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FEDERALLY FUNDED R&D CENTERS

Executive Compensation at The Aerospace Corporation



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National Security and
International Affairs Division

B-259373

February 7, 1995

The Honorable William F. Clinger, Jr.
Chairman
The Honorable Cardiss Collins
Ranking Minority Member
Committee on Government Reform and Oversight
House of Representatives

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As requested, we are reviewing the financial and management practices of The Aerospace Corporation, which operates a federally funded research and development center (FFRDC) sponsored by the Air Force. This report discusses the salary and other benefits provided to Aerospace's corporate officers and other senior management personnel and includes information on Defense Contract Audit Agency (DCAA) audits on Aerospace compensation costs and congressional actions regarding FFRDC compensation. This report does not draw conclusions about the comparability or reasonableness of Aerospace executive compensation. As agreed with your offices, we plan to report later on other issues you asked us to review at Aerospace.

Results in Brief

As of September 1994, Aerospace employed 32 senior management personnel (referred to as Aerospace executives), 12 of which were corporate officers. The officers' total annual compensation averaged about \$240,200 and their annual salary averaged about \$176,400. Corporate officers' benefits included a retirement plan that is not available to senior management personnel or other employees. The total annual compensation for the other 20 Aerospace executives that were not corporate officers averaged about \$154,300 and their annual salary averaged about \$139,500.

From September 1991 to September 1994, total salary cost for all Aerospace executives increased by 78 percent, from about \$2.75 million to about \$4.91 million, primarily due to salary increases of up to 29 percent for individual executives during 1992 and a 45-percent increase in the number of executives from 22 to 32 between 1991 and 1994. During that time, the average annual executive salary increased by 23 percent, from about \$125,000 to about \$153,300. Aerospace officials told us that increasing both the salaries and the number of executives were sound management decisions based on the best information available at the time and were justified for a number of reasons, including to better align

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Aerospace with its customers. In addition, in 1993, Aerospace paid two executives hiring bonuses of \$30,000 each. Aerospace classified these bonuses as nonreimbursable costs, consistent with the Federal Acquisition Regulation (FAR).

Between September 1991 and September 1994, the number of nonexecutive employees at Aerospace decreased by 17 percent, from 3,973 to 3,303. This decrease, coupled with the increase in the number of executives, reduced the ratio of executives to total nonexecutive employees from 1 per 181 employees to 1 per 103 employees.

In an audit started in response to Aerospace's June 1992 salary increases, DCAA initially questioned the reasonableness of corporate officers' salaries and fringe benefits. In its final report, however, DCAA no longer questioned the reasonableness of corporate officers' salaries but recommended that Aerospace provide further support for corporate officers' fringe benefits. The Air Force and Aerospace have been working to resolve the issues raised by DCAA's audit.

Fiscal year 1995 appropriations legislation limits employee compensation at the Department of Defense (DOD) FFRDCs, effective July 1, 1995, to a rate not to exceed Executive Schedule Level I. As of September 30, 1994, 16 Aerospace executives had annual salaries of more than \$148,400, the current Executive Schedule Level I salary amount.

Background

Aerospace is a nonprofit mutual benefit corporation that provides scientific and technical support, principally general systems engineering and integration services, for the Air Force and other government agencies. Aerospace is headquartered in El Segundo, California, and has offices throughout the United States. The corporation, established in 1960, is governed by a 19-member Board of Trustees in accordance with its articles of incorporation and bylaws.

FFRDCs are funded solely or substantially by federal agencies to meet special long-term research or development needs that cannot be met as effectively by existing in-house or contracting resources. One federal agency serves as the primary sponsor and signs an agreement specifying the purpose, terms, and other provisions for the FFRDC's existence. Agreement terms cannot exceed 5 years but can be extended after a review of the continued use and need for the FFRDC. Federal regulations regarding FFRDC policy encourage long-term relationships between the

federal government and FFRDCs to provide the continuity that will attract high-quality personnel.

