

UNITED STATES GENERAL ACCOUNTING OFFICE

~~28892~~
124745

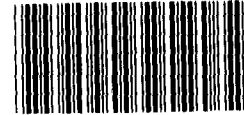
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY

EXPECTED AT 10:00 A.M.

WEDNESDAY, JULY 25, 1984

STATEMENT OF



124745

FRANK C. CONAHAN, DIRECTOR

NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

SUBCOMMITTEE ON LEGISLATION AND NATIONAL SECURITY

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS

UNITED STATES HOUSE OF REPRESENTATIVES

ON

PUBLIC RELATIONS COSTS

029530

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before the Subcommittee to discuss the need to strengthen the criteria governing the allowability of defense contractors' public relations costs.

SOME FEDERAL ACQUISITION REGULATION (FAR) CRITERIA ARE AMBIGUOUS

The Federal Acquisition Regulation (FAR) contains the criteria for determining what is, and what is not, an allowable contract cost. Criteria have been established in the FAR for 48 separate cost elements. "Public relations costs," per se, is not one of the 48 elements. Rather, there are a number of cost categories which could be classified in a general way as relating to defense contractors' public relations activities. The list includes such cost elements as advertising, contributions and donations, entertainment, lobbying, and trade, business, technical, and professional activity costs.

The criteria set forth in some of these costs elements are quite specific. However, many are ambiguous. For example, FAR states succinctly that "contributions and donations are unallowable." The criteria for advertising costs, however, are not as specific. Advertising costs are unallowable unless the costs are for recruiting personnel, acquiring scarce items, or disposing of scrap or surplus materials. Yet, help wanted ads are unallowable if, for example, the ads include material that is not relevant for recruitment, such as extensive illustrations or descriptions of the company's products.

The ambiguity is worsened in that there is another cost element for selling costs. Public relations type costs are routinely questioned by the Defense Contract Audit Agency (DCAA) as being unallowable advertising. However, if you accept the argument often made by contractors that these costs are selling expenses, they could be considered allowable.

According to FAR,

"Selling costs arise in the marketing of the contractor's products and include costs of sales promotions, negotiation, liaison between government representatives and contractor's personnel, and other related activities.

"Selling costs are allowable to the extent they are reasonable and are allocable to government business."

But, this section of FAR refers the reader back to the criteria for advertising costs. The fact that the language on selling costs may, alone or in conjunction with other FAR language on advertising, allow contractors and the government to arrive at different positions suggests the need for greater regulatory definition.

For the most part, the costs covered by the 48 cost elements are indirect costs. Those which are collectively referred to as public relations costs are indirect costs.

The Department of Defense (DOD), through its contracting officers, routinely negotiates overhead agreements with contractors. These agreements are "after the fact" and are done to

determine what indirect costs are to be allowable for reimbursement in overhead. The contracting officer has the responsibility to negotiate the final overhead agreement with the contractor. DCAA's audit reports are used to assist in these negotiations. DCAA's reports evaluate the costs being claimed by the contractor and make recommendations to the contracting officer regarding the propriety of such costs.

Overhead negotiations between the government and the contractors are complex and differences concerning the allowability of certain costs are not easily resolved. We believe that overhead negotiations could be improved if FAR was less ambiguous in its definitions on the allowability of specific overhead costs--especially those costs which are the subject of these hearings.

This ambiguity in FAR causes contractors, DCAA, and contracting officers to have different interpretations on allowability. If a contractor believes a specific cost item is subject to interpretation, the contractor often includes the cost in overhead. DCAA, on the other hand, in performing its contractor overhead audits will use the same or other FAR criteria to question the cost. If the contractor does not concede the questioned costs, they will be introduced into negotiations between the contracting officer and the contractor.

OUR REVIEW OF UNALLOWABLE INDIRECT COSTS

Recently, we completed a review of contracting officer final overhead cost settlements at 12 contracting activities. The com-

panies included in our study were selected because (1) each was part of a company listed as one of DOD's top 100 defense contractors, (2) there was a variety of products manufactured by the companies chosen, and (3) they vary significantly in their percentage of total sales to government sales.

