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Report to Congressional Requesters

March 1994

OVERHEAD COSTS

Unallowable and Questionable Costs Charged by E-Systems, Inc.

GAO/NSIAD-94-113

GAO

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General Accounting Office
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National Security and
International Affairs Division

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March 28, 1994

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

The Honorable Kent Conrad
United States Senate

As you requested, we reviewed the overhead cost submissions of E-Systems, Inc., to determine if they included unallowable costs. We reviewed $16 million of the $362.8 million in general and administrative expenses for 1989-92 for E-Systems' corporate headquarters; its Greenville, Texas, division; and Serv-Air, Inc., a subsidiary. This report also discusses the results of the Defense Contract Audit Agency's (DCAA) latest audits of E-Systems and whether E-Systems' internal controls can adequately identify and segregate unallowable costs.

Background

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 defense contractors to identify and exclude unallowable costs from their overhead submissions. Contractors are also required to certify that, to the best of their knowledge, their submissions do not include unallowable costs.

We have previously identified instances in which defense contractors have included unallowable or questionable costs in their overhead submissions. For example, in November 1992, we reported that six smaller defense contractors included about $2 million in unallowable and questionable costs in their overhead submissions.[1] Also, in October 1993, we testified that McDonnell Douglas Corporation, a large defense contractor, included $1.6 million in unallowable and questionable costs in its overhead cost submissions.[2]

[1] Contract Pricing: Unallowable Costs Charged to Defense Contracts (GAO/NSIAD-93-79, Nov. 20, 1992).

[2] Overhead Costs: Unallowable and Questionable Costs Charged by McDonnell Douglas Corporation (GAO/T-NSIAD-94-60, Oct. 13, 1993).

E-Systems, Inc., was 34th on the 1993 list of the top 100 defense contractors by revenue. E-Systems' sales to the U.S. government amounted to about $1.6 billion, $1.8 billion, and $1.9 billion for 1990-92, respectively, and accounted for about 90 percent of its total net sales for 1990-92. In 1992, about 48 percent of E-Systems' government sales were made by the two business segments we examined.

Results in Brief

Our review of $16 million in general and administrative transactions identified about $120,000 in unallowable costs. These included costs for personal use of automobiles, public relations, travel, and legal services. Our review also disclosed another $2.8 million in questionable charges principally because E-Systems did not keep or was unable to provide sufficient documentation for us to determine the allowability of the questioned costs. We also considered over $39,000 in travel costs to be excessive.

DCAA has also questioned E-Systems' overhead costs. During the last three annual audits of E-Systems corporate headquarters' overhead submissions (1988-90), DCAA questioned about $3.3 million in overhead costs. Also, during the last two overhead audits of E-Systems' Greenville division (1988 and 1989) and Serv-Air (1988 and 1989), DCAA questioned about $957,000 and $502,000, respectively, in overhead costs. DCAA has concluded, and we agree, that E-Systems' internal controls for identifying and segregating unallowable costs were, in some respects, inadequate to ensure that only allowable costs were included in the company's overhead cost submissions. Not all of the unallowable or questionable costs we identified represent overcharges to the government. These costs were included in the contractor's 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 defense versus commercial business performed by the contractor and the types of contracts with the government. In addition to being charged to government cost-type contracts, undetected unallowable costs may affect the negotiation of fixed-price contracts.

Unallowable Costs

We identified about $120,000 in unallowable general and administrative expenses included in E-Systems' overhead submissions. These include costs for personal use of automobiles, public relations, travel, and legal services. Appendix I lists these costs and the specific reference or FAR cost principle that makes them unallowable.

Personal Use of Automobiles

According to the FAR, the cost of using company-furnished vehicles for employees' personal use is unallowable compensation. The employee compensation is reported to the Internal Revenue Service (IRS) as taxable income, while the cost to the company is deducted from its cost submissions. To correctly report and exclude unallowable cost for personal use of company vehicles from the overhead submissions, the contractor's internal controls must be adequate to ensure complete records of employees assigned company vehicles and their personal use mileage.

