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FEDERALLY SPONSORED
CONTRACTS

Unallowable and Questionable
Indirect Costs Claimed by
CH2M Hill

Statement of
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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss the results of our work concerning how indirect cost, or "overhead" as it is commonly known, is charged to federally sponsored Superfund contracts. In the past year, we appeared before you on two occasions to testify concerning universities' inappropriate charges to the federal government for scientific research.¹

Recently, the Subcommittee has intensified its review of contracts sponsored by other government programs. One of these is the Environmental Protection Agency's (EPA) Superfund program for the cleanup of hazardous waste sites. At your request, we focused our audit efforts in a number of EPA contract areas. For example, in our December 1990 testimony we disclosed that EPA had a large backlog of requests for audits on its contractors, and that these backlogs and inadequate audit follow-up were undermining EPA's contract management and increasing the vulnerability of its contracting dollars to waste, fraud, and abuse. We also plan to report later this year on the results of our ongoing audit of direct and indirect program management costs on major Superfund contracts.

My testimony today deals with indirect costs charged by one of Superfund's largest contractors, CH₂M Hill, a consulting engineering firm that had gross revenues of approximately \$425 million in 1990. Sixteen percent, or \$68 million, of the firm's gross revenues were derived from contracts with the federal government--primarily from contracts with EPA and the Departments of Energy and Defense.

Mr. Chairman, you specifically asked us to determine whether CH₂M Hill's claims for indirect costs were allowable under the Federal Acquisition Regulations (FAR). To accomplish this, we examined 15 of the firm's 89 indirect cost accounts, including meals, lodging, relocation, advertising, and social club dues, and 2 of the firm's service functions.² As agreed with your staff, we selected these accounts because of their potential for unallowable or questionable indirect costs based on prior audit concerns and their high dollar value. The indirect costs in the 15 accounts and 2 service functions totaled almost \$30 million for all contracts, or about 19 percent of the firm's claimed allowable indirect costs for 1990. Although the accounts and

¹Federally Sponsored Research: Indirect Costs Charged by Stanford University (GAO/T-RCED-91-18, Mar. 13, 1991). Federally Sponsored Research: Indirect Costs Charged by Selected Universities (GAO/T-RCED-92-20, Jan. 29, 1992).

²A service function, such as CH₂M Hill's flight program, accumulates indirect costs from several accounts.

service functions reviewed totaled almost \$30 million, we were able to judgmentally select and review only a small portion of the costs and vouchers in most of these accounts and service functions during the time available for our review. Just to give you some perspective, we estimate that we looked at 2,000 to 3,000 out of an estimated 4.5 million to 5 million transactions. A complete list of the accounts and service functions we examined can be found in appendix I to our statement.

RESULTS IN BRIEF

In summary, we found many instances in which CH₂M Hill claimed indirect costs that are clearly not allowable under the FAR. Our sampling of the 15 accounts and 2 service functions identified about \$2.3 million of expenses in the overhead pool that the FAR specifically does not allow--such as providing clients with tickets to professional sporting events, alcohol at company parties, and nonemployee travel by spouses. In addition to the almost \$2.3 million in unallowable costs, we identified another \$266,500 in questionable costs. Because only 16 percent of CH₂M Hill's business is directly with the federal government, only a portion of these unallowable and questionable costs, in proportion to those direct labor charges, would have related to federal contracts. These problems with the firm's unallowable and questionable indirect costs charged resulted principally from inadequate contractor internal controls, insufficient oversight and auditing by the cognizant federal agency, and subjective allowability criteria in the FAR.

The unallowable and questionable costs demonstrate several problems with CH₂M Hill's controls over charges to federal contracts. For example, the firm did not adjust its charges to reflect differences between federal regulations and company policy. When CH₂M Hill's own policies were more generous than the FAR--for example, in allowing employees a greater relocation allowance--the firm claimed the full amount as allowable rather than claiming only what the FAR allowed. The firm also had inaccurate recordkeeping that masked more obvious errors. Costs were sometimes claimed as allowable because they had been placed in the wrong account, rather than in an account that labeled them as clearly unallowable. In addition, costs were passed along even though justification submitted by employees was incomplete or nonexistent.