The following are examples of costs we observed in our review which we believe demonstrate the problems caused by the ambiguous criteria. Of the 12 contracting activities we reviewed, costs which could be termed public relations costs challenged by DCAA totalled \$4 million.

Air shows

We found that DCAA questioned \$1.04 million in costs incurred by seven of the contractors for the Paris Air Show, the Farnborough Air Show, and similar events on the basis that these costs were unallowable advertising. Contractors believe these costs are allowable under the FAR's definitions for "Selling Costs" and "Trade, Business, Technical, and Professional Activity Costs." The contracting officers took widely disparate views in settling these costs, ranging from total allowance to total disallowance. For example, the contracting officer at one contractor allowed into overhead 100 percent of the \$28,000 questioned by DCAA for exhibits at the Paris Air Show.

At another contracting activity, the contracting officer disallowed 100 percent of the \$388,000 incurred for constructing, operating, and dismantling a chalet at the Paris Air Show because

these costs were held to be unallowable advertising and entertainment. Incidentally, at this same contracting activity the contracting officer allowed 100 percent of the \$35,000 questioned by DCAA for trips made by high level contractor marketing and public relations personnel to the Paris Air Show. The contracting officer considered these costs to be allowable selling and public relations functions.

Exhibits, displays, promotions, and giveaways

DCAA questioned approximately \$2.33 million incurred by eight contracting activities for exhibits, displays, promotions, models, and giveaways on the grounds these were unallowable advertising costs. Notwithstanding DCAA's recommendations, contracting officers allowed into overhead \$1.04 million, or 45 percent of the amount questioned.

For example, we reviewed a contractor's cost data amounting to about \$358,000 associated with aircraft models and other giveaway items. The contractor stated that these were allowable costs to promote the sale of a company product as defined under the FAR provision on Selling Costs. The contractor argued that the costs were allowable public relations marketing expenses because the contractor kept a list of the recipients of the models and giveaways. For these reasons, the contracting officer allowed about \$250,000, or 70 percent of these costs to be charged to the government.

Another contractor claimed technical display costs of \$33,000 for brochures, prints, models, and mock-ups as allowable public relations costs. According to the contractor, the models were displayed and brochures distributed at the Paris Air Show and other shows, as well as in local banks and other public places. The contracting officer allowed \$18,000 because these costs were considered to be "gray area" expenditures.

Advertising

Of \$574,000 in advertising costs questioned by DCAA at three contracting activities, contracting officers allowed approximately \$218,000 and sustained \$356,000 of DCAA's questioned costs.

For example, at one contracting activity the contracting officer allowed \$202,000 of \$532,400 questioned by DCAA. These costs were for advertisements in magazines such as Newsweek and Time. The full page ads in the magazines contained extensive descriptions of the company's products with approximately 15 percent of the ads devoted to employee recruitment. The contracting officer felt that the recruiting portion of the advertisement should be allowed and thus reinstated the costs.

At another contracting activity, the contracting officer allowed \$15,000, or 44 percent of the \$34,244 questioned by DCAA as unallowable advertising. This amount was apparently allowed because it represented costs incurred in producing a technical public relations film.

CLARIFICATION OF FAR IS NEEDED

Overhead negotiations could be improved if FAR was less ambiguous in its definitions of allowability on those costs which could be termed public relations. Such ambiguity causes contractors and the government to have differing interpretations.

We do not believe that the criteria for all cost elements can be written in such a way as to remove all ambiguity. There undoubtedly will remain differences and disagreements as to the allowability of certain costs. We believe, however, that there are opportunities to clarify the criteria for some of the cost elements so as to reduce these differences and disagreements. Such clarification is particularly important for the cost categories of advertising and selling. We believe that the FAR could address more directly costs for such things as air shows, models, giveaways, exhibits, displays, and promotions. These costs constitute a significant amount of questioned costs each year and their clarification will significantly improve overhead negotiations and reduce inconsistent treatment.

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