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UNITED STATES GENERAL ACCOUNTING OFFICE
REGIONAL OFFICE
ROOM 7054 FEDERAL BUILDING
300 NORTH LOS ANGELES STREET
LOS ANGELES, CALIFORNIA 90012

JAN 22 1971

Lieutenant General Samuel C. Phillips
Commander
Headquarters, Space and Missile
Systems Organization
Air Force Unit Post Office 160034
Los Angeles, California 90045

Dear General Phillips:

We have recently performed a limited survey of the uses made of contract fees paid to the Aerospace Corporation, El Segundo, California, under the annual contract for scientific, engineering, and technical support of the Space and Missile Systems Organization (SAMSO).

As part of this work, we inquired into (1) the extent to which Department of Defense (DOD) funds were used to reimburse Aerospace for bid and proposal and other expenses relating to the development of non-DOD business, (2) the economy of continuing to lease automatic data processing equipment (ADPE), (3) the working capital impact resulting from the accrual of large amounts of unused vacation expenses, and (4) the adequacy of procedures established to assure compliance with the compensation limitation for officers and employees of Federal contract research centers (FCRC's) as imposed by Section 407 of Public Law 91-121. These issues were discussed with SAMSO officials at the completion of our survey; however, we thought it would be beneficial to summarize for you our observations concerning these matters.

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BID AND PROPOSAL AND OTHER NEW BUSINESS DEVELOPMENT EXPENSES

At Aerospace, bid and proposal-type expenses have increased substantially during fiscal year 1970. This primarily resulted from the termination of a major Air Force program and the subsequent reassignment of a select number of technical personnel from this program to proposal efforts involving non-DOD work areas. Correspondence available at Aerospace indicated that the reassignment plan was considered reasonable by General O'Neill.

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JUN 22 1971

Lieutenant General Samuel C. Phillips

The Defense Contract Audit Agency (DCAA) resident staff at Aerospace reported to the administrative contracting officer (ACO) in April 1970 that bid and proposal and other new business development expenses were estimated to be $677,000 for fiscal year 1970, or about $437,000 more than contemplated by the Aerospace reassignment plan. The audit agency concluded that the allowability of these expenses was questionable since they were not necessary for contract performance and did not have prior approval except for the reassignment plan. The ACO subsequently notified DCAA that the expenses were allowable for reimbursement under the fiscal year 1970 Air Force contract, primarily on the basis of comparative bid and proposal expense data from other Defense contractors. We have recently been advised by DCAA that about $626,000 was expended during 1970 for bid and proposal-type efforts.

Prudent action was taken by SAMSO to include an advance agreement in the fiscal year 1971 letter contract with Aerospace which placed a $300,000 ceiling on the amount of bid and proposal-type expenses allocable to the contract. Upon contract definitization, the ceiling was increased to $425,000. You may, however, want to consider whether the expenditure ceiling established complies with the intent of Section 203 of Public Law 91-441, the Military Procurement Authorization Act of 1971. Section 203 restricts the payment of independent research and development and bid and proposal expenses unless a potential relationship to a military function or operation can be established for such work.

We see considerable merit in the DCAA position with respect to the reasonableness and allocability of the non-DOD related bid and proposal expenses. While recognizing that in March 1969, DOD officially encouraged sponsored FCRC's to review the available opportunities to provide the necessary help to solve some of the country's pressing domestic problems through a transfer of Defense-developed technical expertise to the civilian sector, we have no indication that the Department intended to authorize the reimbursement of such expenses. In view of the bid and proposal expense limitations imposed by Section 203 of the Procurement Authorization Act, we intend to explore with DOD officials the need for establishing policy guidance with respect to the reimbursement of non-Defense related bid and proposal expenses at FCRC's.

Lieutenant General Samuel C. Phillips JAN 2 2 1971

LEASING OF ADPE

Aerospace continues to lease certain ADPE at prices which exceed normal ownership costs. The ACO has approved the leasing arrangements on an annual basis due to the nonavailability of funds within the Air Force to purchase the equipment for Aerospace.

