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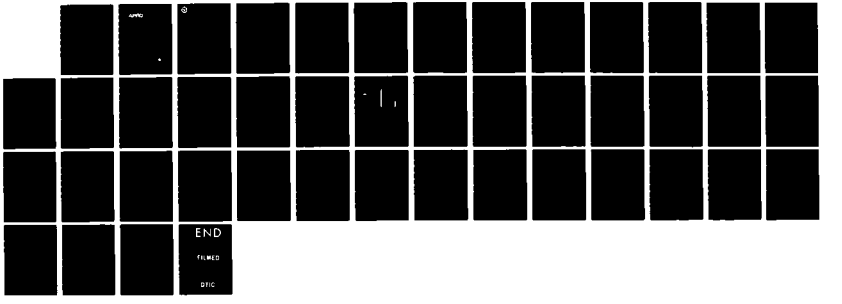

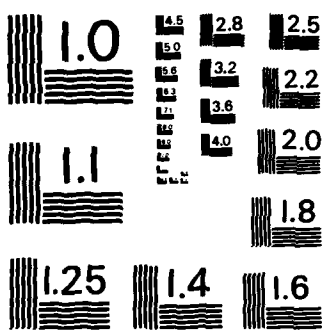

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LABOR COSTS IN DOD CONTRACTS

AUGUST 1985

ARMY PROCUREMENT RESEARCH OFFICE
OFFICE OF DEPUTY CHIEF OF STAFF FOR LOGISTICS
FORT LEE, VIRGINIA 23801-6045

DEPARTMENT OF THE ARMY
OFFICE OF THE DEPUTY CHIEF OF STAFF FOR LOGISTICS
ARMY PROCUREMENT RESEARCH OFFICE
FORT LEE, VIRGINIA 23801-6045

REPLY TO
ATTENTION OF

DALO-PRO

24 Sep 1985

SUBJECT: Army Procurement Research Office Report, APRO 84-07, Labor Costs in DOD Contracts

SEE DISTRIBUTION

A copy of subject report is enclosed for your information. The report discusses DOD contractor employee compensation and analyzes the manner in which the monitoring of those costs is accomplished. The long-run and short-run effects of across-the-board ceilings on contractor employee wages are examined. It is recommended that analyses of contractor compensation costs performed by DLA be made more available to Army contracting officers with a need-to-know.

1 Encl
as

Robert F. Williams

ROBERT F. WILLIAMS, Ph.D.
Director, US Army
Procurement Research Office

DALO-PRO
SUBJECT: Army Procurement Research Office Report, APRO 84-07, Labor Costs in DOD Contracts

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FINAL

LABOR COSTS IN DOD CONTRACTS

By

PAUL R. LAWRENCE, Ph.D.

ARTHUR J. MANDLER

The pronouns "he," "his," and "him," when used in this publication represent both the masculine and feminine genders unless otherwise specifically stated.

Information and data contained in this document are based on input available at time of preparation. Because the results may be subject to change, this document should not be construed to represent the official position of the United States Army.

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US ARMY PROCUREMENT RESEARCH OFFICE
OFFICE OF THE DEPUTY CHIEF OF STAFF FOR LOGISTICS
Fort Lee, Virginia 23801

EXECUTIVE SUMMARY

A. BACKGROUND/PROBLEM. Cost growth in major weapon systems remains one of the more important problems in the Department of Defense. As efforts increase to better control weapon systems costs, recent concern has focused on the cost of defense contractor employee compensation (salary and fringe benefits). Since labor-based costs are a significant part of total contract costs, assuring that the labor-based costs are reasonable has become a higher priority.

B. OBJECTIVES. Determine if the current methods used to monitor and control contractor labor costs are effective. Determine if defense contractor employees receive excessive compensation when compared to their commercial counterparts and if so, recommend corrective action.

C. APPROACH. In addition to reviewing current methods used to monitor and control labor costs, a comprehensive survey was attempted. This survey was to obtain compensation data from defense contractors and compare that data with data compiled by the Bureau of Labor Statistics in order to determine if defense contractor employees are excessively compensated.

D. FINDINGS. The Defense Logistics Agency (DLA) has primary responsibility for monitoring and controlling contractor compensation costs. However, DLA's methods are being completely revised, and it would be inappropriate to base policy changes on a system that will be extensively changed. The attempted compensation survey ran into many obstacles and had to be abandoned. On a more positive note the Army is doing an excellent job of controlling and monitoring contractor employee compensation at the Government-Owned Contractor-Operated (GOCO) Army Ammunition plants.

E. RECOMMENDATIONS. Since it was found that the information on which policy recommendations would be based was either obsolete or unavailable, no major recommendations can be offered. However, the Army should be encouraged to take an active role in the revision of the DLA procedures on employee compensation. In particular, the data compiled by DLA should be made available to purchasing contracting officers who might find the information useful for developing negotiation strategies.

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CHAPTER I

INTRODUCTION

A. BACKGROUND.

Cost growth in major weapon systems remains one of the more important problems in the Department of Defense. As efforts increase to better control weapon systems costs, recent concern has focused on the cost of defense contractor employee compensation (salary and fringe benefits). While estimates of the relative percentage of defense contract costs attributable to labor may vary, there is general agreement that the labor based costs are significant. Therefore, assuring that those labor based costs are reasonable has become a higher priority.

The Federal Acquisition Regulation (FAR) 31-205.6(b) provides guidelines for determining the reasonableness of defense contractor employee compensation. The section states:

> "Compensation for personal services will be considered reasonable if the total compensation conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed."

However, without a means of verification, the mere existence of regulatory guidance does not assure that a desired result is being achieved. Perhaps the guidance is too nebulous, or too difficult to enforce. There is even the possibility the guidance is simply ignored. For reasons such as these there is concern that civilian employees of firms doing business with DOD may be receiving "excessive" compensation. In turn, it is thought that this "excessive" compensation could be a major contributor to the cost growth problem.

A defense contractor's total labor based cost are normally passed on to the government. This means that, if a contractor's labor force receives a 7% increase, the increase would be borne by the government. Because of the pass through of costs, some DOD officials perceive contractor employees as de facto government employees and believe their wages should be controlled much as the salaries of federal employees are controlled. In 1982 the Secretary of the Air Force requested that his department "...make every effort to see that we do not pay negotiated wage settlements to our weapon producers which are greater than the amounts which the federal government decides are adequate for its own employees" (7).