Corporate headquarters from 1989 to 1992 did not have adequate records of employees' assigned company vehicles and their personal use mileage. In 1989 and 1990 corporate records were not adequate to calculate personal use cost for five employees, which should have been excluded from the submissions. In 1991, we could not determine if personal use costs were properly excluded from the submission because the company was unable to supply a list of employees assigned vehicles for the entire period. In 1992, personal use costs for one employee was not excluded from the submission. Based on the reported average personal use in each year, we estimate the company did not exclude about $28,000 for personal use of company vehicles from its submissions. Inadequate records on personal use of company vehicles, we observed, also resulted in the contractor not reporting income to the IRS for three to five employees in each of the years we reviewed.

Public Relations

The FAR states that public relations costs as well as the applicable portion of salaries, travel, and fringe benefits of employees engaged in the functions are unallowable if the primary purpose is to promote the sale of products or services or enhance the company's image. We identified $11,600 for employee attendance at government ceremonies that we believe were unallowable public relations functions. This amount included about $7,350 for employees to attend military change-of-command ceremonies. For example, two company vice presidents and two employees flew in the corporate airplane from Greenville, Texas, to Beale Air Force Base, California, to attend the change-of-command ceremony for the Air Combat Command on August 18, 1992. The 1-day trip, which cost $3,584, was charged as an allowable travel cost.

Travel

Airfare costs are limited to the cost of the lowest standard commercial airfare, according to the FAR. However, E-Systems included the full cost of two chartered aircraft flights in its overhead claim. These chartered flights, costing about $19,300, are significantly more than the maximum amount allowed, based on standard commercial fares. For example, in June 1989, three company executives chartered an aircraft for a trip to an investment conference in South Carolina. This flight cost $13,019, or about $4,340 per person. If standard commercial airfares for these executives had been used, the allowable cost would have been about $11,000 less.

We also identified about $27,100 in travel costs incurred by employees planning or executing unallowable mergers and acquisitions activities. The FAR states that expenses associated with such activities are unallowable. Other unallowable travel costs totaling $11,300 were for activities such as social events and travel for personal convenience.

Legal Services

According to the FAR, legal expenses associated with a proceeding brought by the Federal government are partially or wholly unallowable depending on the outcome of the proceeding. Unallowable legal expenses also include patent costs that are not incurred as requirements of a government contract. We identified abut $23,000 in unallowable legal expenses. For example, E-Systems spent about $35,200 in connection with a federal grand jury proceeding concerning the theft of government property. The costs were incurred in responding to a subpoena and conducting an investigation of the theft allegations. The grand jury proceeding was terminated after the company reported its findings. When a federal proceeding results in no finding of wrongdoing by the contractor, allowable legal expenses are limited to 80 percent of the incurred costs, or $28,200 in this case. Thus, the difference of $7,000 is unallowable.

E-Systems also included in overhead $1,500 to replenish a deposit account with the Patent and Trademark Office for patent costs. However, patent expenses paid from this account were not shown to be required by any government contract. This was also true of $10,300 in other patent costs. In addition, in 1990, E-Systems entered into an agreement with the government in which it pleaded guilty to conspiracy to defraud the United States and to making false claims against the United States. The company agreed to disallow all costs incurred in connection with its defense in civil and criminal proceedings of this case. However, about $4,200 related to the company's defense was charged to allowable overhead accounts.

Questionable Costs

We questioned $2.8 million in expenses due to inadequate documentation and excessive travel costs. Additional documentation and reconstruction of unrecorded activities will likely result in some portion of the questioned costs being reclassified as unallowable and some portion remaining as allowable. Appendix II lists all of the questionable costs and the specific reference or FAR cost principle that is applicable to them.

