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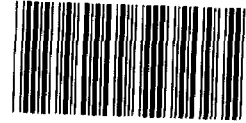
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The Honorable Sam Nunn
Chairman, Committee on
Armed Services
United States Senate

The Honorable John Glenn
Chairman, Committee on
Governmental Affairs
United States Senate

The Honorable Ronald V. Dellums
Chairman, Committee on
Armed Services
House of Representatives

The Honorable John Conyers, Jr.
Chairman, Committee on
Government Operations
House of Representatives

Section 2324 of title 10 U.S.C. requires GAO to evaluate and report on substantive changes to the Department of Defense's (DOD) regulations concerning allowable costs on certain defense contracts. The purpose of this letter is to report our evaluation of recent regulatory changes.

The regulatory changes are published in the Federal Register as revisions to the Federal Acquisition Regulation (FAR) and the Defense Federal Acquisition Regulation Supplement (DFARS). On May 13, 1993, interim DFARS rules regarding overseas severance costs, legislative lobbying costs, and penalties for unallowable costs were published in the Federal Register. These regulatory changes were required by the Defense Authorization and Appropriations acts for fiscal year 1993.

GAO/NSIAD-93-246R DFARS Cost Principles Revisions

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RESULTS IN BRIEF

The language of the interim DFARS rules closely parallels and appears consistent with the legislation. With regard to overseas severance costs, the interim rule provides that the restrictions on cost allowability of severance payments to foreign nationals by defense contractors may be waived under certain circumstances.

A new paragraph on legislative lobbying costs added to the DFARS cost principles specifies as unallowable the cost of preparing any material on the economic or employment impact of an acquisition program in a state or congressional district, if all research, development, testing, and evaluation has not been completed.

The revised DFARS rule covering penalties for unallowable costs reflects provisions of the 1993 National Defense Authorization Act. The rule specifies the effective date of the changes; states that the cost must be specifically unallowable under FAR or DFARS for a penalty to be assessed; incorporates the revised amounts of the penalty; and provides for waiver of the penalty under specified conditions. The rule also defines the responsibilities of the cognizant administrative contracting officer and the contract auditor in implementing the regulations.

SEVERANCE PAY FOR FOREIGN NATIONALS

In recent years, legislation has placed restrictions on the allowability of severance pay to foreign nationals. The amount of severance pay could not exceed the customary amount paid for similar service by the same industry in the United States. In addition, severance payments were unallowable if the foreign national's job dismissal was the result of a request by the host country to close or curtail activities at a U.S. military facility.

DOD officials said that they were having difficulty implementing the restrictions. They pointed out that the amount of severance pay was often set by host country law or a bargaining agreement and was therefore not controlled by the contractor, and that the amount often exceeded the amount of profit to be made on a contract. According to DOD officials, contractors said that they would not accept contracts for overseas defense work unless granted a waiver of the severance

pay restrictions. This could have resulted in DOD requiring additional U.S. government personnel to perform the work.

As a result, the National Defense Authorization Act for Fiscal Year 1993 (P.L. 102-484, section 1352) provides for the waiver of these restrictions when

- nonpayment would adversely affect programs providing significant support services for military personnel outside the United States,
- the contractor has taken or has established plans to take steps to minimize the severance amounts to be paid to foreign nationals, and
- the payments are required by the host country's laws or a collective bargaining agreement.

The language of the interim DFARS rule closely follows the legislation and is consistent with the legislation. The interim rule provides that the restrictions on severance payments to foreign nationals by defense contractors may be waived for reasons cited above. However, waivers may not be granted if the foreign national's dismissal results from terminating the U.S. military's basing rights in the Republic of the Philippines.

LEGISLATIVE LOBBYING COSTS

Congressional hearings held in 1984 and 1985 disclosed that some government contracting officers were allowing contractor costs that other contracting officers were disallowing. Testimony identified the cause of these inconsistencies as ambiguous cost principles.