An Air Force working group suggested limiting increases in wages for employees of defense contractors to the percentage increase Congress authorizes for federal employees. This approach has drawn criticism from representatives of the aerospace industry. While many problems are associated with such an approach, the potential cost controlling features are attractive to other services. The Assistant Secretary of the Army for Installations, Logistics and Financial Management, for example, has suggested that the Army consider taking similar steps (8). In order to determine the best course of action, a study to reconcile these issues is needed.

B. STUDY OBJECTIVES.

1. Describe current methods used to monitor and control labor costs (including Government-Owned Contractor-Operated Army Ammunition Plants) and, if possible, determine their effectiveness.

2. Attempt to determine if a widespread "excessive" compensation problem exists and, if so, attempt to determine the degree of the problem.

3. Recommend actions as appropriate.

C. SCOPE.

This study focused on existing procedures used by the Army to control and monitor contractor labor costs. Primary emphasis was placed on the pertinent regulatory guidance, organizations involved and the incentives/disincentives in the current system. An industry perspective of the compensation issue was also examined. Additionally, the approach required that a compensation comparison between defense contractor employees and commercial contractor employees be undertaken. The purpose of this comparison would be to determine if employees of defense contractors receive excessive compensation when compared to their counterparts employed by commercial contractors. However, because of difficulties involved in quantifying the value of various fringe benefits, only the salary/wage component of compensation was examined. Any differences in fringe benefits between defense contractor employees and commercial contractor employees are unknown.

D. STUDY APPROACH.

Policies, regulations and related literature on DOD contractor compensation costs were surveyed. Knowledgeable and experienced individuals representing the U. S. Army Materiel Command (USAMC), the Defense Logistics Agency (DLA), the Defense Contract Audit Agency (DCAA), and Industry were interviewed to gain insight into this area. Additionally, a comprehensive survey was planned to determine if disparities exist between the compensation levels of DOD contractor employees and their non-defense counterparts.

were only permitted limited access to the data and only impressions of general content and format were gleaned. Detailed comments on specific CECSR reports are not possible.

C. CECSR DISTRIBUTION.

The DLA regulations (11) covering distribution of the full CECSR (also known as Detail Reports) are clearly intended to protect confidentiality of the data. DLAM 8105.1 states "The proprietary nature of the information contained in the CECSR necessitates close control and limited distribution of these reports." Distribution of the CECSR report is completely internal to DLA and is only made to HQ DLA, DCASR (CAS), DCAA (Auditor), and the ACO.

A summary report of a full CECSR is prepared by the CSA and wider distribution is given to these summary reports in accordance with the requirements of DLAM 8105.1. This report need only indicate the acceptance, qualified acceptance or non-acceptance of the contractor's compensation system and the basis for such determination. Of the wider distribution made of the summary reports, all is internal to DLA except that per DLAM 8105.1, "Copies of Summary Reports will also be furnished to PCO's having a significant procurement interest in the contractor (current negotiated contracts in excess of $1,000,000)." The referenced DLAM also states that CECSR summary reports will be distributed to all government PCO's upon request.

At this point, it is important to emphasize that a summary report is only furnished to a PCO (having significant interest) after a contract has been negotiated unless the PCO specifically requests a copy beforehand. Even assuming that the content of a summary report is useful to a PCO entering negotiations (and that is doubtful because of lack of detail), it is unlikely that one will be requested. This is based upon the observation that PCO's

severance pay; backpay; stock options; pension costs; deferred compensation and fringe benefits.

B. DLA RESPONSIBILITIES-OVERVIEW.

For DOD contracts over which they have administrative cognizance, the Defense Contract Administration Service (DCAS) of the Defense Logistics Agency (DLA) has responsibility for determining the reasonableness of compensation costs either charged to government contracts or included in proposed contract prices. Specifically, the cognizant Administrative Contracting Officer (ACO) must make reasonableness determinations. Compensation System Analysts (CSA) assigned to the DCAS Regional (DCASR) office must assist the ACO's by conducting Contractor Employee Compensation System Reviews (CECSR). A CECSR is a full compensation review which considers a contractor's total compensation policies, practices, and compensation structure (including an analysis of a contractor's manpower controls). If there are no significant problems, a CECSR will result in a determination that the compensation conforms to sound business practices and that the total compensation costs produced by the system meet the tests of allowability, allocability and reasonableness required by FAR.

Regulations (10) require CECSR's to be performed every two years for contractors who either have in excess of $10,000,000 in negotiated annual government sales (prime contracts and subcontracts) or contractors who are defined as being "Not-for-Profit". Additionally, full reviews can be requested by the ACO when justified by unusual circumstances. Finally, the ACO can request that selected elements (such as merit increases, deferred compensation or relocation allowances) of a contractor's compensation system be reviewed. Because DLA regulations treat the CECSR data as very sensitive, the researchers

Chapter III

DOD COMPENSATION MONITORING SYSTEM

A. INTRODUCTION.

Federal regulations pertaining to government contracting require the government to pay only contract costs that are deemed reasonable. One of the general guidelines for determining reasonableness is provided by FAR 31.201-3 which states a "cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business." If a cost is not reasonable, all or part of it may be unallowable. FAR 31.201-6 requires that unallowable costs "be identified and excluded from any billing, claim or proposal applicable to a government contract."

There are a number of specific cost categories that, combined together, comprise the total cost of a government contract. One of those cost categories is the compensation for contractor employee labor. Compensation is considered to be the total of wages, bonuses, health benefits, insurance and pension plans, vacation and illness plans and any other company paid allowances that fall within the broad term of "fringe benefit." General guidance for determining the reasonableness of compensation is found in FAR 31.205-6(b) which states, "Compensation for personal services will be considered reasonable if the total compensation conforms generally to compensation paid by other firms of the same size, in the same industry, or in the same geographic area for similar services or work performed." This guidance is followed by five pages of more specific guidance concerning labor-management agreements; domestic and foreign differential pay; bonuses and incentive compensation;

E. SUMMARY

At the beginning of Section C above it was stated that judicious application of a wage suppression policy could overcome many of the drawbacks of an across-the-board policy. If a contractor was paying his work force 50% above the average and there were no mitigating circumstances, a wage suppression policy might be appropriate. But, if a contractor was paying his work force 50% below the average, a wage suppression policy could cause problems. That contractor should not be limited to a 5% or 7% increase.