The Armed Services Procurement Regulation (ASPR) provides that ADPE leasing costs are allowable only up to the amount that the contractor would be allowed had the ADPE been purchased. Since the Air Force contract with Aerospace excludes depreciation as an allowable contract cost for reimbursement purposes, the company must rely upon the Air Force to purchase such capital equipment where the leasing costs exceed ownership costs.

ADPE leasing costs at Aerospace amount to about $3 million a year. Although Air Force correspondence at SAMSO shows that purchase of certain ADPE would have been more economical, we found no indication that alternate means of obtaining the equipment were considered such as (1) the use of the General Services Administration ADP Fund which was established in 1965 for use by any Federal agency when purchase of ADPE is in the best interest of the Government, but funds are not readily available within the agency, and (2) the use of multiyear installment purchase plans for ADPE in the form of an annual contract with renewal options.

Opportunities still exist for savings in the acquisition of ADPE at Aerospace; accordingly, we believe that consideration should be given to alternate more economical means of acquiring such equipment for Aerospace needs.

ACCRUED VACATION EXPENSES

Contract funds retained by Aerospace for employee earned vacation accruals have increased from $4.2 million at June 30, 1968, to $4.7 million at May 31, 1970. Fee utilization reports prepared by DCAA in April 1969 and 1970 for the contracting officer called attention to the fact that the vacation accrual created effective working capital which provided Aerospace with significant amounts of interest income from investments in short-term securities and savings accounts.

JAN 2 2 1971

Lieutenant General Samuel C. Phillips

We believe that during the negotiation of contract fees, SAMSO should consider the financial benefits derived by Aerospace from the investment of vacation accrual funds provided by the Government. As an alternative, you may want to consider the reimbursement of vacation expenses when actually taken by Aerospace employees rather than on an accrual basis. In this manner, such funds would be retained by the Government during the accrual period rather than the contractor.

SECTION 407 OF PUBLIC LAW 91-121

Our survey showed that Aerospace had established adequate procedures for complying with the compensation limitation of Section 407. As you are aware, the legislation provides that annual compensation of officers and employees of FCRC's shall not exceed $45,000 from Federal funds without approval of the Secretary of Defense. At the time of our survey, approval for payment of compensation in excess of the limitation had not been obtained.

It is the practice at Aerospace to pay compensation in excess of $45,000 from interest earned on invested contract fees acquired prior to July 1, 1969. The DCAA resident staff had previously reviewed the established procedures and found them acceptable.

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We would appreciate any comments you may wish to make on the issues discussed in this letter. We would also be pleased to meet and discuss these matters in further detail if you so desire.

Sincerely yours,

H. L. KRIEGER

H. L. KRIEGER
Regional Manager

bcc: Associate Director, DD - H. H. Rubin
Assistant Director, DD - W. D. Lincicome

Assoc. Dir., DD

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JAN 2 2 1971

Mr. Alex Soll
Regional Manager
Defense Contract Audit Agency
1340 West Sixth Street, 2nd Floor
Los Angeles, California 90017

Dear Mr. Soll:

We have recently performed a limited survey of the uses made of contract fees paid to the Aerospace Corporation, El Segundo, and The RAND Corporation, Santa Monica, California. Both of these companies are Federal contract research centers (FCRC's) under Air Force sponsorship.

As part of this work, we inquired into the extent to which Department of Defense (DOD) funds were used to reimburse those FCRC's for bid and proposal and other expenses relating to the development of non-DOD business; the economy of continuing to lease automatic data processing equipment (ADPE) at Aerospace; and the adequacy of procedures established to assure compliance with the compensation limitation for FCRC officers and employees as imposed by section 407 of Public Law 91-121. These issues have been discussed with your Los Angeles Branch Office staff. However, we thought it would be beneficial to share our observations with you.

BID AND PROPOSAL AND OTHER NEW BUSINESS DEVELOPMENT EXPENSES

We found that at both FCRC's, the Defense Contract Audit Agency (DCAA) has been responsible for surfacing apparently unreasonable and nonallocable bid and proposal type expenses of developing new corporate business. Nevertheless, in each instance the cognizant administrative contracting officer (ACO) determined that the expenses would be reimbursable under DOD contracts.

