of management control of fees), it would also be appropriate to acknowledge some of the positive steps that already have been taken to improve the FFRDC fee management process. Two examples are: (1) in FY 1996 the DoD will address inappropriate uses of fee during the contract negotiation process; and (2) starting in FY 1995, MITRE fee expenditures are being associated directly with the cost centers (i.e., contracts) benefiting from the expenses. These positive steps will result in reductions in the amount of fee paid to the FFRDC and help ensure that the DoD pays only its fair share of fee expenses.

The DoD detailed comments to the three GAO recommendations are enclosed. Thank you for the opportunity to respond to the draft report.

Sincerely,

Ann A. Jones

Enclosure
Appendix I
Comments From the Department of Defense

GAO DRAFT REPORT DATED SEPTEMBER 18, 1995
(GAO CODE #705085) OSD CASE 9977

"FEDERALLY FUNDED R&D CENTERS: USE OF MANAGEMENT FEE BY
THE MITRE CORPORATION"

DEPARTMENT OF DEFENSE COMMENTS ON
THE GAO RECOMMENDATIONS

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RECOMMENDATION 1: The GAO recommended that the Secretary of Defense issue guidance
that, to the extent practicable, specifically identifies the nature and extent of non-reimbursable
costs that may be covered by fee and the costs for which fees should not be provided. (p. 21/
GAO Draft Report)

DoD Response to Recommendation 1: Concur. The Department is developing improved
guidance for the determination of FFRDC fee award. However, the level of detail that will be
included regarding the nature and extent of non-reimbursable costs has yet to be determined. A
draft policy document is currently in coordination. The DoD plans to implement the guidance
during FY 1996.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense consider the
feasibility of issuing guidance specifying the circumstances in which each of the various funding
and payment methods devised by the Services should be used. (p. 21/GAO Draft Report)

DoD Response to Recommendation 2: Concur. As discussed in the DoD response to
Recommendation 1, improved guidance for the determination of FFRDC fee award is currently
being developed. The Department will consider the feasibility of including guidance specifying
various funding and payment methods.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense assign
responsibility to the Director of Defense Research and Engineering (DDR&E) for routinely
surveying the Services' fee-granting processes for Federally Funded Research and Development
Centers (FFRDCs), identifying and promoting the use of effective or innovative analytical
practices, and recommending needed changes to eliminate inconsistencies in awarding fees.
(p. 21/GAO Draft Report)

DoD Response to Recommendation 3: Concur. The DDR&E is currently responsible for DoD
fee policy guidance. Once the improved DoD guidance is issued, the DDR&E will determine
what additional steps may be necessary to establish and promote an effective and consistent
policy for all DoD FFRDCs.
Mr. David E. Cooper
Director, Acquisition Policy, Technology, and Competitiveness Issues
National Security and International Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

Thank you for the opportunity to review and comment on the draft report of the GAO regarding the use of fees. I regret being somewhat tardy with our reply.

Before expressing our comments, I note that the GAO staff who have interacted with our organization on this examination are professionals in every sense of the word. They were diligent in gathering data and careful in their analyses. While these matters are inherently burdensome, the staff on site at our facility, S.W. Peters and T.L. Harvey, demonstrated both patience and respect in placing demands upon people within our operations, thereby lessening the potentially deleterious impact on productivity.

Our observations and comments on the fee study were provided orally during a 9 June meeting to review the GAO's preliminary Discussion Paper. We were able to ask questions and point out some areas that we thought were in need of clarification or minor repair at that time. Many of our comments have been taken into account and/or reflected through changes in the draft report which you have forwarded for review and comment.

The principal area of continuing concern is related to the analysis and estimation of fee requirements by business unit and contract. The report seems to indicate that we simply determine our overall needs and then somehow allocate them out to the various contracts. In fact, fee is established for each contract based upon a separate assessment of the associated capital requirements, interest expense, management risk, payment experience, anticipated ordinary and necessary but nonreimbursable costs, etc., associated with that particular customer's work program. The objective is for each to pay its fair share; e.g., foreign contracts which are likely to have a slower payment cycle have a higher fee than the DOD contracts. Some expenses are corporate-wide, or at least bigger than a specific business area; in these cases, the anticipated expenses is pro rated based on a reasonable estimate of use or benefit associated with that contract. For example, the costs related to a facility improvement would be allocated based upon the number of people on the contract using that facility. The report implies a pattern of underestimating the fees to be

The MITRE Corporation
Burlington Road
Bedford, Massachusetts 01730
Mr. David E. Cooper
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received from non-DOD customers, thus overstating the fees needed from the Army and the Air Force; such is not the case, for the fee calculations are independent, and based upon the specific factors associated with the business of each unit. We find that the report is still rather misleading in this regard.

Other lingering concerns involve the use of provocative adjectives associated with fee charges to support discretionary expenditures for items such as employee morale, personnel relocation, and meetings of the Board of Trustees. As noted in the report, these sorts of typical business expense are controversial because of the lack of guidance for FFRDCs. We strongly support the GAO's recommendations for strengthened guidance.

Lastly, we agree with the report's observations regarding interest costs incurred as a result of delays in funding, as well as in billing and payment cycles. Some form of advance funding/payment mechanism would be welcome.

Once again, we appreciate your solicitation of our comments and I apologize for the late response.

Sincerely,

[Signature]

cc: Mr. Charles W. Thompson
Appendix II
Comments From the MITRE Corporation

The following is GAO's comment on the MITRE Corporation's letter dated October 26, 1995.

1. During the period covered by our review, MITRE did not have accounting mechanisms in place to track fee expenditures separately for each contract or customer. Consequently, data was not available to perform a structured analysis of whether contracts or customers paid a fair share of fees. As we note in our report, MITRE has changed its accounting system to account for fee expenditures by division or major customer. This data should facilitate analyses to determine whether fees are equitable among customers.
# Major Contributors to This Report

<table>
<thead>
<tr>
<th>National Security and International Affairs Division, Washington, D.C.</th>
<th>Charles W. Thompson</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office of General Counsel, Washington, D.C.</td>
<td>Ernie E. Jackson</td>
</tr>
<tr>
<td>Boston Field Office</td>
<td>Thorton L. Harvey Monty Peters</td>
</tr>
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