A wage suppression policy would only be plausible (and fair) if the relative position of a contractor's wage rates were taken into account. This means that firms paying above average rates would be subjected to smaller rates of increase than firms paying below average rates. However, even with the application of an equitable wage suppression policy, there would still be serious questions about the government crossing the boundary from purchaser to decision maker in internal contractor matters.

Bonus/Incentive Pay
Leave Policies
Work Rules
Perquisites

For a policy of wage suppression to actually result in lower overall costs it would be necessary to monitor and control all compensation related costs, not just wages. However, even with appropriate controls on all compensation related costs, there is no assurance that this is beneficial in the long term. Lower wages, the result of longer term wage suppression, lead to higher employee turnover rates (assuming there is a demand for the employees skills elsewhere). If only the defense sector were controlled, the non-defense sector would become more attractive to a defense sector employee. Because of this, defense sector employers contending with higher employee turnover rates would consequently have higher recruitment costs. The more capable employees whose abilities are in demand elsewhere would leave and the less capable employees would remain. Potential learning curve benefits would not accrue to the government because personnel turbulence would have an effect on learning. Scrap and rework rates would increase, adding to total costs. It might even be necessary to hire more employees to compensate for the higher turnover rates. A less skilled work force could conceivably drive up total contract costs.

D. INDUSTRY PERSPECTIVE.

Contractors are vigorously opposed to wage suppression policies. They believe that as a part of the contract, the government is purchasing management judgement. Trying to control employee compensation, in their opinion, undermines a company's ability to manage and interferes with managerial discretion. Unions at defense contractor plants are also opposed to this policy.

Just prior to completion of this study, the General Accounting Office (GAO) released a study titled "Compensation by 12 Aerospace Contractors" (14). The purpose of that study was to review the reasonableness of compensation paid in aerospace firms in relation to that paid employees in other industries. A compensation survey of the 12 contractors was necessary. GAO noted many problems and cautioned that the results of their study could not be used to form generalizations. Many of the problems noted were similar to those encountered during this study.

DLA collects compensation data which is potentially useful for analysis. But, for a number of reasons, they were unwilling to release the data. This eliminated an opportunity to ascertain empirically whether or not the concern over excessive compensation is a valid issue. While the data may not have yielded conclusive evidence, it may have provided an indication of the existence of a problem. More information on this point is provided in Chapter III where the DLA actions are discussed.

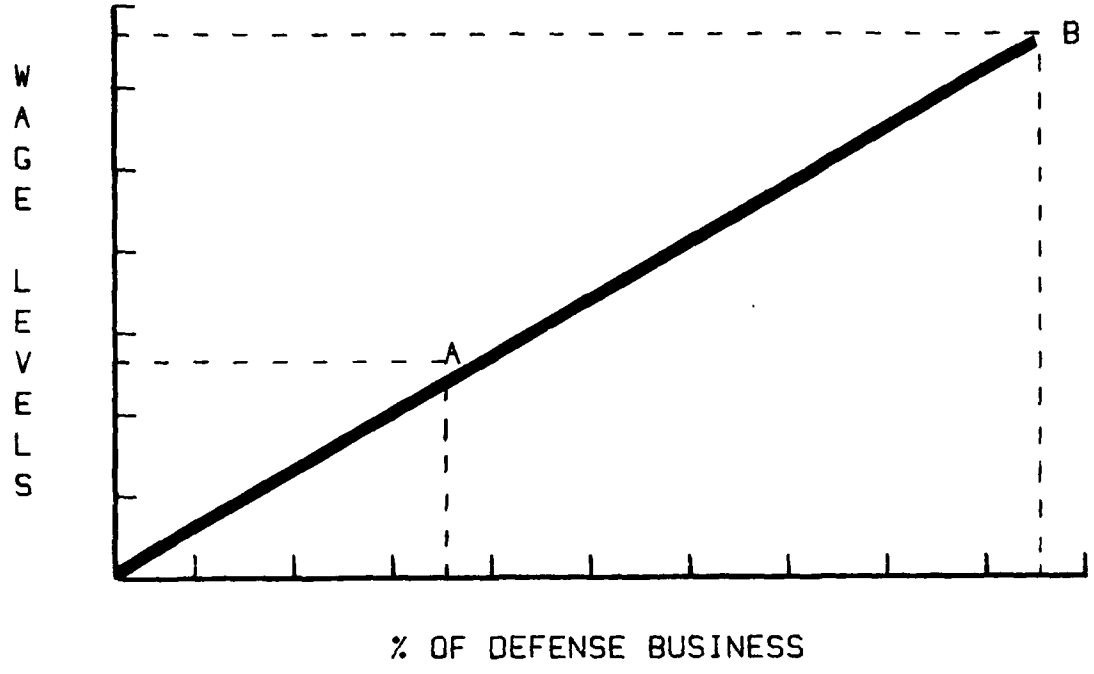
C. WAGE SUPPRESSION.

In spite of potential legal challenges, a policy of limiting the wage increases of defense contractors on an across the board basis could lower the rate of increase in weapons systems costs in the short term. However, the policy would have to be judiciously applied since a number of drawbacks could negate savings and prove to be more costly in the long term.

For example, overall labor costs are influenced by a number of related elements, not just hourly rates. Pressure on wages only may result in cost increases in any of the following:

