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OVERHEAD COSTS

**Unallowable and Questionable
Costs Charged by McDonnell
Douglas Corporation**

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Mr. Chairman and Members of the Subcommittee:

At your request, we have been reviewing the extent to which companies include unallowable and questionable costs in their overhead cost submissions.¹ Today's hearing is on McDonnell Douglas and we have found unallowable and questionable costs included in its overhead cost submissions. However, McDonnell Douglas is not alone among companies including unallowable or questionable costs in overhead claims. Audits we have done for you and others over the last few years, as well as the work of the Defense Contract Audit Agency (DCAA) and the Inspectors General, continue to show unallowable or questionable costs being included in claims.

For example, we issued a report late last year on unallowable costs included in overhead submissions by six small defense contractors. We found that the six contractors had included about \$2 million in unallowable or questionable costs for such items as alcohol, tickets to sporting events and shows, personal use of a boat, and business meetings at resort locations.

More recently, we testified before you on unallowable costs included in the Medicare cost reports by the Hospital Corporation of America. Again, we identified \$1.1 million in unallowable or questionable costs for items such as alcohol, entertainment, marketing and promotional activities, and so forth.

Federal Acquisition Regulation (FAR) cost principles require defense contractors, such as McDonnell Douglas, to identify and exclude unallowable costs from their overhead submissions. Contractors are also required to certify that, to the best of their knowledge, these submissions do not include unallowable costs. The FAR provides varying degrees of specificity regarding allowable overhead expenses.

Our testimony today is based on the preliminary results of our detailed transaction testing of charges included in McDonnell Douglas' Corporate and Aircraft Company overhead accounts for 1991. We chose 1991 because it was the latest overhead submission available at the time we began our review. We reviewed \$2.3 million in individual charges for business conferences, employee relations, travel, memberships, registration fees, and professional services. We selected these accounts for detailed transaction testing because they were, in our judgement, susceptible to questionable charges based, in part, on prior Defense Contract Audit Agency and GAO audits. As a result, our findings cannot be generalized to the \$473 million included in McDonnell Douglas' Corporate and Aircraft Company 1991 overhead submittals.

¹Unallowable costs are those costs that are specifically stated to be unallowable under the provisions of an applicable law, regulation, or contract, including costs directly associated with unallowable costs. Questionable costs, generally, are those costs for which the contractor was unable to provide adequate support, or where the nature, purpose, and reasonableness of the expenditure is in question.

In 1991, McDonnell Douglas, the largest defense contractor in the Nation, had corporate-wide sales totaling nearly \$18 billion.

RESULTS IN BRIEF

Of the \$2.3 million in overhead charges we examined, we consider \$1.6 million to be either unallowable or questionable. This amount includes charges for:

- alcoholic beverages;
- entertainment, including a hospitality suite, golf outings, symphony tickets, and banquets;
- costs directly associated with unallowable charges;
- employee relations costs associated with various employee clubs
- professional services provided by consultants involved in what appears to be unallowable public relations or lobbying activities; and
- meals recorded as business conference and registration fee expenses.

Additionally, included in the amount we question is \$1.3 million for the quarterly distribution of over 100,000 copies of a corporate videotape which we believe is unreasonably high.

Not all of the unallowable or questionable costs we identified represent overcharges to the government because a portion would be allocated to the company's non-defense work. The actual overcharges depend on the amount of defense versus commercial business performed by McDonnell Douglas and the types of contracts it has with the government.

In our view, the inclusion of unallowable or questionable costs in McDonnell Douglas' overhead cost submissions is primarily the result of the manner in which McDonnell Douglas interprets the FAR. Another factor is a breakdown in the company's internal controls for identifying and excluding unallowable costs from overhead submissions.

UNALLOWABLE AND QUESTIONABLE COSTS INCLUDED IN SUBMISSIONS

I'd like to discuss in greater detail the costs that we found to be unallowable and questionable.

Alcoholic Beverages

Although the costs of alcoholic beverages are expressly unallowable under the FAR, we found over \$2,100 for alcoholic beverages included in McDonnell Douglas' overhead submissions. For example,

the company included \$1,403 for alcohol at a banquet held at the Waterfront Hilton in Los Angeles, California, during a 1991 Law Conference; \$118 for alcohol at a farewell dinner held at the Ritz Carlton in Washington, D.C.; and \$67 for alcoholic beverages at a dinner held at the private residence of a McDonnell Douglas employee.

We also found several instances where meals were claimed and supported by a charge card receipt, but no itemized bill. We selected four such charges and asked the Corporate Office to obtain itemized restaurant bills to support them. In three of the four cases, the itemized bill showed charges for alcohol included in the amounts on the charge card receipts. The full cost of these charges were recorded as allowable business conference expenses. In the other case, Corporate Office representatives told us that they were unable to obtain an itemized restaurant bill. There may be additional alcohol charges in other business conference expenses, since we reviewed only a few such charges. We view McDonnell Douglas' acceptance of the charge card receipts, or other total amounts without supporting documentation, as a control weakness limiting its ability to identify and exclude unallowable costs.