Aerospace's primary sponsor is the Assistant Secretary of the Air Force for Acquisition. The Air Force Space and Missile Systems Center (SMC), located adjacent to Aerospace in El Segundo, has day-to-day management responsibility. SMC negotiates annual cost plus fixed-fee contracts with Aerospace. The DOD funding ceiling for Aerospace in fiscal year 1994 was \$365.8 million. Aerospace employed 3,335 personnel at the end of fiscal year 1994 and had an annual payroll of about \$208 million.

Aerospace's typical practice in establishing compensation levels is to recommend an annual salary adjustment to the Board of Trustees for final approval. According to company policy, such recommendations are to be based on an assessment of competitive salary positions, increases and rate structure adjustments at other aerospace industry firms, and other economic considerations.

Compensation to Aerospace employees is primarily paid from government contracts, which represent over 99 percent of the company's total business revenue. A small portion is paid out of government contract fees, nongovernment contracts and fees, interest income, and other sources.

Aerospace compensation is reviewed by the Air Force for reasonableness during its annual contract negotiations. The Air Force routinely requests that DCAA review Aerospace's proposed compensation costs and uses its recommendations during contract negotiations.

Total Executive Compensation

Aerospace corporate officers, in addition to their annual salary, receive the standard benefit package that is available to all employees and several additional benefits that are available only to them. Standard benefits include social security contributions, a retirement plan, medical insurance, dental insurance, long-term disability insurance, and life insurance. Additional corporate officer benefits are a supplemental corporate officers' retirement plan; personal use of a company automobile; airline upgrade coupons; and, in the case of two officers, a home security system. Table 1 summarizes the total fiscal year 1994 compensation provided to Aerospace's 12 corporate officers and 20 senior managers based on actual

benefits paid and salaries as of September 30, 1994.¹ (See app. I for a further breakdown.)

Table 1: Total Aerospace Executives Compensation Paid in Fiscal Year 1994

Compensation	Corporate officers		Senior managers	
	Total cost	Average cost	Total cost	Average cost
Annual salary	\$2,116,712	\$176,393	\$2,789,192	\$139,460
Standard benefits	179,494	14,958	297,495	14,875
Other corporate officer benefits:				
Retirement plan ^a	488,000	40,667	e	e
Personal auto use ^b	61,534	5,128	e	e
Airline upgrade coupons	23,550	1,963	e	e
Home security systems ^c	13,146	1,096	e	e
Total benefits	\$765,724	\$63,810	\$297,495	\$14,875
Total compensation	\$2,882,436	\$240,203	\$3,086,687^d	\$154,334

Note: Totals may not add due to rounding.

^aCurrent year costs for retired and former corporate officers and prior year adjustments totaling \$219,000 were not included.

^bPersonal automobile use cost of \$5,426 was not included for two former corporate officers.

^cHome security system cost included \$11,544 for the system of one corporate officer, which was paid in fiscal year 1994 from fees received on an international contract to cover home security costs for the period of January 1994 to January 2001.

^dThese costs do not include a one-time hiring bonus of \$30,000 for a senior manager.

^eNot applicable.

Executive Salaries

From September 1991 to September 1994, the average annual salary for all Aerospace executives (corporate officers and senior management personnel) increased by 23 percent, from about \$125,000 to about \$153,300. The average salary for corporate officers increased from about \$135,100 to about \$176,400, or 31 percent, and the average salary for senior managers increased from about \$115,000 to about \$139,500, or 21 percent. During those 3 years, the total cost of salaries for Aerospace executives increased by 78 percent, from about \$2.75 million to about \$4.91 million, primarily due to salary increases of up to 29 percent for individual executives during 1992 and a 45-percent increase in the number of

¹Table 1 describes total Aerospace executive compensation, including salaries and other benefits. The FAR defines fringe benefits as including paid absences; however, we included paid absences in salary. Therefore, for this reason and other methodology differences, the total benefits shown in table 1 and appendix I are different than they would be using the strict FAR definition.

executives from 22 to 32. Salaries included paid absences, such as vacations, holidays, and sick leave. Table 2 shows the number and total salaries of Aerospace executives as of September 1991 and September 1994 and the percent increase for both.

