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The Department of Defense's Contractor Weighted Average Share in Cost Risk program, designed to eliminate the evaluations of the reasonableness of contractors' indirect expenses or overhead (such as travel and rent), does not guarantee that costs are controlled effectively.

Findings/Conclusions: The program is based on the assumption that good management by industry, properly motivated by competition and fixed-price contracts, more effectively controls costs than detailed reviews and controls by Government. These assumptions do not seem valid. At the locations reviewed, the agency audits of indirect expenses have generally been adequate except for limitations on questioning the reasonableness of costs imposed by the program. Recommendations: The Secretary of Defense should remove the Contractor Weighted Average Share designation from the Armed Services Procurement Regulation for expenses of corporate aircraft, cafeterias, and leasing buildings and equipment and should reconsider the program altogether, since savings have not been proven and eliminating it would probably not materially increase Government involvement in contractors' affairs or increase, overall, the Defense Contract Audit Agency's audit work. (Author/SC)

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**REPORT OF THE
COMPTROLLER GENERAL
OF THE UNITED STATES**

**Increased Costs To Government
Under The Department Of Defense
Program To Reduce Audits**

The Contractor Weighted Average Share in Cost Risk program is based on the assumption that good management by industry, properly motivated by competition and fixed-price contracts, more effectively controls costs than detailed reviews and controls by Government.

Whenever practicable, administrative controls and audits for reasonableness of costs are eliminated when these conditions are prevalent. However, the program does not seem cost effective and the assumptions for the program do not seem valid.

At the locations reviewed, the Defense Contract Audit Agency audits of indirect expenses have generally been adequate except for the limitations on questioning reasonableness of costs imposed by the program.



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-183327

The Honorable William Proxmire
Chairman, Joint Committee on
Defense Production
Congress of the United States

Dear Mr. Chairman:

Pursuant to your October 21, 1975, request, we have reviewed the Department of Defense's Contractor Weighted Average Share program and related overhead expense audits of the Defense Contract Audit Agency at five major defense contractors.

Originally we were also requested to identify any entertainment facilities maintained by the contractors and the names of any Federal employees who accepted entertainment at these facilities. In early 1976, the defense contractors, including those reviewed by us at a later date, furnished information on the entertainment of Federal employees directly to members of the Committee, and it was agreed with your office that we would drop that portion of the request.

This report contains recommendations to the Secretary of Defense which are set forth on page 7. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House Committee on Appropriations and the Senate Subcommittee on Defense with the agency's first request for appropriations made more than 60 days after the date of the report. We will be in touch with your office in the near future to arrange for release of the report so that the requirements of section 236 can be set in motion.

B-183327

At your request, we did not take the additional time to obtain written comments from the Department of Defense.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Arthur K. ...', is written above the typed name.
**ACTING Comptroller General
of the United States**

D I G E S T

The Department of Defense's Contractor Weighted Average Share in Cost Risk program, designed to eliminate the evaluations of the reasonableness of contractors' indirect expenses or overhead (such as travel and rent), does not guarantee that costs are controlled effectively.

Contractors qualifying under the program cannot be audited by the Defense Contract Audit Agency for reasonableness of some costs. Because of this, a contractor's expenses for use of private aircraft exceeded equivalent commercial travel costs by \$133,000 and were paid by the Government. In two cases, a contractor incurred the same kinds of costs at his qualifying and non-qualifying locations, but costs were questioned only at the nonqualifying location.

Do contractors with a high percentage of fixed-price Government contracts and non-Government business have sufficient competitive motivation to minimize overhead costs? GAO does not think so. (See pp. 5 and 6.)

The contractors reviewed did not always furnish the Defense Contract Audit Agency with documentation necessary to establish what work consultants did. As a result, about \$2.4 million was questioned by the Agency. (See p. 9.)

The contractors, by not supplying supporting documentation of claimed costs at the contractors' Washington, D.C., offices, hindered the Defense Contract Audit Agency efforts to make sure that unallowable costs were not being reimbursed by the Government.

Except for the limitation on questioning reasonableness of costs under the program, the Defense Contract Audit Agency adequately audited indirect expenses. (See p. 9.)