In response to EPA's and our audit work, CH₂M Hill has begun to change its accounting controls and is instituting more complete reviews of certain types of expenses, such as lodging costs. Specifically, CH₂M Hill is planning to review all employee expense sheets for unallowable costs, at which point it will no longer rely on a statistically determined reduction in lodging, meal, and incidental travel costs.

We believe, however, that the problems identified point to the need for two types of federal action. The first is improved oversight by EPA, the federal agency responsible for reviewing CH₂M Hill's charges. EPA's Office of Inspector General has completed audits of CH₂M Hill's incurred costs for 1986, but is still working on 1987 through 1989. Furthermore, although EPA contracting officials have been aware of deficiencies in CH₂M Hill's procedures, they have not seen to it that corrective actions were taken. Also, there is a need to consider whether a number of subjective areas in the FAR, such as employee morale and welfare expenses, should be tightened. However, we recognize that appropriate weight must be accorded to the competing need for flexibility in determining the reasonableness of costs.

Before I get into a more detailed discussion of our findings, let me provide you with some background information on CH₂M Hill and the basic requirements the firm must follow when identifying indirect costs that it may charge to federally sponsored contracts.

BACKGROUND

CH₂M Hill provides engineering designs and related services in such areas as water, wastewater, transportation, and hazardous waste management. In 1990 CH₂M Hill's direct federal contracts amounted to approximately 16 percent of its gross revenues. The firm's charges to the government involve both direct and indirect costs. The former, such as salaries of engineers, can be identified with a specific project, while the latter--such things as rent, utilities, advertising, and general administrative expenses--are too general to be identified with a specific project. Instead, indirect costs are proportionately allocated to all of the firm's clients, including the federal government.

CH₂M Hill bills the government for indirect costs at a specific rate, which is determined by dividing total claimed allowable indirect costs by the firm's total direct labor cost. A more detailed description of the indirect allocation process is contained in appendix II. The firm considers its exact claimed rate to be proprietary information, but for an approximate point of reference, the 1990 claimed rate exceeded 150 percent, meaning that for every \$100,000 in direct labor costs on federally sponsored contracts, an amount exceeding \$150,000 was needed to cover claimed indirect costs. The rate has remained fairly constant during the past 10 years and is among the highest rates charged by engineering firms on their Superfund remedial contracts in 1990. In addition, CH₂M Hill has voluntarily reduced its indirect cost rate charged the federal government, which it claims has resulted in a \$1.5 million to \$2 million reduction to the federal government in 1990.

EPA is a primary federal contractor for CH₂M Hill's services. It contracts with the firm for such Superfund program activities as documenting conditions at hazardous waste sites, defining hazardous waste problems, and evaluating alternative cleanup methods. Since 1986, EPA has been designated the "cognizant agency" for contracts with CH₂M Hill, meaning that it is responsible for audit oversight of all of the firm's federal contracts. These oversight responsibilities include ensuring that indirect costs are correct and that federal payments are for requirements specified in the contracts.

EPA's guidance for reviewing CH₂M Hill's indirect costs is contained in the FAR. The FAR states that certain costs are unallowable and cannot be allocated to federally sponsored contracts. Examples of unallowable expenses include payment for alcoholic beverages or for the loss on the sale of an employee's home. The FAR also calls for a reasonableness test to be applied to costs that are allowable. Costs are considered to be reasonable if, in their nature and amount, they do not exceed what would be incurred by a prudent person in the conduct of a competitive business. This test requires a degree of subjective judgment, and contractual parties might not always agree as to whether a cost is reasonable.

With this in mind, I would like to turn to problems we found when we examined CH₂M Hill's indirect costs.