At Aerospace, bid and proposal along with other new business development expenses increased substantially during fiscal year 1970. This primarily resulted from the termination of a major Air Force program and the subsequent reassignment of a select number of technical

personnel from this program to proposal efforts involving non-DOD work areas. Correspondence available at Aerospace indicated that the reassignment plan was considered reasonable by the Commander, Air Force Space and Missile Systems Organization (SAMSO).

Your resident staff at Aerospace reported to the ACO on April 21, 1970, that bid and proposal and other new business development expenses were estimated to be $677,000 for fiscal year 1970, or about $437,000 more than contemplated by the Aerospace reassignment plan. The report concluded that the allowability of these expenses was questionable since they were not necessary for contract performance and did not have prior approval except for the reassignment plan. The ACO subsequently notified DCAA that the expenses were allowable for reimbursement under the fiscal year 1970 Air Force contract primarily on the basis of comparative bid and proposal expense data from other defense contractors. We have recently been advised by the resident auditor that about $626,000 was expended during 1970 for bid and proposal type efforts.

SAMSO included an advance agreement in the fiscal year 1971 letter contract with Aerospace which placed a $300,000 ceiling on the amount of bid and proposal type expenses allocable to the contract. Upon contract definitization, the ceiling was increased to $425,000.

At the RAND Corporation, there have been significant increases in non-DOD related bid and proposal expenses over the past several years. For example, in 1964 and 1965, those expenses amounted to about $12,000 a year. The expenses increased to $71,000 in 1966 and $194,000 in 1967. A majority of the expenses were questioned by DCAA as unreasonable and not allocable to DOD contracts. For example, in 1967, the audit agency reported that DOD contracts did not generate the expenses nor would they receive any benefit from this effort and that reimbursement of such expenses would amount to Government subsidization of the company's expansion into non-Federal areas. The ACO reinstated the bid and proposal expenses on the basis that they were necessary to maintain the size and quality of the corporate research product and staff.

On April 8, 1969, your office reported to DCAA Headquarters the reinstatement of the disapproved costs. It was subsequently determined that no further action would be taken in this instance as the ACO had issued a formal decision letter nor would the case be forwarded to higher DOD levels under DCAA's reinstatement reporting procedures.

During 1968 and 1969 bid and proposal expenses continued at approximately the 1967 level. During that time DCAA did not question the reasonableness or allocability of the expenses. The resident auditor advised us that because the ACO had determined the bid and proposal expenses to be reasonable and allocable for 1967, he believed it impractical to question the expenses in subsequent years.

It does not appear that the ACO's reinstatement of the 1967 bid and proposal expenses necessarily formed a precedent for evaluating subsequent year expenses. Furthermore, the DCAA Headquarters decision not to take further action specifically applied to the expenses in 1967. Consequently, we believe that if the resident auditor at RAND believed the 1968 and 1969 bid and proposal expenses to be unreasonable or not allocable to DOD contracts, the ACO's reinstatement of 1967 expenses should not have precluded further questions of such expenses.

RAND estimates that the 1970 expenses will amount to about $300,000. Subsequent to the completion of our survey, we were advised that the ACO had taken action to explore with RAND the possibility of establishing an advance agreement on the allowability of bid and proposal expenses.

Your Los Angeles Branch Office Manager has advised us that the reasonableness and allocability of the latest increases in bid and proposal expenses at both contractors will be closely examined as part of the annual overhead audits.

LEASING OF ADPE

Aerospace continues to lease certain ADPE at prices which exceed normal ownership costs. However, DCAA has not questioned the excess lease costs during the annual overhead audits because the ACO has approved the leasing arrangements on an annual basis due to the non-availability of funds within the Air Force to purchase the equipment for Aerospace.

