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STATEMENT OF

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RESEARCH, DEVELOPMENT, ACQUISITION, AND PROCUREMENT SUBDIVISION

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON INVESTIGATIONS

OF THE

COMMITTEE ON ARMED SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

ON

H.R. 2397 "ALLOWABLE COST REFORM ACT"

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Mr. Chairman and Members of the Subcommittee:

We are pleased to appear before the Subcommittee to discuss defense contractors' overhead cost billings and your proposed legislation which is designed to limit the payment of unallowable overhead costs. Overhead or indirect costs at contractors' operations represent a significant amount of costs reimbursed to contractors under government contracts. On an average, overhead represents almost 66 percent of total in-plant costs.

#### NEGOTIATION OF OVERHEAD COSTS

Contractors incur some overhead costs which the government deems to be unallowable and, therefore, not reimbursable under government contracts. Unallowable costs are those that under the provisions of any pertinent law, regulation, or contract cannot be included in prices, cost reimbursements, or settlements under a government contract. The government, through the Federal Acquisition Regulation (FAR), provides guidance on the allowability of contract costs.

The Department of Defense (DOD), through its Administrative Contracting Officers (ACOs), routinely negotiates final overhead agreements with contractors. These agreements determine what indirect costs are to be allowable for reimbursement in

overhead. The contracting officer has the responsibility to negotiate the overhead agreement with the contractor. In discharging this responsibility, the ACO seeks advice from the Defense Contract Audit Agency (DCAA) which has the responsibility to audit the books and records of defense contractors and make recommendations to the ACOs regarding the allowability of such costs.

We recognize that overhead negotiations between the government and its contractors are complex. We believe, however, that these negotiations could be improved considerably if FAR was less ambiguous in its definitions on the allowability of specific costs. In fact, it is this ambiguity which has contributed, in large measure, to the inconsistent treatment of questioned costs we found in a review we conducted in 1983 of final overhead cost settlements at 12 major DOD contracting activities.

Our review noted that there were numerous instances where DCAA was challenging, as unallowable, significant amounts of contractor costs only to have the ACOs overrule DCAA and allow a significant percentage of the costs questioned. We have read the testimony presented to this subcommittee by Mr. Williston

Cofer on May 15, 1985. The details of that testimony are very consistent with the findings made in our review.

Ambiguities in FAR permit contractors, DCAA, and contracting officers to have different interpretations on allowability. If a contractor believes a specific cost item is subject to interpretation, the contractor generally includes the cost in overhead. DCAA, in performing its overhead audits, uses the same FAR criteria, but often arrives at a different interpretation and questions the costs. If the contractor does not concede the questioned costs, they will be introduced into negotiations between the contracting officer and the contractor. Generally, the negotiations are concluded on a total, or "bottom line" basis without specific agreement on individual items that have been identified in a DCAA audit report.

Contractors are reluctant to negotiate and agree to individual cost items questioned by DCAA audit reports. This reluctance apparently stems from the knowledge that once an item of cost is mutually agreed to as being unallowable, Cost Accounting Standard (CAS) 405 "Accounting for Unallowable Costs" would require that, thenceforth, such costs would have to be excluded from any billing, claim, or proposal applicable to a government contract.

CAS 405 was promulgated to facilitate the negotiation, audit, administration, and settlement of contracts by establishing guidelines covering: (1) the identification of costs specifically described in FAR as unallowable and (2) the accounting treatment to be accorded such costs.

It is this reluctance to identify and mutually agree to specific cost items on the part of the contractors and the acquiescence to this procedure by ACOs which produces in large measure, the bottom line negotiations which we found so prevalent. By agreeing to the compromise figure in total, without addressing specific cost items such as airshows, entertainment, or giveaways, contractors can continue, year after year, to keep these costs in the overhead proposal for bottom line negotiations. We believe a more aggressive pursuit by contracting officers in identifying and documenting individual items of cost in overhead settlements as unallowable would contribute to the effectiveness of CAS 405 and represent a major step toward preventing reimbursement of unallowable costs on government contracts.

#### RECOMMENDATIONS TO IMPROVE THE SYSTEM

On two occasions we testified before the Congress and made recommendations to the Secretary of Defense on the need to strengthen the criteria governing the allowability of defense

contractors' public relations costs and the need to improve DOD's system to prevent payment of defense contractors' unallowable overhead costs.<sup>1</sup> We are pleased to note that a proposed change to FAR is now being circulated for comment. This gives specific definition to public relations and advertising costs and specifically addresses circumstances under which these types of costs are allowable or unallowable. In addition to recommending that FAR be strengthened, we also recommended that the Secretary direct administrative contracting officers to negotiate, settle, and document costs questioned as unallowable by DCAA on overhead claims on an item-by-item basis.