UNALLOWABLE AND QUESTIONABLE INDIRECT COSTS CLAIMED AS ALLOWABLE BY CH₂M HILL

First, we identified many instances in which CH₂M Hill charged the government for indirect costs that were clearly unallowable under the FAR. Second, we identified several indirect costs that, while not specifically unallowable, appear questionable for allocation to federally sponsored contracts. Because only 16 percent of CH₂M Hill's business is directly with the federal government, only a portion of the unallowable and questionable costs we identified, in proportion to direct labor charges, would have related to federal contracts.

Examples of Unallowable Indirect Costs CH₂M Hill Claimed as Allowable

The 15 accounts and 2 service functions we reviewed contained almost \$2.3 million in indirect costs specifically disallowed by the FAR. For example, we found \$873,000 in excessive charges for using the firm's aircraft. The aircraft overcharges stemmed from several specific problems. First, we believe costs for aircraft usage identified specifically with a contract should be charged directly to that contract, rather than as an indirect cost. Instead, CH₂M Hill charged as direct costs only about 47.4 percent of the aircraft's total operating costs,

having based this amount on the cost of commercial flights. The firm placed the remaining \$873,000 in the overhead accounts. Placing these costs in the indirect accounts instead of the direct accounts causes the government to pay for a disproportionate share of these costs since the government aircraft usage rate is less than 5 percent.

Furthermore, the FAR specifies that if the cost of using company aircraft is higher than the cost of commercial airfare, the excess must be documented and justified. Such documentation and justification are required regardless of whether the aircraft usage costs are ultimately charged as direct or indirect costs. CH₂M Hill has not documented and justified the excess as required by the FAR or subtracted this excess amount from allowable costs in the overhead pool. Let me provide an illustration of the types of excess aircraft costs the firm has not documented or justified. The cost of a commercial coach flight from Seattle, Washington, to Portland, Oregon, is \$149, while CH₂M Hill's cost for this same flight on one of its own aircraft was nearly three times that amount.

We also found about \$121,000 in unallowable incentive payments for employee sale of homes. The FAR specifies that only actual selling costs associated with the sale of a home are allowable. CH₂M Hill encourages its employees to sell their own homes. To assist employees in the self sale of their homes, CH₂M Hill will provide an employee with (1) an incentive payment of 6 percent of the average of two appraised values or the actual sale price, whichever is higher, up to a maximum of \$15,000 with a \$3,000 minimum, and (2) a 1-1/2 percent self-sale premium of the selling price for sales in which the employee finds a buyer and carrying costs or loan points are not incurred. CH₂M Hill considers the incentive and premium payments to be allowable costs even though the actual selling costs incurred by an employee may be less. We believe the incentive and premium payments are unallowable if they exceed actual selling expenses. For example, a CH₂M Hill official's home was sold by a realty company for \$980,000. The realty company was paid \$66,000, and the firm official was paid \$14,700 for the self-sale bonus.

Finally, we also found about \$7,700 for alcoholic beverages and about \$4,100 for tickets to Denver Nuggets basketball, Seattle Mariners baseball, and Seattle Seahawks football games. The FAR disallows alcohol altogether and such tickets if they are provided to clients. CH₂M Hill agrees that these costs are unallowable and has made the appropriate adjustments. Further examples of unallowable costs claimed by CH₂M Hill are identified in appendix III.

Examples of Questionable Indirect
Costs CH₂M Hill Claimed as Allowable

As I mentioned earlier, the FAR requires that the reasonableness of indirect costs be considered in determining their allowability. In calling for application of a "prudent person" standard, the FAR does not specifically illustrate what a prudent person would consider a reasonable cost. On the basis of our application of this admittedly subjective standard, however, we question about \$266,500 in costs that CH₂M Hill claimed as allowable.