Medical Benefits
Pension Plans
Stock Plans

PERCEIVED EXCESSIVE COMPENSATION

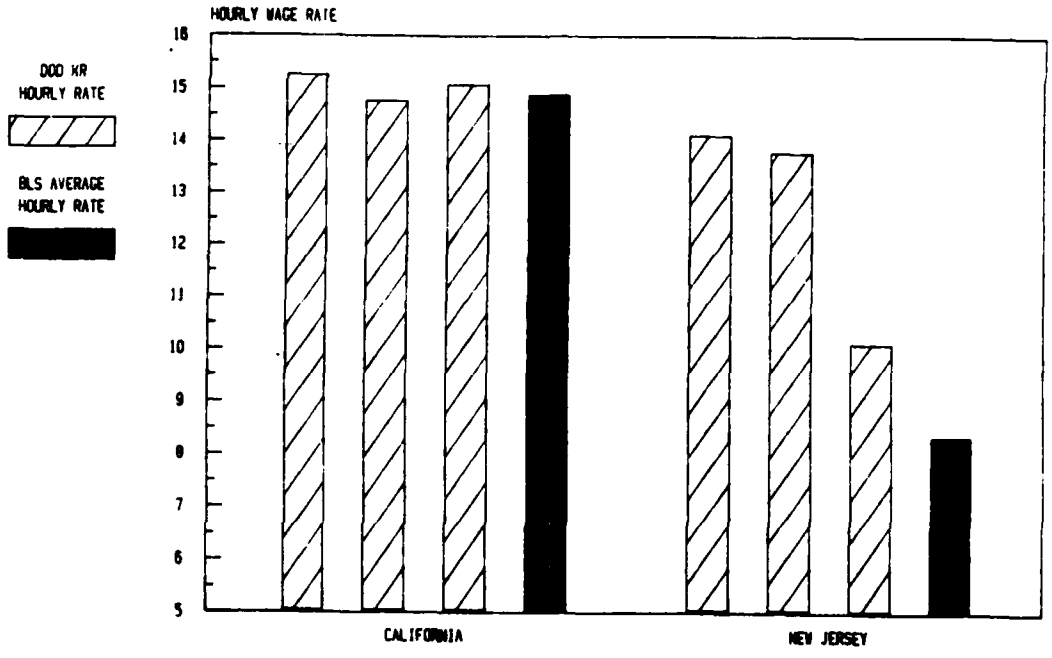


Point A - Lower % of Defense business = lower wages for employees
Point B - Higher % of Defense business = higher wages for employees

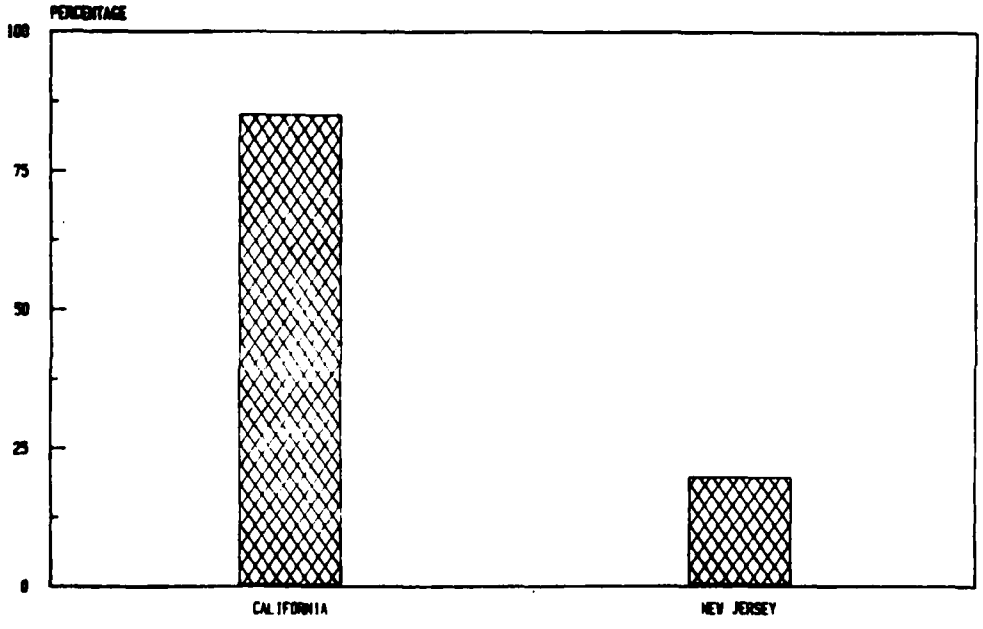
Figure 3. Perceived Excessive Compensation

COMPENSATION COMPARISON

DEFENSE CONTRACTOR & BLS WAGE COMPARISON



% OF DOD CONTRACTORS IN BLS DATA BASE



Above charts are intended to represent a concept and do not represent actual data.

Figure 2. Compensation Comparison

contractors. Therefore, it was unknown if the data compiled on a particular job in a particular geographic area included a high or low population of defense contractor employees. Because of this difficulty it was not possible to compare defense employees to non-defense employees using BLS or AMA data. The only comparison possible was that of defense employees to all employees included in the data service survey. If a high percentage of employees included in the data service (for an area) were defense contractor employees (unknown), any comparison made would entail comparing one group to the average of all those included in the group. This is akin to comparing something with itself. The comparison might show that the compensation was not out of line with the average compiled by the data service, however, the average supplied may have been skewed. Figure 2 is a graphic depiction.

Additionally, all the above is compounded by defining what constitutes a defense contractor. Many firms have a mix of defense and commercial business. In order to properly answer the "excessive" compensation question, labor rates for a number of categories of labor for different contractors with different mixes of defense/commercial business must be graphically plotted. If the persons who perceive defense contractor employees as receiving excessive compensation were correct, the data would show that as the percentage of defense business increases, the salary levels for the employees increase. Figure 3 illustrates such a relationship. It must be noted that this study was not able to verify the above supposition.

As noted in Chapter I, fringe benefits, although applicable to a true measure of compensation, were not examined because of the complexity involved in quantifying the benefits for comparison purposes.