Table 2: Increase in Number of Executives and Salary Cost Between September 1991 and September 1994

Type of executive ^a	September 1991		September 1994		Percent increase	
	Number	Total annual salary cost	Number	Total annual salary costs	Number	Annual salary cost
Corporate officer	11	\$1,486,500	12	\$2,116,700	9	42
Senior manager	11	1,264,200	20	2,789,200	82	121
Total	22	\$2,750,700	32	\$4,905,900	45	78

^aAll managers at pay levels 5 through 7.

Aerospace increased the average salary of its executives by about 18 percent in 1992, from about \$132,900 to about \$156,600. Most of this increase occurred by implementing a special, one-time increase in June 1992 that averaged 13 percent and by giving a merit pay increase in December 1992. (See app. II for more details.)

Aerospace justified the June 1992 pay increase based on the need to bring its salaries more in line with industry salaries and resolve a pay compression problem that had developed between technical staff managers and their subordinates. Although Aerospace notified the Air Force 3 weeks before implementing the increase, the Air Force expressed concern that Aerospace did not present the salary increase and supporting documentation to the government in time to allow the Air Force to review the increase and determine its reasonableness.

According to the Air Force, the salary increase represented a major change to Aerospace's compensation package and the process used by Aerospace was inconsistent with SMC's environment of trust and teamwork. Even though the Air Force allowed the salary increase, it requested a DCAA audit of Aerospace's compensation and warned Aerospace that the government would request full reimbursement of any costs determined to be unreasonable.

Aerospace told us that it believes that SMC's environment of trust and teamwork has continued throughout this period and that it notified the Air Force immediately after its Board of Trustees approved the salary

adjustment, which was based on a sound business position and the best information available at the time. Aerospace also noted that the FAR does not mandate prior contracting officer review; it only mandates that there will be no presumption of allowability when a contractor introduces major revisions of existing compensation plans and has not notified the contracting officer either before implementation or within a reasonable period after implementation. Aerospace maintained that the salary increase did not represent a major revision to its existing compensation plan. Further, Aerospace advised us that the salary adjustment occurred during fiscal years 1992-93, when it was confidently looking toward an increased budget and workload. Even though an unanticipated downturn in Aerospace employment occurred, the increase only restored salaries to market levels, in Aerospace's view. However, Aerospace records provided to us showed that, before the June 1992 salary increase, Aerospace reduced its employment by 423 (272 technical staff and 151 nontechnical staff) through a reduction in force in November 1990 and a retirement incentive program in November 1991.

No merit salary increases were given in December 1993, but 13 executives received additional salary increases since December 1992 through 13 promotions.

From September 1991 to September 1994, Aerospace increased the number of its executives by 45 percent, from 22 to 32. During the same period, Aerospace nonexecutive employment decreased by about 17 percent, from 3,973 to 3,303. As a result, the ratio of executives to nonexecutive employment decreased from 1 per 181 employees to 1 per 103 employees. Aerospace did not, and is not required by the past or current contracts to, obtain Air Force approval for changing the number of executives. Table 3 compares the number of executives and the total number of employees since September 1991.

Table 3: Aerospace Employment From September 1991 to September 1994

Type of employee	Number of employees			
	9/30/91	9/30/92	9/30/93	9/30/94
Corporate officer	11	12	12	12
Senior manager	11	14	17	20
Total executives	22	26	29	32
Total other employees	3,973	3,770	3,739	3,303
Number of other employees per executive	181	145	129	103

Aerospace gave us many reasons for increasing the number of executives, including satisfying customer requirements and customer reorganizations and its continuing efforts to improve customer support. For example, when the SMC chief engineer position was expanded to emphasize horizontal engineering and integrated product teams, Aerospace said it added a corporate chief engineer to interface with SMC's chief engineer. Also, it said that a general manager position was created in its Colorado division to improve support to the U.S. Space Command and the Air Force Space Command and consolidate seven different Aerospace organizational units at that division. Aerospace cited other factors, such as more robust succession planning and creating a senior manager position to better distinguish FFRDC and non-FFRDC activities, in response to recent congressional focus on FFRDC activities. It also concluded that increasing the number of senior managers would increase the leverage of the corporate officers. Aerospace noted that, even though the number of executives increased, the total number of managers decreased and the cost per member of the technical staff decreased. Aerospace further concluded that the pressure to downsize programs required adding some higher level managers with a broader perspective to support the Air Force and that the total number of employees decreased because of funding ceilings, not workload.