The majority of this amount--about \$167,900--was for employee parties and picnics. These expenses represented party and picnic costs incurred during 10 of the 96 months worth of billings submitted by CH₂M Hill's eight companies for 1990. Under the FAR, expenses designed to improve employee morale are allowable. Expenses of parties may well be allowable under that provision. However, the FAR requires that these expenses be reasonable. The amounts claimed as allowable by CH₂M Hill included \$19,600 for entertainment, \$300 for party invitations, \$850 for photographers, and \$100 for a dance instructor. In one instance, the firm spent \$3,200 for a dance band at a Christmas party. We question whether these kinds of expenses and the total costs are reasonable. Without more specific guidance--a point I will return to later in my statement--deciding what constitutes reasonable expenditures in such an area is tantamount to navigating a minefield. Both the contractor and the federal audit agency can experience difficulty in determining the allowability of such costs.

We also question the allowability of about \$63,600 for general advertising. Under the FAR, the only advertising costs allowable are for recruiting personnel, acquiring scarce items, and disposing of surplus materials. In addition, the FAR provides that costs of recruitment advertising are unallowable if the advertising does not describe specific positions or classes of positions. The advertisements we question, in our view, promote CH₂M Hill, but they do not describe specific positions or classes of positions available for employment. CH₂M Hill believes these are allowable because the advertisements made the public aware of the firm's employment opportunities.

In addition, we observe that CH₂M Hill claims as allowable about \$13,700 for travel clubs at airports, such as United Airlines' Red Carpet Club. Under the FAR, travel costs incurred in the normal course of overall business are allowable. CH₂M Hill states that membership in the travel clubs is provided for employees who have a need to conduct business while traveling. However, we could not document that CH₂M Hill used the travel clubs solely for this purpose.

Finally, we question some relocation costs charged by CH₂M Hill. The FAR specifies that costs associated with a move are allowable if the move is for an indefinite period or for a stated period of at least 12 months. We found that one CH₂M Hill employee relocated twice in 1990. The \$12,627 relocation cost for the first move may be unallowable if CH₂M Hill knew that the relocation assignment would be for less than 12 months. In addition, we believe relocation costs identified specifically with a contract should be charged directly to that contract, rather than as an indirect cost.

Let me turn now, Mr. Chairman, to what we believe are some of the reasons why the indirect costs charged by CH₂M Hill included unallowable and questionable costs.

CH₂M HILL HAS POOR INTERNAL CONTROLS FOR DETERMINING ALLOWABLE COSTS

Indirect cost findings can be attributed to numerous weaknesses in CH₂M Hill's internal controls. For example, CH₂M Hill's practices allow reimbursement for some items that are expressly disallowed by the FAR--alcoholic beverages and spouse's travel costs are two instances. In other cases, the firm's provisions for reimbursement are higher than those the FAR allows--employee relocation expenses are an example. Nonetheless, CH₂M Hill chose to claim the full amounts as allowable.

While CH₂M Hill may argue that its policies are in line with others in the private sector, the costs it submits must be adjusted to meet the FAR's standards when contracting with the federal government. CH₂M Hill officials acknowledged that the company's internal controls need to account for these differences and to make appropriate adjustments.

Another internal control weakness focuses on CH₂M Hill's recordkeeping. We found many instances in which CH₂M Hill employees placed unallowable costs into allowable-cost categories. Entertainment costs, for example, are unallowable under the FAR and should not be passed on to the federal government. However, we found entertainment expenses recorded in other accounts. For example, the cost of football, baseball, and basketball tickets were recorded in the "other employee expense" account. This account is used to record the costs--costs considered totally allowable by CH₂M Hill--associated with the recreational and social activities of the firm's employees. In addition, we found that the cost of alcoholic beverages appeared in both the meals account and the other employee expense account and that the cost of a fishing license for a CH₂M Hill employee was included in the licenses and fees account, an account used to record the cost of acquiring licenses needed by the firm to conduct its business.

We also found poor recordkeeping for business meals. For example, employees did not always provide required information--such as the names of guests, their companies, and business topics discussed--to document that meals were for business rather than entertainment purposes. Although a 1984 audit report by the Defense Contract Audit Agency (DCAA) for EPA disclosed the recordkeeping problem for business meals, CH₂M Hill management did not take action to correct the problem until we brought the matter to its attention.