The Secretary of Defense should:

- Remove the Contractor Weighted Average Share in Cost Risk designation from the Armed Services Procurement Regulation for expenses of corporate aircraft, cafeterias, and leasing buildings and equipment.**
- Reconsider the program, since savings have not been proven and eliminating it would probably not materially increase Government involvement in contractors' affairs or increase, overall, the Defense Contract Audit Agency's audit work.**

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	<u>ABBREVIATIONS</u>	
ASPR	Armed Services Procurement Regulation	
CWAS	Contractor Weighted Average Share	
DCAA	Defense Contract Audit Agency	
DOD	Department of Defense	

CHAPTER 1

INTRODUCTION

On October 21, 1975, the Joint Committee on Defense Production requested that we examine costs incurred by selected contractors and determine whether any such costs were charged to Government contracts in violation of the Armed Services Procurement Regulation. The request was prompted by congressional investigations into the possible allocation to Defense contracts of unallowable consultant and entertainment expenses by the Northrop Corporation. The Committee requested that we investigate five other major Defense contractors--Raytheon, Martin Marietta, Lockheed, General Dynamics, and Rockwell International.

We examined the Department of Defense's Contract Audit Agency's procedures to determine their effectiveness in determining whether unallowable costs were being charged to Government contracts. We also examined the Department of Defense's program entitled "Contractor Weighted Average Share in Cost Risk" (CWAS). This program, designed to lessen Government surveillance under certain circumstances, is largely applied to indirect cost or overhead.

For cost-type contracts, the Department of Defense reimburses Defense contractors for allowable, allocable, and reasonable costs incurred in the performance of contracts. The same cost principles apply to the pricing of fixed-price type contracts and contract modifications whenever cost analysis is performed.

The contractor submits an overhead cost proposal soon after the close of the contractor's fiscal year, and the Defense Contract Audit Agency performs an overhead audit for that year.

There are two methods for settling the final overhead rates. One is for the contracting officer to authorize the audit agency to determine settlement which can be appealed by the contractor to the contracting officer. The other more frequent method is by negotiation between the contractor and the contracting officer after an advisory report has been submitted by the audit agency. Auditors may or may not be present for the negotiation.

THE CONCEPT OF CONTRACTOR WEIGHTED AVERAGE SHARE

The CWAS program developed by the Department of Defense is based on the assumption that contractors with a high percentage of competitive firm-fixed-priced Government contracts and non-Government business have sufficient competitive motivation to minimize overhead costs. In contrast, contractors with a high percentage of cost-type and non-competitive fixed-price contracts are assumed to have little motivation to control overhead costs. Each year the Department of Defense classifies contractors and contractor divisions as one of these two types using a weighted dollar value for each category of contract. A description of how CWAS is applied is provided in appendix I. The objective of this program is to reduce Department of Defense surveillance of contractor's activities and thereby reduce its manpower requirements.

The CWAS rating may apply to one or more profit centers within a corporation or to the entire corporation. Costs incurred at the corporate office are subject to audit at the corporate office only. Once they are allocated to operating divisions they are not subject to audit. Costs subject to audit at the division level are those which have been incurred at that level.

When a contractor becomes qualified, the CWAS concept eliminates an audit determination of reasonableness of specifically identified types of expenses. Examples of CWAS-designated costs are travel costs; travel via contractor-owned, leased, or chartered aircraft; rental costs (including sale and leaseback of property); and employee morale, health, welfare, and food service and dormitory costs.

The Defense Contract Audit Agency normally audits contractors' expenses on a continuing basis for allowability, allocability, and reasonableness. When a particular contractor's plant meets the CWAS threshold, the audit agency omits its test of reasonableness for those costs designated as CWAS-rated. Examples of costs questioned for the above reasons at the five contractors we reviewed are:

- Allowability - Most advertising is unallowable. One contractor's cost of participation in a foreign city's air show was questioned on that basis.

The contracting officer disagreed with the audit agency and allowed the costs.

--Allocability - Costs for corporate aircraft which were used for both commercial and Government business were incorrectly allocated to a plant engaged in only Government business. The allocability of costs applicable to commercial activities was questioned. Settlement was not completed during our review.

--Reasonableness - Leasing costs of automatic data processing equipment in excess of ownership costs were questioned. Settlement was not completed during our review.

Our review concentrated on the audit agency's audits of overhead costs for calendar or fiscal years 1972, 1973, and 1974. We reviewed DCAA audit reports and working papers, audit guidance, audit programs, and requirements of the Armed Services Procurement Regulation and the Defense Contract Audit Manual. In addition, we reviewed contractors' policies and procedures relating to indirect costs, and documentation pertaining to CWAS-affected costs, and discussed the CWAS effects on Government contracts with Defense Contract Audit Agency officials. We also discussed each cost settlement with the audit agency and with the contracting officer who negotiated the settlement with the contractor.