We believe that adoption of the FAR changes we proposed would reduce differences and disagreements among contractors, DCAA, and ACOs; improve overhead negotiations; and reduce inconsistent treatment of costs under FAR section 31.205 "Selected Costs." We also believe that our recommendation that ACOs negotiate and settle costs on an item-by-item basis would be a significant contribution to the effectiveness of CAS 405. We believe this one action would eliminate the perennial and unproductive negotiations concerning those costs.

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<sup>1</sup>Testimony before the Subcommittee on Legislation and National Security, House Committee on Government Operations, July 25, 1984.

Testimony before the Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, April 24, 1985.

Ambiguous Federal Acquisition Regulation Criteria on Defense Contractors' Public Relations Costs (GAO/NSIAD-85-20, Oct. 29, 1984).

Improvements Needed in Department of Defense Procedures to Prevent Reimbursement of Unallowable Costs on Government Contracts (GAO/NSIAD-85-81, May 7, 1985).

COMMENTS ON H.R. 2397

H.R. 2397, the concepts of which we support, addresses many of the problems uncovered by your Subcommittee and our review concerning the reimbursement of unallowable costs on government contracts. We would like to address some of the particulars in that bill.

We note, for example, that under the bill the Secretary of Defense in developing specific criteria for cost allowability must consider the best interests of the United States. Although we believe that contractors, as a rule, do not incur costs without what their management deems good reason the government, however, should not attempt to determine what are good business costs for any company, but rather should determine those costs which are in its interest and which it chooses to reimburse.

We strongly favor also the provision in H.R. 2397 which provides that costs which are specifically unallowable under one cost principle are not allowable under another related FAR principle. We believe this provision would reduce differences and disagreements among contractors, DCAA, and ACOs; improve overhead negotiations; and reduce inconsistent treatment of questioned costs.

We note that the bill provides for amending the DOD supplement to the FAR that deals with the allowability of contractor costs. As recommended in our previous reports, we suggest that the bill, direct the Secretary of Defense to coordinate with the Civilian Agency Acquisition Council in amending the applicable FAR provisions.

In addition, we favor the bill's provision that if a contractor's claim is not supported by adequate documentation, the cost becomes expressly unallowable and is not subject to negotiation. In our review we found that on several occasions, ACOs would reinstate questioned costs with little or no evidence provided by the contractors. For example, one ACO reinstated the entire amount of \$87,000 for questioned consulting service costs based on the contractor's oral promise that future billings would be supported.

We also strongly support H.R. 2397's provision that ACOs negotiate and settle costs questioned as unallowable on an item-by-item basis. This recommendation was included in our May 7, 1985 report to Secretary Weinberger on unallowable costs. We believe that negotiating and settling questioned costs on an item-by-item basis will enhance the effectiveness of CAS 405. When the contractor and ACO agree that selected cost items are unallowable, those costs will be eliminated from future billings. This, in turn, would eliminate recurring negotiations on these costs.

Further, we support the bill's 5-year limitation on the length of duty for ACOs. Although we do not have empirical data to support this view, we believe that the provision should assist in ensuring that unbiased negotiations and decisionmaking are achieved. We note, for example, that DCAA already has a mandatory 5-year rotation policy for its principal auditors located at the various DCAA field audit offices and we believe that this management philosophy should be applicable to ACOs as well.

Regarding the resolution of allowable expenses, H.R. 2397 provides that, "whenever feasible and practicable, the contract auditor may be present at any negotiation or meeting with the contractor. . . ." We would suggest that the bill's language be amended so that the requirement is that the contract auditor should be present at all overhead negotiations with the contractor. Currently, FAR 42.7 "Indirect Cost Rates" provides that in negotiating final indirect cost rates, "individuals or offices that have provided a significant input to the Government position should be invited to attend . . ." the negotiation proceedings. Our review found, more often than not, that DCAA auditors, while providing significant input (namely, the audit report) were not invited by the ACOs to attend the negotiations. We believe that the government's negotiating position would be strengthened considerably by DCAA's attendance at these negotiations.

In summary we support the objectives of H.R. 2397 and we believe that this bill addresses most of the significant problems currently surrounding unallowable costs and provides a structure for accomplishing what needs to be done in preventing reimbursement of unallowable costs on government contracts.

Mr. Chairman, this concludes our prepared statement and we will be pleased to answer any questions you or members of the Subcommittee may have.