Subsequently, Congress added section 2324, "Allowable costs under defense contracts", to title 10 U.S.C. To eliminate any ambiguities, section 2324(e)(1) initially listed 10 specific costs contractors could not charge to defense contracts. Costs resulting from attempts to directly or indirectly influence legislative action on any matter pending before the Congress or a state legislature was 1 of the 10 expressly unallowable costs. The FAR defines unallowable costs associated with legislative lobbying to include any costs of preparing material used for lobbying.

The Department of Defense Appropriations Act for Fiscal Year 1993 (P.L. 102-396, section 9048) prohibits funds provided by the act to be obligated or expended to prepare or assist a contractor in preparing any material, report, list, or analysis on the actual or estimated economic or employment impact in a state or congressional district of an acquisition program for which all research, development, testing, and evaluation has not been completed. The same prohibition was included in the Department of Defense Appropriations Acts for Fiscal Year 1990 (P.L. 101-165, section 9076), Fiscal Year 1991 (P.L. 101-511, section 8057), and for Fiscal Year 1992 (P.L. 102-172, section 8050). DOD officials concluded that this legislative prohibition was to prevent the government or the contractor from trying to gain legislative support for particular programs, without being specifically requested by congressional committees or members to provide material for hearings or through other documented requests for information.

Because this prohibition was included in the four defense appropriations acts, DOD officials incorporated the language, by the interim rule, into the DFARS to make those costs specifically unallowable.

PENALTIES FOR UNALLOWABLE COSTS

Section 818 of the National Defense Authorization Act for Fiscal Year 1993 (P.L. 102-484) amended 10 U.S.C. section 2324 to (1) change the criteria by which a contractor incurred a penalty for submitting unallowable costs, (2) change the amount of the penalty to be charged the contractor, and (3) provide for a waiver of the penalty under certain conditions. The original criteria for incurring the penalty was that the cost submitted be "unallowable based on clear and convincing evidence." The criteria now is "expressly unallowable" under a FAR or DFARS cost principle. The amount of the penalty for submitting an indirect cost rate proposal containing a cost previously determined to be unallowable was three times the amount of the disallowed cost, plus a possible \$10,000 additional penalty. The 1993 act deleted the \$10,000 additional penalty and reduced the penalty for submitting a previously determined unallowable cost to two times the amount of the disallowed cost applicable to government contracts.

The 1993 act also provides that the penalty be waived in the case of a contractor's proposal for settlement of indirect costs when

- the contractor withdraws the proposal before the formal initiation of an audit of the proposal by the federal government and resubmits a revised proposal;
- the amount of the unallowable costs subject to the penalty is insignificant; or
- the contractor demonstrates, to the contracting officer's satisfaction, that (1) it has established appropriate policies and personnel training and an internal control and review system that provide assurances that unallowable costs subject to penalties cannot be included in the contractor's proposal for settlement of indirect costs; and (2) the unallowable costs subject to the penalty were inadvertently incorporated into the proposal.

The 1993 amendments are effective as of October 23, 1992, and apply to proposals for settlement of indirect costs for which the federal government has not formally initiated an audit before that date.

The revised DFARS rule implements the 1993 National Defense Authorization Act. The rule specifies the effective date of the changes; states that the cost must be specifically unallowable under FAR or DFARS for a penalty to be assessed; incorporates the revised amounts of the penalty; and provides for waiver of the penalty under specified conditions. The administrative contracting officer retains the right to determine whether a waiver should be granted.

SCOPE AND METHODOLOGY

We reviewed the relevant sections of the 1993 defense authorization and appropriations acts; the accompanying House and Senate reports; the DFARS sections that implemented the legislation; Office of Management and Budget, Department of Defense, and Council of Defense and Space Industry Associations reports pertaining to the cost principles; and public comments on the DFARS changes. We also discussed the changes with appropriate officials.

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This letter was prepared under the direction of Paul F. Math, Director, Acquisition Policy, Technology, and Competitiveness, who may be reached on (202) 512-4587, if you have any questions. Other contributors to this letter were Charles W. Thompson, Assistant Director, and Carol S. Markson, Evaluator-in-Charge.



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GAO/NSIAD-93-246R DFARS Cost Principles Revisions