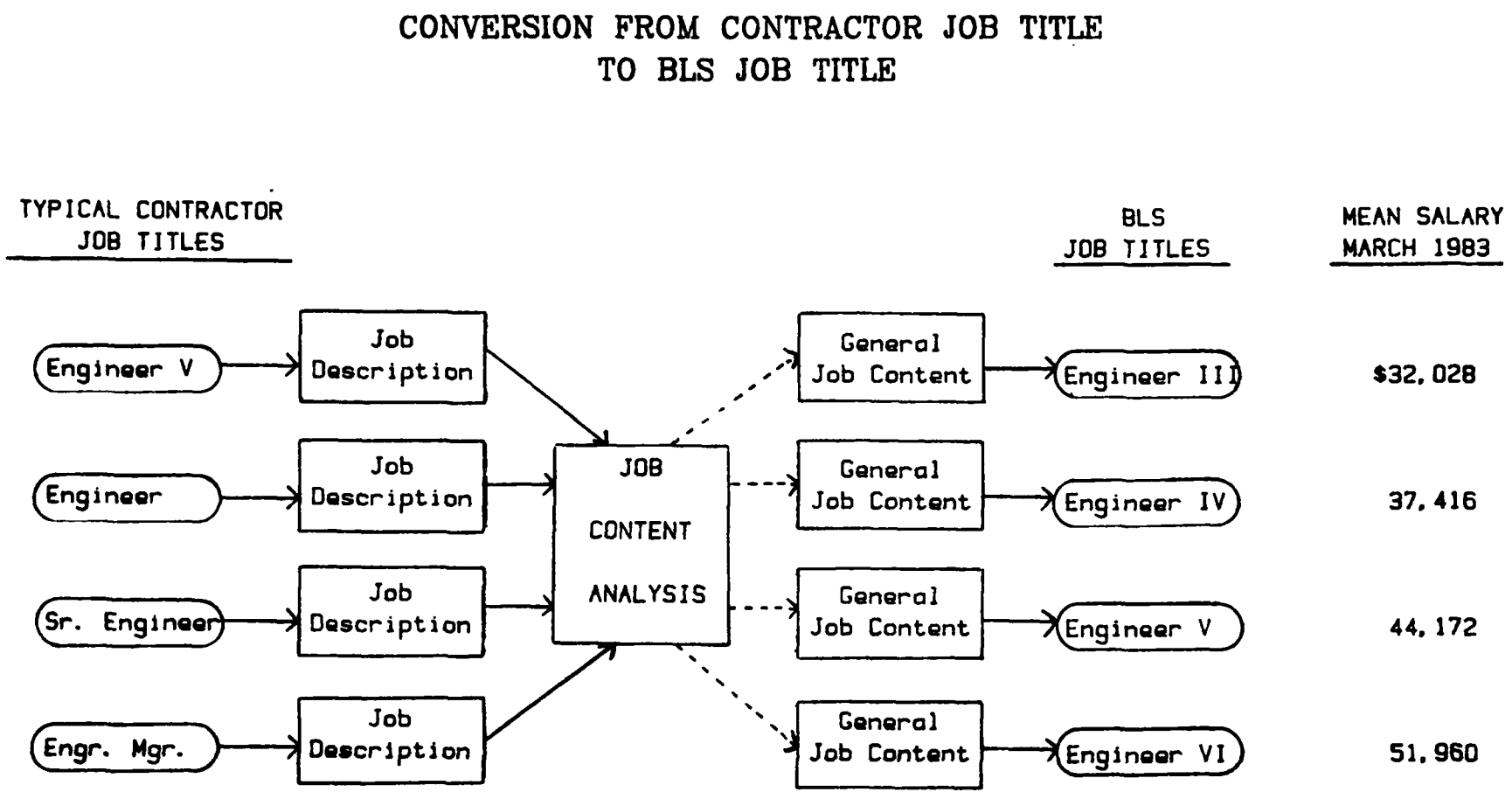


Figure 1. Conversion from Contractor Job Title to BLS Job Title

be required to provide salary data for an engineer at X Company with a certain level of education and experience. The data would be analyzed and comparisons between defense and commercial contractors could be made. It soon became evident that this approach was not feasible because contractors do not maintain salary data in such a manner and the baselines that were to be used for comparison purposes did not provide salary data in the job title-education-experience format.

After exploring many different proposed compensation comparison methodologies, it was discovered that a technique called "job content analysis" must be performed in order to assure that personnel with similar responsibilities/abilities are being compared. As can be seen from Figure 1 job titles alone are no basis for comparison. A Senior Engineer at one firm may be called an Engineer V at another firm, an Engineering Manager at a third firm, or something entirely different at yet another firm.

It was necessary to establish a baseline for comparison purposes. There are a number of services that compile compensation data which could be used as baselines. Among the services examined were the BLS and the American Management Association (AMA). BLS and AMA define a general job content (generic job description) for the positions on which they supply salary data. In order to get a valid comparison a targeted contractor job must have a content analysis performed so that it can be matched with a similar job of one of the data services cited above. This is also clearly portrayed in Figure 1. Unfortunately, the researchers were unable to draw upon the resources necessary to perform a job content analysis.

In addition to an inability to perform job content analyses, the data compiling services did not distinguish between defense and non-defense

of the first group. The second group believed that since profit/fee in government contracts is usually a function of cost, a defense contractor can reap greater profits by "excessively" compensating his labor force. A consequence of getting greater profits in this manner is increasing total contract costs to the government. Observations also indicated that those with little or no knowledge of the mechanics of determining employee compensation were likely to hold to this belief. Both of these arguments make valid points, but the compensation issue simply remains a debate between these two schools of thought in the absence of empirical data proving whether defense contractor employees receive excessive compensation when compared to non-defense contractor employees. If conclusive evidence supporting one of the schools of thought was found, DOD could develop policy and procedure based upon clear knowledge rather than conjecture. This research attempted to develop a comparison survey to end the debate with conclusive evidence.

Unfortunately the researchers' expectations were changed by the developing complexities and recognition of the knowledge and training necessary to carry out such a comparison survey. Personnel contacted at the Bureau of Labor Statistics (BLS) commented that their employees require a minimum of 4 years training and experience before they would be deemed capable to undertake such a survey. An explanation of some of the difficulties encountered follows.

Initially, it was believed that wage data from different defense contractors could be acquired through tasking the Defense Contract Administration Service (DCAS). This approach would identify targeted categories of labor by job title, education and experience. As an example, DCAS would

CHAPTER II

BACKGROUND AND ISSUES

A. INTRODUCTION.

During the course of this study it became clear that the various concerns over better control of contractor employee compensation costs fell into one of two related categories. The first category of concern was that employees of defense contractors were receiving excessive compensation when compared to their counterparts in nondefense sectors of the economy. The second category of concern was that union wage settlements and yearly salary adjustments were causing employee compensation to increase at too great a rate. As pointed out in Chapter I, the Secretary of the Air Force and the Air Force working group have proposed courses of action to control the rate of wage increases.

This chapter first discusses the researchers' attempts to determine the validity of the perception that defense contractor employees are excessively compensated. Then the short and long term effects of the wage suppression approach suggested by the Air Force are discussed.