Inadequate Documentation of Costs

We questioned about $2.7 million in overhead cost submissions because E-Systems did not keep or was unable to provide sufficient documentation for us to determine the allowability of submitted costs. One of the expenses associated with the questioned cost submissions was for a new business development unit that E-Systems created to, among other things, identify, investigate, and analyze possible acquisition and merger opportunities. Even though expenses related to acquisitions and mergers are unallowable, most of this unit's expenses (about $1.9 million) was submitted as allowable. E-Systems did not keep records to permit segregating these expenses between allowable and unallowable activities.

In addition, legal services performed for E-Systems lacked the supporting documentation required by the FAR. The bills received for these services did not include the time spent on each service, who rendered the service, and how much the service cost. Without this information, we could not determine whether the cost was reasonable. Also, about $89,000 of travel expenses for company employees was classified as allowable, even though there was not sufficient documentation showing the purpose for the travel, as required by the FAR. E-Systems subsequently provided documentation showing that about $19,600 in travel expenses was for allowable purposes and $27,100 was directly associated with unallowable mergers and acquisition activities. We questioned the remaining $42,300 because the company could not demonstrate that the travel was for allowable purposes.

Reasonableness of Travel Costs

We also questioned whether about $39,400 in travel expenses were allowable. The expenses included $1,100 for limousine services for company executives when other, less costly means of transportation, such as taxicabs or rental cars, appeared to be available. For example, company executives rented a limousine for 9-1/2 hours at a total cost of $389 and asserted, without supporting cost documentation, that the limousine service was less costly than a taxicab because of the number of meetings and their different locations.

The expenses also included the use of the corporate aircraft to transport cargo at passenger rates. In general, the cargo was not adequately identified and weighed to permit exact determination of what the cost would have been to ship the cargo commercially. However, on the basis of a general cargo description, we believe some could have been shipped commercially for less cost. For example, the company charged $5,128 for delivering a contract proposal from corporate headquarters in Dallas, Texas, to Washington, D.C. The proposal, which was shipped in several boxes over a 2-day period, weighed about 600 pounds. According to DCAA, shipment by commercial overnight express would have cost about $1,000. Further, this and other cargo was shipped one-way, yet the company charged for a round-trip. The difference between the round-trip charged and a one-way trip for 1990 and 1991 amounted to about $20,100, which is the amount we questioned. Also, the corporate aircraft was used to transport non-employees, such as city officials and foreign customers, at a total cost of $11,200. Finally, about $7,000 of travel expenses for employees was questioned because it appeared unreasonable.

DCAA's Review of E-Systems

DCAA also questioned E-Systems' overhead costs. During its audits of corporate headquarters' 1988-90 overhead submissions, DCAA questioned about $3.3 million of the $75 million claimed. Questioned costs included about $578,000 for deferred compensation payable to directors, $99,000 for lobbying, $218,000 in recruitment advertising, $101,000 for travel, $249,000 for employee compensation, and $449,000 for a supplemental executive retirement plan.

During its audits of the Greenville division's 1988 and 1989 overhead proposals, DCAA questioned about $957,000 of the $89 million claimed. Questioned costs included about $451,000 in domestic field office allowance, $139,000 in domestic marketing, and $56,000 in legal, consultant, and audit costs.

During its audits of Serv-Air, Inc.'s 1988 and 1989 overhead proposals, DCAA questioned about $502,000 of the $12.5 million claimed. Questioned costs included $229,000 in dental insurance, $101,000 in franchise taxes, and $17,000 in recruitment advertising.

In its 1993 audit of internal controls covering the accounting for unallowable costs at E-Systems corporate headquarters, DCAA concluded that the company's internal controls for identifying and segregating unallowable cost are, in some respects, inadequate to ensure that only allowable costs were included in overhead cost submissions. For example, the company lacks formal written policies and procedures covering the identification and segregation of unallowable costs. On the basis of our findings, we agree with DCAA that E-Systems' internal controls are not adequate to identify and exclude unallowable costs.

