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Report to the Chairman, Legislation and National Security Subcommittee, Committee on Government Operations, House of Representatives

June 1994

OVERHEAD COSTS

Costs Charged by McDonnell Douglas Aerospace's Space Station Division

94-25187

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

National Security and
International Affairs Division

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June 23, 1994

The Honorable John Conyers, Jr.
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

As you requested, we reviewed the overhead cost submissions of McDonnell Douglas Aerospace's Space Station Division, Huntington Beach, California, to determine if the company included unallowable costs in its submissions. We also determined the extent to which overhead costs questioned by the Defense Contract Audit Agency (DCAA) were sustained during annual indirect expense rate negotiations. You also requested that we review another major National Aeronautics and Space Administration (NASA) contractor. This review is currently in progress, and we will report the results to you in a separate report.

Background

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Contractor overhead submissions establish overhead rates used in the settlement of cost-type contracts. They also provide the historical cost basis for overhead rates used in the negotiation of fixed-price contracts. The Federal Acquisition Regulation (FAR) cost principles require contractors to identify and exclude unallowable costs from their overhead submissions.

The Space Station Division is a major NASA contractor. The Department of Defense (DOD) provides administrative contract support to NASA to support its work at the Space Station Division.

DCAA reviews the Space Station Division's and other contractors' overhead submissions for allowability. Since NASA's space station program is under a cost-reimbursable contract and represents over 99 percent of the Space Station Division's sales, incurred costs are reimbursed almost dollar for dollar by NASA. McDonnell Douglas Aerospace is part of McDonnell Douglas Corporation.

Results in Brief

Our review of about $3.6 million of the contractor's overhead costs for 1989-92 identified about $251,000 in unallowable costs and about $77,000 in insufficiently documented consultant costs. The Space Station Division's controls are not adequate to identify and segregate unallowable costs. Also, DCAA did not perform sufficient transaction testing of the costs included in the company's overhead submissions.

The Space Station Division's overhead submissions also included about $53,000 attributable to employee federal and state income and Federal Insurance Contributions Act (FICA) taxes under an employment referral program, $348,000 in assignment payments as inducements to employees to transfer to new work locations, and $1.9 million for employee educational expenses. FAR provides that, in some cases, payments to employees as compensation for increased taxes are unallowable, but does not specifically address the allowability of amounts paid for employee taxes under certain forms of incentive compensation. FAR also does not specifically address payments for disruptions incident to employee relocations, and it contains few limits on employee education expenses. Additional FAR coverage or other guidance on these areas may be needed.

The sustention of DCAA questioned costs in negotiated overhead settlements was an inconsequential issue, as minimal costs were questioned by DCAA in the most recently audited overhead submissions.

Unallowable Costs

We identified about $251,000 in unallowable costs in the Space Station Division's overhead submissions. These costs were for lobbying, advertising, consulting services, travel, and registration fees.

Lobbying

FAR states that costs incurred to influence the enactment or modification of pending federal legislation through communication with any employee or Member of the Congress are unallowable. We identified about $129,000 in legislative branch lobbying costs incurred primarily under agreements with outside consultants. For example, one consultant was paid about $74,000 for lobbying activities that McDonnell Douglas acknowledged were charged in error.

In another case, the contractor incurred about $50,000 in consultant costs for professional services to promote corporate goals relative to the national space program. Government contacts included the Congress and executive branch officials with interests in the space station program.

Monthly consultant invoices contained detailed explanations of activities that exclusively involved contacts with senators, Members of the Congress, and congressional staffs.

Advertising

Employment advertising expenses included a duplicate payment of about $42,000. After we brought this matter to the company's attention, it requested a refund from the vendor, which was subsequently credited to the overhead account.

Consulting Services

The contractor spent about $69,000 in consultant costs for advice and interpretation of executive branch space policy and insights on aerospace activities relative to space programs and issues. These costs were not all allocable to the Space Station Division because most of the consultant activities involved programs other than the space station. McDonnell Aerospace agreed and said it will adjust the Space Station Division's overhead submissions to reflect the proportionate share of the consulting services for the appropriate years.

Other Unallowable Costs

We also identified about $7,000 in unallowable travel costs for first-class airfare and about $4,400 in registration fees associated with unallowable social or public relations activities.

Unsupported Consultant Service Costs

FAR places the responsibility for adequately documenting overhead costs on the contractor. We questioned about $77,000 because of a lack of adequate documentation of the nature and scope of services provided by consultants. For example, a marketing consultant was reimbursed about $34,000. Monthly invoices documenting these costs essentially consisted of a "boilerplate" statement, such as attendance at meetings and conferences, competitive assessments, or strategy development and program planning, without additional detail.