McDonnell Douglas agreed that the alcohol charges we identified were unallowable and stated that they were inadvertently recorded as allowable.

Entertainment

The FAR states that entertainment expenses are unallowable. Yet, we found over \$14,500 in such charges for entertainment. These charges include \$3,411 for a banquet at the Waterfront Hilton in Los Angeles, California during a 3-day lawyers conference which was identified on the conference agenda as a reception, dinner and social event; \$2,482 for a banquet to entertain 76 international and domestic bankers at the Hyatt Regency in Long Beach, California held the night before a day-long visit to Douglas Aircraft facilities; \$2,184 for a hospitality suite at the Las Vegas Hilton, during the 1991 TAILHOOK convention; \$2,100 for 12 tickets, costing \$175 each, for a Congressional Club Chili Cook-Off; \$500 for two tickets to an Italian American Foundation Gala Dinner; \$217 for golf outings and greens fees; and \$83 for tickets to the Philadelphia Philharmonic.

McDonnell Douglas stated that the hospitality suite and the Chili Cook-Off tickets were inadvertently charged as allowable and that it will remove these charges from its overhead submissions. With respect to the Waterfront Hilton and Hyatt Regency banquet charges, McDonnell Douglas said that although its supporting documentation indicates that the banquets were business conferences, it could not locate business agendas for the dinners and that descriptions of the dinners do not contain sufficient detail to determine what business matters were discussed. As a result, it agrees to record those charges as unallowable.

McDonnell Douglas also told us that charges for the Italian American Gala, the golf outings and greens fees, and the tickets

for the Philadelphia Philharmonic were inadvertently charged as allowable.

Costs Directly Associated With Unallowable Charges

The FAR defines as unallowable any cost directly associated with another unallowable cost. We identified \$4,961 in travel, indirect labor, and other costs directly associated with attendance at the 1991 TAILHOOK convention.

McDonnell Douglas said that the TAILHOOK associated costs were inadvertently charged as allowable and should be unallowable.

Employee Relations Costs

We question about \$115,000 in the employee relations account for employee recreation clubs, such as the Rockhound Club, the Saddle Club and the Beer Can Collectors Club. While the FAR allows employee morale and welfare costs for activities designed to improve working conditions and employer-employee relations, we question whether the government should be paying for employee recreation clubs.

The Defense Contract Audit Agency also questioned the allowability of about \$125,000 in McDonnell Douglas employee relations charges associated with various employee clubs in 1989 and 1990. In responding to DCAA, McDonnell Douglas agreed to voluntarily withdraw employee club expenses for calendar year 1990 and thereafter, "...due to concern that the general public may perceive this type of cost as one that should not be reimbursed (on Government contracts)...".

Public Relations and Lobbying

We question \$76,936 paid to a public relations firm which appears to have been incurred to develop and disseminate a favorable impression of McDonnell Douglas, thereby enhancing the company's public image. For example, the public relations firm developed media lists, reviewed newsclips and press releases, and drafted a media plan for upcoming congressional hearings. In addition, the firm developed profiles on congressional members and staff; developed information on the outlook for the 1992 elections; and performed other "hands on lobbying" activities. The firm spent over \$5,000 for work that it classified as lobbying, but which McDonnell Douglas classified as allowable. Image enhancement and lobbying activity costs are unallowable under the FAR.

We also question an additional \$36,084 paid to two individuals for what, again, appears to be unallowable lobbying. In one case, McDonnell Douglas included \$9,762 in consultant costs based on its calculation that 20 percent of the consultant's costs are allowable professional service charges. However, our review of this consultant's agreements with McDonnell Douglas, as well as monthly activity reports, show that the consultant uses, almost exclusively, as a measure of work progress, the ability to influence budgets, appropriations, authorizations, and

congressional plans for upgrades and sales of McDonnell Douglas products.

Similarly, when we reviewed the work products provided in support of the other \$26,322 in consultant costs, we found that the activities and tasks claimed to be performed by the consultant seemed to be primarily associated with maintaining contact with key congressional members and staff on behalf of McDonnell Douglas. Only two of ten monthly reports supporting these charges contained information on major achievements, and, in these cases, the achievements described were full funding from the Senate and House Armed Services Committees for the procurement and upgrade of various McDonnell programs. Although the \$26,322 results from McDonnell Douglas' estimate that 35 percent of this consultant's charges are allowable, the monthly reports suggest that most, if not all, of the charges are associated with what appears to be unallowable lobbying activities.

McDonnell Douglas does not agree that the public relations firm's charges are unallowable. Rather, it says that the activities do not fit the unallowable cost definition in the FAR, because the firm was providing a technical and factual presentation of information on a topic directly related to the performance of a contract. Likewise, McDonnell Douglas does not agree that the individual consultant charges we questioned are unallowable lobbying.