DCAA also concluded in its audit that the risk of significant unallowable costs being charged to government contracts was minimized because E-Systems' employees that process vouchers and prepare cost submissions are experienced in performing their duties without written policies and procedures. However, employee turnover could significantly alter this risk.

E-Systems Response to Our Findings

E-Systems agreed with most of the findings in this report. It acknowledged that it did not identify unallowable costs in some cases or sufficiently document other costs so that allowability could be determined.

E-Systems said the findings in this report were relatively insignificant, considering the complex and changing regulations with which the company must comply. Nevertheless, it said it would improve its controls to avoid future inappropriate charges to overhead and to improve documentation of cost charges. The company agreed that it should eliminate all unallowable costs in its overhead submissions.

Scope and Methodology

We selected E-Systems, Inc., of Dallas, Texas, for our review because it was 1 of the top 100 defense contractors by revenue and because we could obtain a wide variety of activity with corporate headquarters, a manufacturing division, and a wholly owned subsidiary within the same geographical area. In our examination of E-Systems' indirect costs, we reviewed the overhead submissions for 1989-92 for those accounts we believed to be vulnerable to overbilling. We focused principally on 1990-92 since these years had not been completed by DCAA. We selected individual summary vouchers that appeared to be questionable. We then traced voucher costs to documentation supporting their nature and purpose and determined whether the costs were allowable under the applicable FAR cost principles.

We conducted our work between November 1992 and September 1993 in accordance with generally accepted government auditing standards. As requested by your office, we did not obtain written agency comments on a draft of this report. However, we discussed the results of our review with appropriate E-Systems' and DOD officials and incorporated their comments where appropriate.

Copies of this report are being sent to the Secretary of Defense; the Director, Defense Contract Audit Agency; the Director, Office of Management and Budget; and other interested parties. 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.

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

E-Systems' Unallowable Overhead Costs

Unallowable cost claimed	Business segment	Cost principle	Amount
Personal use of automobile	Headquarters	FAR 31.205-6(m)(2)	$28,000
Public relations	All	FAR 31.205-1	11,600
Merger/acquisition associated travel costs	Headquarters	FAR 31.205-27	27,100
Excessive travel costs	All	FAR 31.205-46	15,800
Other unallowable travel	All	FAR 31.205-46	11,300
Legal services			
Response to Grand Jury subpoena	Serv-Air	FAR 31.205-47 (e)	7,000
Patent	Headquarters	FAR 31.205-30	1,500
Patent	Greenville	FAR 31.205-30	10,300
Criminal prosecution of four employees	Headquarters	Plea agreement between Justice Dept. and E-Systems	4,200
Directly associated costs	All	FAR 31.201-6	3,400
Total			**$120,200**

Note: Dollar amounts have been rounded.

E-Systems' Questionable Overhead Costs

Questionable cost claimed	Business segment	Cost principle	Amount
Travel reasonableness			
Use of limousine	Headquarters	FAR 31.201-2 and -3	$1,100
Use of corporate aircraft			
Cargo	Greenville	FAR 31.201-2 and -3	20,100
Non-employees	Greenville	FAR 31.205-46	11,200
Employees	All	FAR 31.201-2 and -3	7,000
Subtotal			**39,400**
Lack of documentation			
New business unit	Headquarters	FAR 31.205-27	1,900,000
Legal			
Investigation of corporate liability for wrongdoing	Headquarters	FAR 31.205-33	752,800
Wrongful discharge	Greenville	FAR 31.205-33	41,600
Investigation	All	FAR 31.205-33	12,100
Miscellaneous patent	Headquarters	FAR 31.205-33	4,900
Patent matters	Headquarters	FAR 31.205-33	2,600
Travel expenses	All	E-Systems' travel directives	42,300
Total			**$2,795,700**

Note: Dollar amounts have been rounded.

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