Another consultant was reimbursed about $22,000 for training designed to assess and influence customer decisions. The consultant's fees ranged from $2,750 to $3,250 a day. The consultant agreed to provide a detailed report so the contractor could evaluate the nature and scope of the services. However, the consultant never submitted the report.

Factors Contributing to Unallowable Costs in Overhead Submissions

The Space Station Division has no written policies or procedures on screening overhead costs for allowability determinations when its overhead submissions are prepared. In addition, it did not screen expenses in its overhead submissions, except for first-class airfare and promotional-type expenses. These weaknesses in the Space Station Division's internal controls were the principal reasons unallowable costs were included in the division's overhead submissions.

At the time of our review, the most recently completed audit by DCAA was on the company's 1989 overhead submission, where DCAA did limited transaction testing[1] and did not question any costs. DCAA's audit of the Space Station Division's 1989 overhead submission concluded that the contractor's internal controls for screening for unallowable costs were generally adequate to ensure that the cost submissions were prepared in accordance with applicable laws and regulations. DCAA's conclusion was based on the results of its audit of the Space Station Division's internal controls, which included some transaction testing. However, DCAA's transaction tests were limited to determining that invoices existed, check requests were approved by authorized officials, and remittances were made to approved vendors. DCAA's transaction testing did not assess the purpose of the expenses, nor their allowability. Our review of selected accounts in the 1989 overhead submission identified almost $134,000 in unallowable costs.

Other Costs of Concern

We are concerned about three other overhead cost areas. They relate to amounts attributable to employee federal and state income and FICA taxes under an employment referral program, assignment payments for employee relocations, and employee education expenses. In all three cases, the contractor included significant amounts of such costs in the overhead charged to the government.

Employee Taxes

The Space Station Division paid employees about $53,000 to cover additional federal and state income and FICA taxes under an employment referral program. The program was designed to provide $1,000 incentive bonus payments to employees who referred applicants to job openings for which the applicants were hired. Instead of $1,000, however, the amounts credited to the employees and charged to overhead ranged from $1,299 to $1,569, with the difference comprising employee federal and state income

[1]Transaction 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.

and FICA taxes due on the bonus. This practice is commonly referred to as "grossing up."

When FAR addresses the practice of "grossing up," it provides that payments to employees as compensation for increased taxes are unallowable. Specifically, while foreign differential pay as an element of total employee compensation may consider the impact of federal, state, local and foreign income taxes, any increased compensation calculated directly on the basis of an employee's specific increase in income taxes is unallowable. Moreover, differential allowances for additional federal, state and local income taxes resulting from domestic assignments are unallowable. Finally, employee income and FICA taxes are not allowable incident to reimbursed relocation costs.

Although FAR does not specifically address the payment of income taxes on incentive compensation such as the bonuses discussed here, it does state that the allowability of any unaddressed item of cost should be determined based on the treatment of similar or related selected items. In view of the disallowance of incremental tax obligations arising from other payments to employees, we question whether such payments associated with incentive bonuses are allowable. A DCAA review of this issue reached a similar conclusion.

Assignment Payments

Selected employees transferred to new work locations received assignment payments as an inducement to accept the new positions. In addition to the expenses normally associated with relocating employees, the Space Station Division's overhead cost submissions included about $348,000 in assignment payments—$62,000 at the Division's Huntington Beach, location and $286,000 at its Houston, Texas, location. As an example, the $286,000 in assignment payments for the Division's Houston location were associated with moving a senior management team from Huntington Beach to Houston. Assignment payments were computed at 15 percent of annualized weekly salary based on the start date of the new assignments. The contractor justified the payments on the basis of (1) disruption in social life and quality of life; (2) interruption of educational activities; (3) career conflicts, with potential loss of investment or business income; and (4) other inconveniences.

Since assignment payments do not reflect actual expenses incurred in relocations, they are not expressly reimbursable under FAR as relocation expenses. They also do not meet the FAR definition of bonus or incentive

compensation as these payments are not based on production, cost reduction, or efficient performance. In our view, FAR suggests that the government's responsibility for costs associated with relocations is limited to actual expenses.

Employee Education

FAR authorizes reimbursement of contractor tuition and fee payments for employee part-time undergraduate or post graduate education. Consequently, in the absence of an advance agreement, each contractor has considerable latitude as to the amount of employee education expenses reimbursed by the government for part-time education.