CH₂M Hill officials recognize the continuous need to improve internal controls and are now planning to take appropriate action. For example, to better ensure that unallowable costs are assigned to the correct account, the firm has now updated its accounting manual and revised its chart of accounts. The firm is also providing better supervision and training to employees who assign costs. The firm also issued a memorandum in December 1991 calling for employees to provide proper support for business meal costs.

In addition, starting in January 1992 CH₂M Hill was required to comply fully with Cost Accounting Standards (CAS) requirements, including ones on the segregation of unallowable costs. To comply with these CAS requirements, CH₂M Hill will divide its costs among three cost pools. If CH₂M Hill cannot properly code the costs to its accounts and assure that unallowable costs have been excluded from the indirect accounts, the firm's efforts to accurately allocate indirect costs among its three cost pools could result in misallocations of costs to the government and others.

PROCEDURES FOR REDUCING INDIRECT COSTS RAISE SERIOUS QUESTIONS

I would now like to discuss two specific practices that CH₂M Hill has used to reduce the indirect costs it charges the government. The first involves adjusting indirect lodging, meal, and other travel costs for unallowable costs. The firm's approach is to examine a sample of employee expense sheets, determine the percentage of indirect costs unallowable under federal travel regulations, and apply that percentage to all indirect travel costs. This reduction--called a "decrement factor"--was 16 percent in 1990 and was agreed to by EPA for use on all federal contracts with CH₂M Hill awarded after July 1986.

To put the use of the 16-percent decrement factor in perspective, CH₂M Hill reduced the almost \$5.2 million in 1990 indirect meals, lodging, and other travel costs to about \$4.4 million. While intended to compensate for unallowable costs in these accounts, the decrement factor did not apply to the cost of business meals recorded in the same meals account. We found that business meals, which were claimed as totally allowable costs by

CH₂M Hill, contained numerous unallowable costs. For example, our review of 30 randomly selected expense sheets from the sample used by the firm for determining the decrement factor showed that approximately 77 percent of the business meal costs, or about \$2,100, were not adequately documented and should have been unallowable. Unallowable business meal costs are in addition to the costs determined unallowable by the firm from application of the decrement factor.

In August 1991 EPA told the firm to stop using the decrement factor beginning in 1992 because of concern that the factor may not eliminate all unallowable travel costs. Instead, CH₂M Hill is to perform a full review of all expense sheets. It is not clear when this will occur. CH₂M Hill officials said they are willing to do whatever EPA mandates, but question who should pay the added cost. They estimated the change would cost the company in excess of \$1 million during the first year and about \$540,000 per year thereafter. They also said a full review could not be done in early 1992 because more time was needed to change computer systems and procedures and train the employees who would do the work.

Let me now turn to CH₂M Hill's voluntary reduction of its allowable indirect cost rate. The firm began charging a discounted rate by applying a voluntary management reduction, or VMR, in 1982. Firm officials said they implemented the VMR to make the claimed indirect cost rate more consistent from year to year and to make CH₂M Hill more competitive for federal contracts. Under the Brooks Act, however, contracts for architect and engineering services are negotiated on the basis of technical competence, rather than lowest dollar bid. CH₂M Hill regards the dollar value of the discount as proprietary information, but it claims the VMR lowered the cost of federal contracts by \$1.5 million to \$2 million in 1990.

Although we are not opposed to CH₂M Hill's offering the federal government a discount, the firm must remove unallowables and account for its costs in accordance with the FAR regardless of whether it subsequently chooses to offer a discount. As the VMR now operates, it acts, in essence, as a cushion to keep the firm from being affected by any indirect costs later found to be unallowable. If unallowable costs are found after the discount has been determined, the firm's practice is not to reimburse EPA, but rather to reduce the VMR by the amount of the aggregate unallowable costs. The VMR may also encourage CH₂M Hill to not be as conscientious as necessary when making an allowability determination because the VMR pool is available to cover errors. The detrimental effect is that the government may never get an accurate view of whether the firm's discount, with all these unallowable costs mixed in, is anywhere close to what CH₂M Hill says it is. Unless unallowable costs have been removed prior to