A list of the contractor locations visited is shown below:

<u>Contractor</u>	<u>Locations</u>
Raytheon Executive Office	Lexington, Massachusetts
Raytheon Missile Systems Division	Lexington, Massachusetts
Rockwell International Corporate Office	Pittsburgh, Pennsylvania
Rockwell Electronics Operation, Autonetics Group	Anaheim, California
General Dynamics Corporate Office	St. Louis, Missouri
General Dynamics, Fort Worth Division	Fort Worth, Texas

**Lockheed Aircraft Corporation
Lockheed-California Company**

**Burbank, California
Burbank, California**

**Martin Marietta Corporate
Office
Martin Marietta, Denver
Division**

**Rockville, Maryland
Denver, Colorado**

CHAPTER 2

CWAS DOES NOT ASSURE EFFECTIVE CONTROL OF COSTS

The CWAS concept is based on the assumption that good management by industry, properly motivated by competition and fixed-price contracts, accomplishes more effective control of costs than detailed reviews and controls by Government. Whenever CWAS qualifications are met, administrative controls are relaxed and consideration of the reasonableness of costs is eliminated.

From discussions with Defense Contract Audit Agency officials and contracting officers, and a review of the scope of the audit agency's work, we found that use of the CWAS concept has had little impact on the audit agency's workload. Essentially, most major overhead costs must be audited for allowability and allocability regardless of the CWAS program, and the additional effort to consider the reasonableness of such costs is minimal.

Overhead costs totaling \$41.0 million were not audited for reasonableness during 1972 to 1974 at three CWAS-qualified contractors which we visited. The CWAS program prevented the auditors from questioning the reasonableness of one contractor's corporate aircraft costs of \$733,000 in excess of commercial equivalent costs.

By comparing the same types of costs at both a CWAS and a non-CWAS location, we found indications that CWAS-qualified cost centers do not control expenses any more closely than do non-CWAS-qualified cost centers.

COSTS IN EXCESS OF COMMERCIAL EQUIVALENT TRANSPORTATION ARE CHARGED TO THE GOVERNMENT

Normally any increased costs from using a company's private aircraft rather than available commercial airlines are questioned by Government auditors on the basis of reasonableness. However, corporate aircraft costs are designated in the Armed Services Procurement Regulation as CWAS, meaning that the reasonableness of such costs incurred at a CWAS location is not questioned.

In an audit of 1972 expenses at one contractor, the audit agency questioned the reasonableness of \$161,000 in corporate aircraft costs in excess of commercial equivalent costs. A Defense Contract Audit Agency auditor stated that the contractor did not provide supporting records justifying use of the corporate aircraft. The excess aircraft costs questioned for 1972 were disallowed and were not paid by the Government. Subsequently, the corporate office became CWAS-qualified and thereafter, aircraft expenses were not questioned for reasonableness.

In 1973 and 1974 at the same contractor location, the total allowable aircraft costs were \$600,000, according to the audit agency. However, we calculated an equivalent acceptable commercial cost of about \$67,000 for the same period. Because of CWAS, the audit agency was not able to question the \$733,000 in excess of the cost of commercial equivalent transportation.

THE CWAS CONCEPT OF ASSURING REASONABLENESS IS UNREALISTIC

We were able to make a limited test of the assumption underlying CWAS. We examined contractor records to see if there were any significant differences in cost control at a contractor's CWAS-qualified cost center, with a large proportion of high-risk contracts, as compared with a non-CWAS cost center of the same contractor. We found that the contractor had the same policy of not operating the executive cafeteria on a break-even basis at both non-CWAS and CWAS-qualified locations. The Defense Contract Audit Agency questioned the reasonableness of the loss of \$152,000 charged to overhead for a 2-year period (1972 and 1973) at the non-CWAS-qualified location but could not question the reasonableness of a similar \$303,000 loss charged to overhead for a 3-year period (1972 through 1974) at the CWAS-qualified location. Costs have not been settled at this location pending completion of other audits.

Also, at the contractor's CWAS-qualified plant location, automatic data processing equipment leasing costs amounted to \$12.4 million. The reasonableness of the costs was not determined. However, at one of the same contractor's non-CWAS-qualified locations, the total data processing equipment leasing costs amounted to \$3.3 million. The Defense Contract Audit Agency questioned the reasonableness of excess lease costs over ownership costs of \$561,000.

In these two instances, the concept that competition and fixed-price contracts motivates contractors to accomplish effective control of costs did not prove valid.

CHANGES MADE AND PROPOSED IN THE CWAS PROGRAM

In January 1976, as the result of a recommendation made in a DOD task force report to enhance the audit of contractors, the Deputy Secretary of Defense approved tightening up the procedure for contractors to become CWAS-qualified. To become CWAS-qualified contractors are now required to show that 75 percent of all costs incurred were for commercial and competitively awarded firm-fixed-price contracts.