The Armed Services Procurement Regulation (ASPR) provides that ADPE leasing costs are allowable only up to the amount that the contractor would be allowed had the ADPE been purchased. Since the Air Force contract with Aerospace excludes depreciation as an allowable contract cost for reimbursement purposes, the company must rely upon the Air Force to purchase such capital equipment where leasing costs exceed ownership costs.

ADPE leasing costs at Aerospace amount to about $3 million a year. Although Air Force correspondence at SAMSO shows that purchase of certain ADPE would have been more economical, we found no indication that alternate means of obtaining the equipment were explored, such as (1) the use of the General Services Administration ADP Fund which was established in 1965 for use by any Federal agency when purchase of ADPE is in the best interest of the Government, but funds are not readily available within the agency, and (2) the use of multi-year installment purchase plans for ADPE in the form of an annual contract with renewal options.

Since opportunities still exist for savings in the acquisition of ADPE at Aerospace, we believe that DCAA should take the necessary action to surface the excess leasing costs in its annual overhead audits in accordance with the requirements of ASPR section 15. The issue concerning leasing of ADPE at Aerospace may require action by higher levels within DOD since the leasing arrangements have previously been justified on the basis of the unavailability of procurement funds. We believe that your office could furnish valuable assistance to the contracting officer in exploring alternate more economical means of acquiring ADPE to meet Aerospace needs.

SECTION 407 OF PUBLIC LAW 91-121

Our survey showed that Aerospace and RAND had established procedures for complying with the compensation limitation of section 407. At RAND, however, we found that revisions to existing accounting procedures were necessary to ensure that the limitation was not exceeded.

As you are aware, section 407 provides that annual compensation of officers and employees of FFRDC's shall not exceed $45,000 from Federal funds without approval of the Secretary of Defense. Approval for payment of compensation in excess of the limitation has not been obtained at either corporation.

Aerospace has established a procedure by which compensation in excess of $45,000 is paid from interest earned on invested fees acquired prior to July 1, 1969. We found that the Aerospace practices clearly provided that non-Federal funds were being used to pay the compensation in excess of the limitation. Your staff had previously reviewed these practices and found them acceptable.

At RAND, compensation in excess of $45,000 was to be paid from fees earned through non-Federal contracts. However, we found that the account from which the excess was paid consisted of commingled funds from Federal and non-Federal contract sources. Therefore, it was not readily apparent whether the excess was being paid from non-Federal fees as intended. After discussing this matter with the resident auditor and RAND officials, action was taken to revise accounting procedures to clearly identify that non-Federal contract fees were used to pay compensation in excess of the limitation.

We noted that DCAA had previously made limited inquiries into the RAND practices for payment of compensation over $45,000, but had not identified the commingling of Federal and non-Federal funds. We believe that a more in-depth examination would have shown the need for improved accounting practices.

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We would appreciate receiving whatever comments you may have on the issues discussed in this letter. In particular, your comments concerning the acceptance of bid and proposal expenses at RAND for 1968 and 1969 and your current thoughts with respect to the reimbursement of non-DOD related bid and proposal expenses at FCRC's would be of primary interest. In this connection, we plan to explore with DOD officials the need for establishing policy guidance with respect to the reimbursement of non-Defense related bid and proposal expenses at FCRC's in view of the requirements of section 203 of Public Law 91-441. Section 203 restricts payment of such expenses unless a potential relationship to a military function or operation can be established for this work.

We would be pleased to discuss these issues in further detail if you so desire.

Sincerely yours,

H. L. KRIEGER

H. L. KRIEGER
Regional Manager

bcc: Associate Director, DD - H. H. Rubin
Assistant Director, DD - W. D. Lincicome

UNITED STATES GENERAL ACCOUNTING OFFICE
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JAN 2 2 1971

Brigadier General John S. Chandler
Commander, Defense Contract
Administration Services Region
11099 South La Cienega Boulevard
Los Angeles, California 90045

Dear General Chandler:

As you are aware, we have recently performed a limited survey of the uses made of fees paid to The RAND Corporation, Santa Monica, California, under the Air Force Project RAND and other Government contracts. As part of this work, we inquired into the extent to which Department of Defense (DOD) funds were used to reimburse RAND for bid and proposal expenses relating to non-DOD contract areas, and the adequacy of procedures established to assure compliance with Section 407 of Public Law 91-121 concerning compensation limitations for officers and employees of Federal contract research centers (FCRC's).