Hiring Bonuses

In 1993, Aerospace paid two executives hiring bonuses of \$30,000 each. Aerospace informed us that the hiring bonuses were needed, over and above an initial annual salary of \$155,000, to hire these two individuals and that the special circumstances of each offer were reviewed and approved by Aerospace's Board of Trustees.

Aerospace initially reported these two hiring bonuses as government-reimbursable costs in June and October 1993. Subsequently, Aerospace reclassified these costs as nonreimbursable expenses in accordance with the FAR in July 1994 and December 1993, respectively. Aerospace commented that these were one-time bonuses that were paid in only two special cases for employees that had successfully discharged important responsibilities.

DCAA Audit of Aerospace Compensation Costs

After the Air Force's request in June 1992, DCAA initiated a review of Aerospace's compensation. On December 9, 1993, DCAA issued its report, which was subsequently revised three times.² DCAA compared Aerospace positions with comparable compensation market survey data and used FAR criteria to initially conclude that Aerospace had provided \$616,846 and \$4,092,954 in unreasonable compensation for fiscal years 1992 and 1993, respectively. The FAR criteria call for general conformity with compensation practices of other firms of the same size, in the same industry, and in the same geographic area that are engaged in predominantly nongovernment business.³

Aerospace objected to the comparable compensation market survey DCAA used because it included a number of industries and corporations that Aerospace judged had no comparability to the technical education and experience of the FFRDC staff. Aerospace's objection was that the FAR provides, in part, that the relevant fact is the general conformity with the compensation practice of other firms of the same size, industry, and geographic area. Aerospace noted that its own compensation survey included companies with which it competes for scientific and engineering talent.

Aerospace also objected to the market compensation survey data used by DCAA because it did not include bonuses and other monetary compensation of the comparison group. Since Aerospace officers do not receive performance bonuses, Aerospace informed DCAA in December 1993 that all remuneration must be used for a valid comparison. DCAA agreed and, as a result of using additional data, issued a revised report in January 1994, which no longer questioned the reasonableness of corporate officers' salaries and reduced the compensation costs considered unreasonable for other employees. DCAA made further revisions to its report in February and March 1994 to (1) use more current compensation market survey data; (2) challenge, rather than classify as unreasonable, corporate officer fringe benefit costs because Aerospace had not performed a fringe benefit market survey to justify the costs; and (3) adjust the amount of unreasonable compensation to include only that portion of fringe benefits costs that were determined based on a percentage of base salaries.

²DCAA issued two supplemental audit reports and one memorandum, each updating the findings in the December 9, 1993, report. DCAA said that these revisions were in response to additional, more current information provided by Aerospace. The memorandum directed that 18 pages of the prior supplemental report be replaced because of an error found in a calculation.

³DCAA's audit involved reviewing the compensation of Aerospace's corporate officers, managers of members of the technical staff, and certain nonsupervisory personnel for a total of 104 positions.

DCAA's fourth and final memorandum reduced the costs classified as unreasonable compensation to \$306,809 and \$1,788,612 for fiscal years 1992 and 1993, respectively. DCAA informed us that these revisions were done after consideration of additional, more current information. In addition, the final report also challenged \$2,124,291 for fiscal year 1993 due to the lack of adequate supporting documentation. DCAA's final memorandum also stated that Aerospace should have provided the government an opportunity to review the reasonableness of the June 1992 increase. DCAA concluded that it was unreasonable for Aerospace to increase salaries by a significant percentage at a time when other industries were implementing cost-saving measures and planning smaller salary increase budgets in response to DOD downsizing and other economic conditions that have resulted in major cutbacks of employees. Appendix III summarizes the four DCAA products.

Aerospace objected to each of DCAA's products, including the final one. It concluded that, despite some improvements, DCAA still used inappropriate data and reached erroneous conclusions. Aerospace also said that DCAA's statements were unsupported opinions and that its actions to redress the then-existing salary situation were entirely reasonable. In addition, Aerospace stated that it had complied with FAR requirements by providing the government with notice of the salary increase before implementation.