CONCLUSIONS

The Department of Defense's program to eliminate questioning the reasonableness of certain indirect expenses does not assure effective control of such costs, nor has the Department proven that eliminating audits for reasonableness of indirect expenses is cost-effective since such costs are audited on a continuing basis for allowability and allocability. At CWAS-qualified locations, additional costs can be charged to the Government because the reasonableness of costs is not subject to review. We believe that it is unrealistic to assume that the CWAS concept achieves better control over the reasonableness of costs.

We found no evidence that CWAS is cost-effective. Indeed, we found examples indicating that for corporate aircraft, cafeteria, and leasing expenses it increases costs. We believe that the Department of Defense should, as a minimum, remove the CWAS designation from these costs.

While the Department's desire to reduce Government involvement in contractors' affairs is praiseworthy, we believe that terminating the CWAS program for overhead audits will not necessarily increase overall audit activity. Since the scope and depth of the Defense Contract Audit Agency's audits depends on past experience, cost effectiveness, and Department policy, we would expect a redistribution of effort between other audits presently conducted and audits for reasonableness.

RECOMMENDATIONS TO THE SECRETARY OF DEFENSE

We recommend that the Department of Defense remove the CWAS designation from the Armed Services Procurement

Regulation for expenses of corporate aircraft, cafeterias, and leasing buildings and equipment.

We also recommend that the Department reconsider the CWAS program on the basis that no savings have been demonstrated, and it appears that its elimination would not materially increase Government involvement in contractor's affairs nor increase overall Defense Contract Audit Agency audit effort.

CHAPTER 3

DCAA AUDITS ARE GENERALLY ADEQUATE

At the locations where we conducted our review, we found that the Defense Contract Audit Agency's audits of indirect expenses are generally adequate. The planning, executing, and reporting functions were being performed in a satisfactory manner. The audit agency used criteria set forth in the Armed Services Procurement Regulation and the Defense Contract Audit Manual to develop audit programs. Indirect expense areas having the greatest probability of unallowable, unallocable, and/or unreasonable claimed costs were selected for audit. Most elements of claimed costs were receiving adequate audit coverage.

The Defense Contract Audit Agency's auditors were complying with applicable regulations, audit manuals, and audit programs. The agency audit manual states that audits of indirect expenses should include a review, evaluation, and verification of accounting transactions to enable the auditor to express an opinion on the acceptability of claimed indirect costs.

We found the audit reports on overhead expenses generally adequate in identifying costs questioned in sufficient detail, in describing the issues, and in supporting the auditor's reasons for questioning the costs.

However, in some cases, contractors hindered the audit agency's efforts.

INCOMPLETE CONTRACTOR DOCUMENTATION OF CONSULTANT COSTS

The Armed Services Procurement Regulation 15-205.31, entitled "Professional and Consultant Service Costs--Legal, Accounting, Engineering and Other," states that the cost of professional and consultant services rendered by persons who are members of a particular profession or possess a special skill, and who are not officers or employees of the contractor, are allowable, with certain qualifications, if reasonable in relation to the services rendered. The regulation also states that allowable retainer fees must be supported by evidence of bona fide services available or rendered. These costs are identified in the Armed Services Procurement Regulation as CWAS designated, meaning that at CWAS-qualified locations the costs are not subject to audits for reasonableness.

We found that the agency's audits of consultant costs are hindered because contractors do not always furnish the documentation necessary to establish the nature of services performed. At seven contractor locations a total of \$2.4 million in consultant costs were questioned by the audit agency because documentation was not available or not furnished to the auditors.

One CWAS-qualified contractor claimed \$627,000 for consultant services in 1972, but refused to submit documentation requested by the audit agency on the basis that the Armed Services Procurement Regulation does not require written reports supporting consultant service costs. The audit agency questioned \$112,000 claimed as a retainer fee for an individual who was a prior member of the contractor's Board of Directors and the Chairman of the Retirement Committee. The contractor refused to provide the Defense Contract Audit Agency with evidence as to the nature of services performed. During subsequent negotiations, however, the contractor supplied documentation showing that the individual provided the services, and the contracting officer reinstated the total amount of the retainer fee for payment by the Government. In answer to the auditors questioning consultant salaries, the contractor stated that all consultant costs questioned, including the one described above, were for former senior executives of the corporation who were engaged in the broad administration of the business. The consultant was required to make himself available at all times for personal advisory services to the corporation.