Meals Charged to Business Conference and Registration Fee Accounts

We question \$14,120 in meal expenses charged to business conference and registration fee accounts. In reviewing these two accounts we question:

- meal charges that exceed the maximum daily allowance as defined by the FAR for employees in a travel status, and
- meal charges associated with activities that appear to be primarily social.

Meals for employees traveling on official company business

The FAR allows meal costs incurred by contractor personnel on official company business to the extent that they do not exceed, on a daily basis, the maximum government meal allowance in effect. However, we found instances where McDonnell Douglas officials exceeded the meal cost limitation and charged the total meal cost, for themselves and others, as a business conference or registration fee expense.

By examining vouchers for a 4-day period in September 1991, we identified 12 McDonnell Douglas executives, traveling to Washington, D.C., who collectively charged as allowable about \$117 per day more for meals than the FAR allows for government and

contractor employees traveling on official business.² They did this by charging the meals as a business conference expense, which does not have a limitation, rather than as a travel expense, which is subject to the limitation.

For example, four McDonnell Douglas executives had a \$33 breakfast (\$8 per person) at a Washington, D.C. area hotel and called the meal a "Glass Ceiling Task Force Meeting." The same day, three executives, two of whom participated in the breakfast, had a \$125 dinner (\$41 per person) at a Virginia restaurant and called the meal an "Executive Council" business conference. On a different day, three executives had a \$159 dinner (\$53 per person) at a Virginia restaurant and called the meal a business conference for "Financial Discussions." In each instance, the total meal charges were recorded as an allowable business conference expense.

We do not know the extent to which McDonnell Douglas uses the business conference account as a vehicle to charge meals while on official business travel. We do know, however, that 97 percent of the charges to the business conference account in 1991--about \$324,000--was to a subaccount for meals.

McDonnell Douglas generally agreed that meal costs for employees in a travel status should be limited to the General Services Administration (GSA) daily maximum.

Meals associated with social activities

We also question meals charged as business conference or registration fee expenses when the meals appear to be associated with a social activity. For example, we question a \$922-dinner charge for 14 McDonnell Douglas executives and 7 members of the board of directors held at the St. Louis Club, a private dinner club. The dinner receipt included \$294 for wine and cocktails which McDonnell charged to an unallowable account. Since the dinner was held at a private dinner club after normal working hours, and by McDonnell Douglas' description was an opportunity for attendees to become personally acquainted, we consider the activity to be primarily social and, consequently, entertainment.

McDonnell Douglas believes these charges represent good business practices; however, it agrees to record the charges as unallowable " ... since public perception concerning this meeting is questionable."

In another example, we question a \$323-dinner for six members of the McDonnell Douglas Board of Directors (\$54 per person) since a memo inviting the members to the dinner describes it as an "informal dinner ... not a working dinner." Three of the directors were in a travel status; three were not.

For those in a travel status, McDonnell Douglas agreed to record as unallowable, meal costs in excess of the GSA maximum daily allowance. For those directors not in a travel status, McDonnell

² In September 1991, the applicable daily meal allowance was \$34.

Douglas agreed to record these costs as unallowable due to "... lack of sufficient documentation to support continuation of McDonnell Douglas Corporation business."

Quarterly Corporate Video

We question almost \$1.3 million for the distribution every 3 months of over 100,000 videotapes of the corporation's "90 Days Chairman's Quarterly Report." In 1989, McDonnell Douglas began producing a quarterly videotaped report, purportedly to provide, in part, greater visibility and awareness of the McDonnell Douglas Corporate Chairman and Chief Executive Officer, and to incorporate the principles of Total Quality Management by making the Chairman involved and in touch with all employees. McDonnell Douglas also said it uses the videotapes as a vehicle for the Chairman to candidly inform employees about financial conditions, problems, and the people, policies, and events that impact them and the corporation.

The FAR allows reimbursement for activities designed to improve employer-employee relations to the extent that the net benefit of the expenditure is reasonable. While we are not questioning the cost of producing the videotape, or its value as a communications medium, we believe that the \$1.3 million annual cost of purchasing, duplicating, and distributing more than 100,000 copies of the videotape, four times a year, to all company employees, some retirees, and others is unreasonably high.

OBSERVATIONS

We are obviously concerned by the inclusion of unallowable and questionable costs in McDonnell Douglas' overhead accounts. Many of the costs we identified and reported to you today, especially costs for alcoholic beverages, are without question unallowable and should have been caught by the company and eliminated from its overhead submission. Clearly, the company's controls for identifying and excluding unallowable costs need to be strengthened. But, catching and excluding clearly unallowable costs is only part of the issue; the other is the reasonableness of costs that the government and the taxpayer should pay for. For example, when employees are on travel, why shouldn't they be limited to the maximum allowance provided by GSA, irrespective of the account to which the costs are charged?

This concludes my statement, Mr. Chairman. I would be glad to answer any questions.



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