B. EXCESSIVE COMPENSATION.

The research suggested that there are two distinct schools of thought concerning the existence of an "excessive" compensation problem. The first believes that a problem does not exist since "free market" theory applies to labor costs and, aside from some distortions caused by unions, supply and demand for certain categories of labor determine the cost of that labor. It was observed that a great majority of those with an understanding of the mechanics of determining employee compensation were members

E. REPORT ORGANIZATION.

Chapter I provides the Introduction to this study. Chapter II, Background and Issues, provides detailed background data and a clear explanation of the issues involved. Chapter III, DOD Compensation Monitoring System, examines and comments upon the primary compensation related efforts DLA performs for the services. Chapter IV, Government-Owned Contractor-Operated Army Ammunition Plants (GOCO AAP's) Compensation Monitoring, explains how HQ AMCCOM deals with these issues at the Government-Owned Contractor-Operated (GOCO) Army Ammunition Plants (AAP's). Chapter V presents conclusions and recommendations.

are generally not even aware of the existence of these reports. Their lack of awareness may be due to the fact that CECSR's and DLA procedures are only addressed in DLA documents.

D. DETERMINATION OF REASONABLENESS.

Earlier it was explained that the ACO (assisted by the CSA) was responsible for determining the reasonableness of total compensation charged to the government. Determining reasonableness is sometimes very difficult because few firm guidelines exist and ultimately a very high degree of judgement is required.

From the CECSR's reviewed, it was found that salary levels were often expressed as a percentage above or below an average for that category of labor. The averages were obtained from a BLS or AMA type statistical information gathering service and they were sometimes tied into a particular industry and/or a particular geographic area. The salary levels were sometimes compared to rating service averages for a specific job, such a forklift operator or accountant. Other times the salary levels were aggregated and compared by more general groupings such as hourly or administrative. But at all times it was noted that percentages over/under a reference point (average salary level) were expressed. Figure 4 shows an example of the format.

The consensus among interviewees representing DCAS and DCAA was that determining reasonableness of salary levels based upon a percentage over/under an average salary was difficult because the statistics did not always yield a clear cut answer. For example, if a firm was paying its employees (on average) 3% above the prevailing rate in the area, one would be justified in determining those salaries reasonable. If, on the other hand, a firm was

EXAMPLES OF DLA CECSR DATA

CONTRACTOR IN DCAS REGION A

CONTRACTOR JOB TITLE	ANNUAL SALARY	WEIGHTED AVERAGE ANNUAL SALARY	COMPARISON BASE	OVER/UNDER AVERAGE
Forklift Operator	$22,000	$18,000	BLS	+22%
Sr. Engineer	47,000	42,500	BLS	+11%
Computer Operator	21,000	24,000	BLS	-12%

CONTRACTOR IN DCAS REGION B

LABOR CATEGORY	ANNUAL SALARY	WEIGHTED AVERAGE ANNUAL SALARY	COMPARISON BASE	OVER/UNDER AVERAGE
Administrative	$24,000	$22,000	AMA	+ 9%
Clerical	17,000	17,500	AMA	- 3%
Professional	41,000	43,000	AMA	- 5%

Figure 4. Examples of DLA CECSR Data

paying 300% of the prevailing rate, a determination of unreasonableness might be supportable. But from the reports reviewed, not all determinations were that easily made.

In one partial CECSR-type report reviewed, a particular firm was paying its employees (on the average) 128% of the prevailing rate for the geographic area. Was that rate reasonable? Does that firm determine it needs to pay that salary level to attract better qualified personnel? Does that rate allow the firm to increase its employee retention rate and thereby reduce its recruitment and training costs? If the above answers are "Yes", does that firm's more stable work force produce better quality goods with a lower scrap rate than some of their competitors who pay salaries closer to the average? In the long run is the total contract cost to the government less because the firm's wage policies are more generous than those of its competitors? In this cited report the salary levels were considered reasonable, but would the salary levels be considered reasonable if the rate was 143% of the prevailing area wage? What about 159%? 182%? 210%? There is no clear cut outline that separates reasonableness from unreasonableness. The GAO study cited earlier states that the definition of reasonableness embodied in in DAR lacks quantitative criteria and there is no generally accepted pay survey to which contractors might be compared (14).

While it is necessary that judgement dictate the determination of reasonableness of salary levels, it is important to understand the difficulties involved in supporting an unreasonableness determination. There are administrative incentives for CSA's and ACO's to accept salary related costs as reasonable in all but the most outrageous circumstances. The first incentive is the mere reality that if salaries are deemed reasonable there are no

problems and everyone moves on to other responsibilities. The basis for that incentive seems to be that the government is normally in a no-win position when it challenges contractor salary levels. From information available through interviews and a review of published cases of the Armed Services Board of Contract Appeals (ASBCA) cases, the responsibility for proving unreasonableness lies with the government. The author of Accounting Guide for Government Contracts, Paul M. Trueger comments at length on the burden of proof issue. He states:

> "...contract auditors seldom have a solid basis for questioning compensation, and where the contractor stands firm on the issue, the auditor generally will be overruled by the contracting officer. The major reason for such an overruling is the lack of supportable data to establish what salary level would be appropriate in the circumstances."

Based upon the ASBCA decisions and his observations above, Trueger advises that "where the amounts challenged by the government are substantial, contractors should contend vigorously and retain outside experts for assistance if in-house know how seems insufficient"(6).

E. CECSR Process Summary.

Aside from periodically monitoring selected contractor's compensation systems, and thereby making the statement that "we are concerned and watching," the entire CECSR process seems to have very little value as a practical tool to control contractor salary levels. The emphasis is placed on large contractors (over $10,000,000 annual negotiated sales) which are often publicly-held firms and are subject to many existing institutional controls (and occasionally competitive pressures) which act as inhibitions to paying their employees exorbitant wages. These large contractors have in their employ compensation specialists who use analytical techniques to

determine salary ranges for different classes of non-union workers. It is unlikely these compensation specialists are conspiring with management to develop a salary structure which is clearly excessive and ignores the analytical techniques. Furthermore, if the incentives to government contractors are to have higher costs in order to reap higher profits, logic dictates that those higher costs should be found in areas where the contractor has flexibility to reduce those costs if the need arises. An example of such an area is the quantity of labor hours. If the hours required to do a task(s) are significantly overstated and successfully defended during negotiations, a contractor retains the ability to perform more efficiently and thereby better control costs. If a contractor is paying highly excessive salaries to his personnel there is less ability to control costs and therefore less flexibility.