The audit agency's advisory report contained the statement that "the contractor contends it is not required to furnish any evidence of service rendered especially since the contractor is CWAS-qualified." The contractor felt that the CWAS qualification protected the company from having to prove consultant services were rendered, even though under the Armed Services Procurement Regulation, the CWAS designation only exempts a contractor's consultant costs from being questioned on the basis of reasonableness. The contractor is still required to substantiate that consultant services are, in fact, available or rendered.

The Department of Defense has recommended changes to the Armed Services Procurement Regulation requiring more specific documentation of consultant services rendered and proof of the cost effectiveness of any retainer. The recommended changes also include removing the CWAS designation.

**CONTRACTORS LIMIT THE AUDIT AGENCY
IN ITS AUDIT OF WASHINGTON, D.C., OFFICES**

In late 1975 the audit agency conducted an audit of eight major Department of Defense contractors' Washington, D.C., office operations. This was a special audit to determine the allowability, allocability, and reasonableness of expenses generated by these offices. The audits were conducted at the contractors' Washington, D.C., offices and at their corporate headquarters where the records were maintained.

The Defense Contract Audit Agency's audits of the contractors' Washington, D.C., offices were generally adequate to the extent data was made available. The audit agency reviewed supporting documentation made available to it; however, all of its audit reports contain some qualifications indicating that the audits were hindered by a lack of data. For example, contractors did not furnish all documentation needed for the audit agency to determine the allowability of costs.

The audit agency interviewed contractor personnel to determine the percentage of time devoted to unallowable activities. These interviews resulted in identification of unallowable expenses which the agency questioned.

At one of the five contractors' Washington, D.C., offices, employees were not permitted by the company to estimate time spent on unallowable activities. Because of lack of support, approximately 33 percent of the costs of this contractor's headquarters marketing and marketing liaison activities was questioned, and 100 percent of the public relations costs allocated from the Washington, D.C., office to the corporate location was questioned as unallowable lobbying and entertaining expenses.

RECOMMENDATION MADE BY TASK FORCE

In developing the January 1976 report to enhance the audit of contractors, the Department of Defense task force reviewed the present Defense Contract Audit Agency policy concerning audit responsibility for unallowable costs incurred by contractors but not claimed or charged to Government contracts. The present policy used by the audit agency is to review only those costs charged to Government contracts. The task force considered the policy to be appropriate.

The report also considered ways to increase the visibility, at the Office of the Secretary of Defense level, of final cost decisions made in connection with Defense procurement. It recommended greater use of a procedure which stemmed from a previous suggestion of ours. This procedure provides for the Defense Contract Audit Agency to report instances where significant amounts questioned or considered unallowable by auditors, were reinstated or allowed by contracting officers. It is designed to afford high-level departmental officials an opportunity to consider auditor-contracting officer differences involving large dollar amounts or important principles.

CONCLUSIONS

Generally, the audit agency's audits of consultant costs were adequate; however, contractors did not always provide the agency with necessary supporting documentation of claimed costs.

While the audits of the contractors' Washington, D.C., offices' expenses are adequate, the expression of an opinion as to allowability, allocability, and reasonableness is qualified because of the failure of contractors to give the Defense Contract Audit Agency's auditors supporting documentation of claimed costs.

The auditors have the authority to take exception to all unsupported payments as they did in several cases we reviewed. However, there will always be differences of opinion as to the adequacy of support for some expenditures. In this regard, we were pleased to note that the Department of Defense task force is considering ways to make these differences more visible at the Office of the Secretary of Defense level.

In view of the proposed action, we have no further recommendation at this time.

PROCEDURES FOR DETERMINING A CONTRACTOR'SWEIGHTED AVERAGE SHARE IN COST RISK 1/

To establish a CWAS rating, a contractor develops cost data for his latest fiscal year. This data is broken down to show costs relating to (1) the contractor's Government business by various types of contracts, and (2) his commercial business.

For each of these two categories of contracts, the total weighted dollar value of costs incurred depends on a range of weights from 0 to 7 percent that is applied to the costs. The assignment of 0 is made if the contractor assumed minimal cost risks; e.g., a predominance of cost-type and noncompetitive fixed-price contracts. The weight of 7 percent applies if the contractor assumed maximum risk--competitive firm-fixed-price Government contracts and all non-Government commercial business.

When determining a contractor's share in cost risk, the following steps are followed:

- (1) Determine the total dollar costs incurred for commercial work and Government competitive firm-fixed-price contracts and by specific contract types for other Government business.
- (2) Multiply these costs incurred by the approved percentage factor for the respective contract types, which becomes the contractor's "dollar risk."
- (3) Total the resulting contractor dollar cost risks for the respective types of contracts, and divide this result by the total incurred on all Government and commercial work.

1/In effect for the period covered in our review.