Although these issues were discussed with you and your staff at the completion of our work, we thought it would be useful to summarize those observations pertaining to contract administration matters.

BID AND PROPOSAL EXPENSES

Bid and proposal expenses have increased substantially at RAND over the past several years. The majority of these expenses, however, were incurred for non-DOD related projects and accordingly the benefits derived by the sponsoring agency in reimbursing these expenses appear questionable. Since 1965 bid and proposal expenses at RAND have increased, as follows:

Calendar year	Amount
1965	$ 11,800
1966	71,100
1967	194,500
1968	151,700
1969	191,400
1970 (RAND estimate)	300,000

The substantial increases in 1966 and 1967 were reported by the Defense Contract Audit Agency (DCAA) to be unreasonable and not allocable to DOD contracts. For example, about $185,000 of bid and proposal expenses for 1967 were disallowed for reimbursement on the basis that the DOD contracts did not generate the expenses nor would they receive any benefit from this effort. DCAA further commented that the reimbursement of the bid and proposal expenses would amount to Government subsidization of the company's expansion into non-Federal areas.

Upon appeal by RAND, the administrative contracting officer (ACO) reinstated the bid and proposal expenses on the basis that they were necessary to maintain the size and quality of the corporate research product and staff. Since that time, all bid and proposal expenses have been accepted for reimbursement under DOD contracts although the majority of such expenses have been incurred for the purpose of diversification into non-DOD areas.

We see considerable merit in the DCAA position with respect to the reasonableness and allocability of bid and proposal expenses. Subsequent to the completion of our work, we were advised that the ACO has taken action to explore with RAND the possibility of establishing an advance agreement for bid and proposal expenses. In view of the continued increase in these expenses resulting from RAND's efforts to diversify into non-DOD areas, we believe that a contractual agreement should be established for the reimbursement of bid and proposal expenses at a level consistent with the benefits to be derived by DOD contracts.

Although DOD has recently encouraged FCRC's to diversify their operations to help solve some of the domestic problems facing the Nation, it is not entirely clear whether DOD intended to reimburse bid and proposal expenses resulting from such efforts. Accordingly, we plan to bring this matter to the attention of Defense officials for their consideration in establishing policy guidance for the administration of FCRC contracts. This matter is of particular concern in view of the restriction on payments of such expenses as imposed by Section 203 of Public Law 91-441, the Military Procurement Authorization Act of 1971.

SECTION 407 OF PUBLIC LAW 91-121

As you are aware, Section 407 provides that annual compensation of officers and employees of FCRC's shall not exceed $45,000 from Federal funds without the approval of the Secretary of Defense. Approval for payment of compensation in excess of the limitation has not been obtained by RAND. Accordingly, compensation over $45,000 was to be paid from fees earned through non-Federal contracts. A special payroll account was established for this purpose. We found, however, that the particular account included commingled funds from both Federal and non-Federal contract sources. Therefore, it was not readily apparent whether the excess compensation was being paid from non-Federal fees as intended. Upon bringing this matter to the attention of RAND and cognizant DCAA personnel, action was taken to revise accounting procedures to clearly identify that non-Federal contract fees were used to pay compensation over the $45,000 limitation.

A Defense Contract Administration Services Region compensation system review had recently been performed at RAND which included a limited evaluation of compliance with Section 407 requirements. The review, however, did not identify the commingling of Federal and non-Federal funds used to pay compensation in excess of the monetary limitation.

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We would appreciate any comments you may wish to make on the issues discussed in this letter. We would also be pleased to meet and discuss these matters in further detail if you so desire.

Sincerely yours,

H. L. KRIEGER

H. L. KRIEGER
Regional Manager

bcc: Associate Director, DD - H. H. Rubin
Assistant Director, DD - W. D. Lincicome