After the DCAA compensation audit reports and subsequent fiscal year 1994 contract negotiations between the Air Force and Aerospace, additional provisions were placed in the fiscal year 1994 contract with Aerospace for determining reasonable technical staff compensation costs. First, the Air Force and Aerospace agreed that about \$1.4 million of Aerospace's billings would not be paid until the Air Force determined the reasonableness of the cost of Aerospace's supervisory and nonsupervisory technical staff salaries. To assist the Air Force in making this determination, Aerospace was to provide current and accurate job descriptions and use a compensation market survey agreed to by the government. Second, Aerospace was to commission an independent survey to establish a reasonable executive fringe benefit level. Third, to resolve the notification issue, Aerospace is to notify the contracting officer at least 60 days before announcing any major salary adjustment that was not planned or included in the estimated contract cost. As of December 1994, Aerospace and government contracting representatives were in the process of implementing these contractual provisions and clarifying the computation of Aerospace executive fringe benefits. According to the Air Force, the

compensation market survey has been completed and the results are being reviewed.

Congressional Actions Regarding FFRDC Compensation

DOD's FFRDCs are privately operated contractors of the United States, and the salaries of officers and employees have not generally been subject to federal government pay scales. However, the Congress has at times restricted the use of DOD appropriations to pay compensation of FFRDC officers or employees over certain levels and has imposed notice requirements concerning certain payments. In the Fiscal Year 1995 DOD Appropriations Act, the Congress placed a limit on defense FFRDC compensation after July 1, 1995. The act states that no employee or executive officer of a defense FFRDC can be compensated from DOD appropriations at a rate exceeding Executive Schedule Level I. The act's legislative history indicates that the July 1, 1995, date was selected to allow individuals affected by the compensation limitation to adjust to its impact. As of September 30, 1994, there were 16 Aerospace executives with annual salaries of more than \$148,400, the current Executive Schedule Level I salary amount.

The National Defense Authorization Act for Fiscal Year 1995 requires, in part, that DOD funds may not be paid to an FFRDC unless it enters into an agreement with DOD that no officer or employee who is compensated at an annual rate that exceeds Executive Schedule Level I will be compensated in fiscal year 1995 at a higher rate than in fiscal year 1994 and that no such officer or employee will be paid a bonus or provided any other financial incentive in fiscal year 1995. This act also requires the DOD Inspector General to review compensation paid by FFRDCs to all officers and employees who are paid at a rate exceeding the Executive Schedule Level I rate. According to the act, the Inspector General is to (1) assess the validity of the data submitted by FFRDCs, justifying salaries that exceed the Executive Schedule Level I rate; (2) compare the compensation paid to those individuals exceeding that rate with the compensation of similar technical and professional staff from profit and nonprofit organizations that must compete for defense work and with government officials of comparable expertise and responsibility; and (3) examine other appropriate forms of nonsalary compensation, such as bonuses and retirement plans. The results of the Inspector General's review are to be reported to the Senate and House Committees on Armed Services no later than May 1, 1995.

We are also reviewing compensation at FFRDCs sponsored by DOD, as required by the Fiscal Year 1992 Defense Appropriations Conference Report. This review will collect data on compensation for selected professional, technical, and managerial employees, not just the highest paid executives, as discussed in this report.

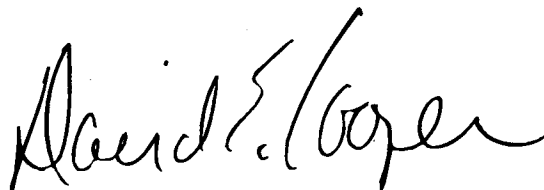
Scope and Methodology

To determine the compensation Aerospace provided corporate officers and senior managers, we reviewed Aerospace personnel and payroll records, Board of Trustees' minutes and resolutions, contract documents, accounting records related to executive benefit costs, and policies and procedures that relate to Aerospace's compensation program. We also reviewed DCAA compensation audit reports, supporting workpapers, and Aerospace's responses to the audit reports. In addition, we met with Aerospace's compensation and benefits officials, Air Force program and contract administration officials responsible for overseeing the work at Aerospace, and cognizant DCAA officials.