Educational expenses in the Space Station Division's overhead submissions for 1989-92 totaled about $1.9 million. The Space Station Division's education costs increased significantly from $119,000 in 1989 to $672,000 in 1992, due primarily to the larger number of employees taking advantage of the educational opportunities. A 74-percent increase in the Space Station Division's employment from 1989-92 was accompanied by a 400-percent increase in the number of employees receiving educational program reimbursements.

During most of this period, the contractor's policy was to fully reimburse employee educational expenses. For example, one employee was reimbursed $41,700, including $21,350 for a master's degree in business administration and $20,350 toward a doctorate degree in information systems. Another employee was reimbursed $33,000 for a master's degree in business administration.

In January 1992, however, citing serious financial challenges and the need to manage educational expenses responsibly, McDonnell Douglas limited reimbursements for employee education expenses. The change limited annual reimbursement to new students to 100 percent of the first $3,500 and 50 percent of expenses between $3,501 and $10,000. However, employees enrolled in job- or career-related degree or certificate programs before December 31, 1991, continued to be fully reimbursed.

FAR does not establish specific limitations on a per person, per contract, or per company basis on how much of the contractor's costs for helping educate employees can be charged to the government as reimbursable overhead. As a result, we believe that administrative contracting officers need to be particularly sensitive to these costs, especially when the

government assumes all or most of the contractor's costs, such as exists with the Space Station Division.

Sustention of DCAA Questioned Costs

The most recent indirect expense rate negotiations completed at the Space Station Division covered 1988 and 1989. DCAA questioned $29,946 in overhead costs in the 1988 submission. The government administrative contracting officer, however, accepted the 1988 questioned costs as allowable because they represented costs transferred to the Space Station Division from other company entities. Indirect expense rates had not been settled by the government at these company entities when the Space Station Division indirect expense rates were finalized. Provisions were made for adjustments, as necessary, in the 1990 Space Station Division overhead cost settlement when negotiations are completed at the other company entities. No costs were questioned in 1989.

Contractor Views

The Space Station Division agreed with most of our findings on unallowable and unsupported costs. It agreed to voluntarily delete these costs from its overhead submissions for years that had not been settled or closed. The company also agreed to pursue a corporatewide methodology for equitably handling adjustments for the settled 1989 overhead submission. The company stated that assignment payments, education expenses, and employee tax payments were allowable under FAR.

Recommendations

We recommend that the Administrator, Office of Federal Procurement Policy, initiate action to revise FAR to clearly state that contractor payments attributable to employee tax liability under all forms of incentive compensation, bonus plans, and expense reimbursements are unallowable. We also recommend that the Administrator clarify FAR as to the allowability of employee assignment pay and consider whether additional guidance is needed concerning the allowability of educational expenses, particularly where these expenses are reimbursed almost entirely by the government. Finally, we recommend that the Secretary of Defense direct the Defense Contract Management Command to emphasize to government contracting officers the need to ensure that there are reasonable limits on the government's liability for employee educational expenses. This could be done through establishing advance agreements with the contractor.

Scope and Methodology

We selected McDonnell Douglas Aerospace's Space Station Division for our review because over 99 percent of the Division's sales were to NASA under a cost-reimbursable contract. We focused our review on the accounts included in the overhead cost submissions for 1989-92 that we believed were vulnerable to mischarges. We examined source documents for these accounts to determine the nature and purpose of the expenses in relation to the FAR cost principles in effect at the time. Since the accounts we reviewed were not selected on a random basis, our results are not necessarily representative of the total overhead submission of the company.

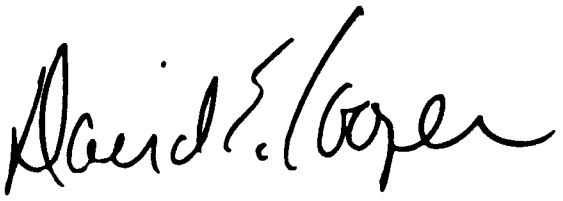
We also reviewed DCAA overhead cost audit reports and related work papers to determine the scope and depth of coverage and the adequacy of transaction testing to establish the allowability, allocability, and reasonableness of expenses included in the overhead submissions. We conducted a similar review of contractor audits and related work papers to assess the adequacy of internal controls of the overhead cost submissions.

We conducted our review between March and August 1993 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 DOD, NASA, and McDonnell Douglas Aerospace's Space Station Division and incorporated their comments where appropriate.

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 of the Defense Logistics Agency, DCAA, and Office of Management and Budget; and the Administrator, Office of Federal Procurement Policy. We will also provide copies to others upon request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix I.

Sincerely yours,



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