The CECSR distribution process would normally keep the PCO from receiving the data until it was of very little value. Data showing that a contractor's work force is receiving 140% of the average prevailing wage rate is surely a topic that would be subject to discussion during negotiations. However, if the PCO receives that information at all, it is normally after he has "a significant procurement interest" in the contractor. Moreover, the fact that an ACO makes a determination of reasonableness leaves the PCO with little room to negotiate even if he were privy to the data at a time when it was useful.

But, finally, the capstone to the assertion that the current CECSR process has little value as a practical tool is that the only likely present use of the data would be to withhold a portion of payment on cost-type contracts. Assuming that a CECSR shows that a contractor's labor rates are 151% of the

prevailing wage rates and, further assuming that the cognizant ACO determines those rates to be unreasonable, what courses of action are open to the government? The ACO can ask the contractor to lower his wage rates to be more in line with the area. But what if the contractor refuses? The ACO can withhold a portion of payment by determining the excessive costs are unallowable based upon the reasonableness test. Then, if the contractor were to appeal to the ASBCA, chances are that the government's determination of unallowability would not survive the challenge.

F. Proposed CECSR Changes.

HQ DLA recognizes the existence of problems in the present CECSR process. However, they stated that the findings in this chapter are no longer revelant since major changes are currently underway. As an example, they said that there are plans for revising all regulations pertaining to CECSR's. The plans call for active involvement by the Army, Navy, and Air Force in rewriting and coordinating the regulations. While those interviewed did not cite specific changes to be made, they stated that the whole CECSR system would be examined.

CHAPTER IV

GOCO AAP's COMPENSATION MONITORING

A. INTRODUCTION.

As stated in Chapter III, DLA only performs CECSR's for contracts over which they have administrative cognizance. If administrative cognizance is retained by one of the services, e.g. Army Tank Plant, Lima, Ohio, CECSR's will not be performed by DLA except on request. Additionally, the CECSR's must be partially funded by the requestor.

The Army Munitions and Chemical Command (AMCCOM) located at Rock Island, Illinois, maintains administrative cognizance over all the Government-Owned Contractor-Operated (GOCO) Army Ammunition Plants (AAP). These plants produce explosives and various types of ammunition. The Contractor Industrial Relations Branch of the Procurement and Production Directorate is responsible for monitoring the compensation systems of the GOCO operating contractors. Their mission statement specifically requires that branch to:

> "Approve for reimbursement, under cost type contracts, wage and salary structure, compensation plans, individual salaries of key employees, fringe benefit programs, and health and welfare plans."

AMCCOM carries out the above mission independent of DLA. Although AMCCOM processes emanate from the same FAR guidance as the DLA processes, it is interesting to note the differences. In the following pages it will become evident that the greatest difference is the basic approach of determining reasonableness. AMCCOM places the onus of proving reasonableness on the contractor while DLA assumes the burden of proving a contractor's unreasonableness.

B. GOCO CONTRACTORS' HOMOGENEITY.

The methods that AMCCOM uses to determine reasonableness would not be feasible for DLA to adopt. To understand why, it is first important to point out that all GOCO AAP operating contractors have many similarities including the nature of their work and their contractual arrangements with the government.

On the other hand, the group of contractors over which DLA has cognizance are very dissimilar. The environment in which AMCCOM operates allows the command to maintain better control (and monitor more effectively) than is possible in the DLA environment.

At any one time, there are approximately 20 GOCO AAP's operating at various levels of activity. DLA representatives said that they have CECSR data on over 500 contractors. The work being performed at the AAP's is similar, therefore a limited number of generic job descriptions could account for all the workers and managers at all the plants. The work being performed by the contractors over which DLA has cognizance include almost every type of product and service the military acquires. One can only speculate on the number of different generic job descriptions that would be needed to account for all employees working for all defense contractors. With the exception of one contractor, who produces fabricated metal parts on a fixed-price basis, all GOCO AAP contracts are cost-type. The DLA environment includes every type of contract used by the military. And finally, all the GOCO AAP contracts are entered into by only one agency (Army) who maintains total administrative control. DLA must deal with contractors who have contractual relationships with all the services, and administrative control is often segmented

between an agency purchasing office (PCO) and an administrative office (DCAS ACO). Figure 5 summarizes these differences.

In sum, GOCO AAP operating contractors are fewer in number, perform the same type of work and have similar categories of workers. Also, they have the same (with one exception) contractual arrangements with the same purchaser. The administrative responsibilities are all performed by the one agency that is the purchaser.

C. SYSTEM OVERVIEW.

For a number of years the compensation systems of GOCO AAP operating contractors have been closely monitored and controlled. Determinations of reimbursability on cost-type contracts (based upon reasonableness) are made at the time of contract negotiations. In this manner the contractor must convince the government that his costs are reasonable for them to be accepted for reimbursement purposes. If some compensation costs are deemed to be unreasonable, contractual clauses clearly set out the maximum the government will pay. If the operating contractor chooses to exceed what is considered reasonable he may do so; however, the government will only reimburse to the limit of reasonableness agreed to during negotiations. Needless to say there are sometimes difficulties reaching agreement with the contractor over some compensation issues but dealing with them during a contract negotiation phase is of great value. During this phase the onus is on the contractor to prove reasonableness. It is important that agreements on reasonableness and reimbursability be reached during this phase since trying to limit reimbursability after contract award requires a determination of unallowable cost

DIFFERENCE IN CONTRACTING ENVIRONMENT BETWEEN GOCO AAP'S AND DLA FOR COMPENSATION RELATED ACTIONS

GOCO	DLA
Approximately 20 Contractors	Approximately 500 Contractors
Similar Work	Work Very Diverse
Cost-Type Contracts	All Type Contracts
Only One Service	All Services
Total Administrative Control	Partial Administrative Control

Figure 5. Difference in Contracting Environment Between GOCO AAP's and DLA for Compensation Related Actions

based upon a finding of unreasonableness that must be fully substantiated.

To determine reimbursability, AMCCOM personnel review area wage and salary data for the purpose of approving either the levels or the increases in wage and salary rates. Additionally, all other forms of compensation are analyzed for reasonableness. Among the other forms are group insurance plans, retirement plans (including method of funding), merit increases and promotion systems, deferred payments, stock option plans and year-end bonuses.