We conducted our work from April to December 1994 in accordance with generally accepted government auditing standards. As agreed with your office, we did not obtain written agency comments on a draft of this report. However, we discussed our results with officials from DOD and Aerospace and included their comments where appropriate.

We are sending copies of this report to the Secretary of Defense; the Director, Office of Management and Budget; the Administrator, Office of Federal Procurement Policy; and other interested congressional committees. Copies will also be available to others on request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix IV.



David E. Cooper
Director, Acquisition Policy, Technology,
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Abbreviations

FAR	Federal Acquisition Regulation
FFRDC	federally funded research and development center
DCAA	Defense Contract Audit Agency
DOD	Department of Defense
SMC	Space and Missile Systems Center

Aerospace Executive Compensation for Fiscal Year 1994

Number in position	Average annual salary ^e	Average benefits	Average total compensation
Corporate officers			
1	\$265,000	\$149,691 ^a	\$414,691
1	202,400	48,691	251,091
3	181,467	55,109	236,576
1	155,012	70,121	225,133
5 ^b	161,980	53,088	215,068
1	140,000	66,456	206,456
Senior managers			
1 ^c	181,100	14,953	196,053
15 ^d	140,443	15,483	155,926
2	132,220	12,674	144,894
1	125,000	12,634	137,634
1	112,000	12,313	124,313

^aIncluded in the benefit cost is a corporate officer retirement plan cost of \$117,000. This plan exceeds the amounts paid to other executives, since it is based on salary, number of years until age 62, and time as a corporate officer.

^bTwo newly appointed corporate officers were not included in the corporate officer retirement plan cost for fiscal year 1994 because they became officers after the cost had been assigned. A cost adjustment will be made in fiscal year 1995.

^cCorporate officer retirement plan cost of \$15,000 and personal use of company auto cost of \$4,821 associated with time as a corporate officer are not included.

^dRetirement plan cost of \$10,000 for one senior manager that was previously a corporate officer is not included.

^eAs of September 30, 1994.

Executive Salary Increases Between December 1991 and December 1992

Type of executive	December 1991		December 1992		Percent increase in average salary	Range of salary percent increase ^a
	Number	Average annual salary	Number	Average annual salary		
Corporate officer	11	\$144,327	12	\$174,167	21	11 to 29
Senior manager	11	121,427	15	142,600	17	0 to 25
Total	22	\$132,877	27	\$156,630	18	0 to 29

^aRange is only for executives that were in place as of both dates.

Summary of DCAA's Compensation Audit Reports

Issue	DCAA reports ^a			
	12/9/93	1/26/94	2/18/94	3/17/94
Fiscal year 1992 costs (unreasonable compensation)				
Corporate officers	\$188,737	0	0	0
Technical staff managers ^b	428,109	\$384,383	\$384,383	\$306,809
Total	\$616,846	\$384,383	\$384,383	\$306,809
Fiscal year 1993 costs (unreasonable compensation)				
Corporate officers	\$67,388	0	0	0
Corporate officers fringe benefits	804,854	\$804,854	0	0
Technical staff managers ^b	2,290,291	1,445,026	\$1,417,330	\$1,133,666
Technical staff non-supervisors ^b	930,421	876,185	818,825	654,946
Total	\$4,092,954	\$3,126,065	\$2,236,155	\$1,788,612
Compensation challenged				
Corporate officers fringe benefits	c	c	\$1,688,579	\$1,688,579
Positions with no position descriptions available	c	c	435,712	435,712
Total	c	c	\$2,124,291	\$2,124,291

^aDCAA issued its audit report on December 9, 1993. DCAA then issued two supplemental reports on January 26, 1994, and February 18, 1994, and one memorandum on March 17, 1994, which was issued to correct a computation in the supplemental report.

^bThe senior manager category discussed in this report is included in these DCAA categories but is not comparable, since DCAA included personnel below pay level 5.

^cNot applicable.

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