For the GOCO AAP cost-type contracts, contractual provisions are negotiated whereby the PCO must approve the assignment of GOCO Plant Managers and some of their specific subordinates. Additionally the PCO must approve the assignment of any salaried contractor employee receiving $30,000 or more per year. These provisions are meant to prevent abuses such as a $100,000 per year Corporate Comptroller being assigned as a GOCO Financial Manager when a $40,000 per year accountant would be satisfactory. A recent innovation sets a negotiated ceiling on the total amount of yearly merit increases a contractor can allocate among his exempt salaried employees. The contractor is not limited to this budget but any amount in excess will not be reimbursed.

For cost control of hourly labor (whether union or non-union) the contractor is limited to area-weighted averages. Either a salary level or a rate increase method can be used. The contractor is free to choose one or the other; however, once chosen that method continues in use. Under the salary level method, reimbursements for hourly employees are limited to the area-weighted average salary for similar work. The rate increase method limits reimbursability to the area weighted average

increase. According to AMCCOM personnel this approach has always proved successful.

Once salary schedules and benefit plans are agreed upon, any changes must be approved by the PCO if the contractor plans to seek reimbursement for the changes.

CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS

The primary objective of this study was to recommend policy to deal with the perception that defense industry workers receive excessive compensation. To achieve that objective it was necessary to understand current policy and to examine the methods used to monitor and control labor costs. Also, to determine if the perceived problem actually existed, a comprehensive data collection and analysis was required.

The information concerning monitoring and controlling contractor labor costs was readily available. DLA has primary responsibility for performing these functions for the services. However, since DLA claims the current methods are about to undergo a complete change, it would be very troublesome to use the current procedures as a basis for developing policy. The attempt to validate the excessive compensation perception through a comprehensive survey ran into many obstacles and had to be abandoned. Therefore, it is very difficult to make any policy recommendations since the information that was to be the basis of those recommendations is either obsolete or unavailable.

In the absence of evidence either supporting or denying the existence of an excessive compensation problem, it is recommended that no policy change be made at this time. Conclusive evidence can only be obtained through the use of a survey. As stated in Chapter II, that survey must include labor rates for a number of categories of labor for a number of contractors with different mixes of defense/commercial business. If such a survey is desired it will probably be necessary to contract out

the effort. The AMA, the Executive Compensation Service, or some other organization that gathers salary and wage data could likely perform this task.

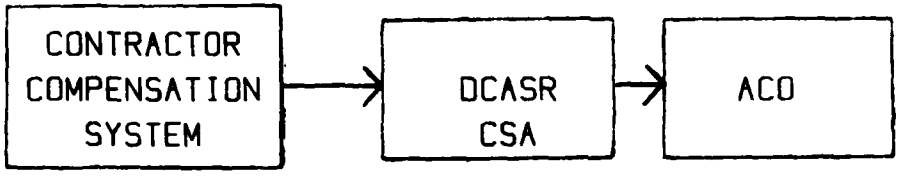
DLA will receive input from all the services for the revision of their procedures. At that time the Army will have a voice. One of the most important changes that should be considered is to make the PCO aware of the relative level of salary rates. This would enable the PCO to use salary levels as a negotiation point. Figure 6 depicts the current and proposed flow of compensation information. However, even this seemingly valuable change has potential drawbacks. PCO's at various purchasing offices in all of the services may be negotiating different labor rates for the same contractor. The "one face to industry" approach would not exist in the compensation area. If possible, a balance between that approach and a more suitable way to determine reasonableness must be achieved.

The best course of action to take at this time is to insure aggressive Army participation in the revamping of DLA procedures. Additionally, the Army should attempt to expedite the proposed DLA changes. At the GOCO AAP's, where the Army has administrative cognizance, AMCCOM is doing an excellent job monitoring and controlling the compensation of the operating contractors.

In conclusion, the General Accounting Office (GAO) recently studied the compensation paid to employees of 12 firms in the aerospace industry (14). The report found that executive pay (1% of total payroll) was 42% more than AMA average; professional pay (40% - 75% of payroll) was 2.5% below BLS average; clerical and technical pay (10% - 20% of payroll)

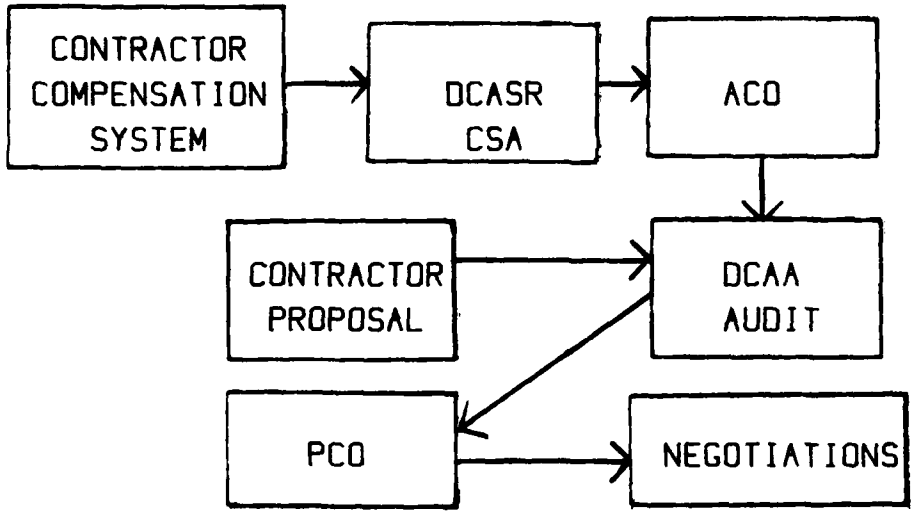
COMPENSATION DATA INFORMATION FLOW

CURRENT DATA FLOW



Currently ACO determines reasonableness and information flow ends. PCO does not receive information.

PROPOSED DATA FLOW



ACO reviews data but leaves reasonableness determination to PCO. Compensation data flows to PCO to be used in negotiations.

Figure 6. Compensation Data Information Flow

was 9% more than BLS averages and, factory pay (5% - 40% of payroll) was 8% more than the BLS average. However, GAO cautioned that generalizations cannot be formed from their findings.

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