

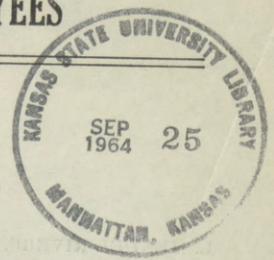
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COST OF MORALE AND RECREATION BENEFITS FOR DEFENSE CONTRACTOR EMPLOYEES

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HEARINGS BEFORE THE SUBCOMMITTEE FOR SPECIAL INVESTIGATIONS OF THE COMMITTEE ON ARMED SERVICES HOUSE OF REPRESENTATIVES EIGHTY-EIGHTH CONGRESS

SECOND SESSION
UNDER THE AUTHORITY OF

H. Res. 84

HEARINGS HELD JULY 21, 22, AND 23, 1964

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COST OF MORALE AND RECREATION BENEFITS FOR DEFENSE CONTRACTOR EMPLOYEES

TUESDAY, JULY 21, 1964

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
SUBCOMMITTEE FOR SPECIAL INVESTIGATIONS,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to notice, in room 313-A, House Office Building, Porter Hardy, Jr. (chairman) presiding. Members present: Hon. Porter Hardy, Jr., and Hon. Otis G. Pike. Staff present: John T. M. Reddan, special counsel; Walton Woods, staff investigator; and Phyllis M. Seymour, secretary.

Mr. HARDY. Let the committee come to order.

I have a brief opening statement which I wish to read.

This morning the subcommittee begins 3 days of public hearings to inquire into certain aspects of expenditures by defense contractors for employee morale and recreational activities. We will be concerned primarily with the performance of Government auditors, negotiators, and other contracting personnel.

The Government spends millions of dollars annually for the morale and recreational activities of defense contractor employees. These costs are included by the contractors as part of overhead in cost-plus-fixed-fee contracts and the amount of reimbursement is negotiated with the Government. It is therefore important that we consider the justification for such expenditures and this, of course, requires examination of the activity involved.

The Department of Defense, in its Armed Service Procurement Regulation (ASPR) 15-205.10, states in part that:

Reasonable costs of * * * recreational activities * * * incurred in accordance with a contractor's established practice or custom in the industry or area, for * * * employer-employee relations, employee morale, and employee performance, are allowable.

This broad approval gives rise to a number of questions to which the subcommittee will seek answers during these hearings. For example, what is meant by "established practice;" who determines "custom" in an industry or area, and what criteria are used in making this determination; what limits, if any, are set with respect to "established practice" and what limits are set as to "custom;" what are the expenditures intended to accomplish and how is the degree of success or failure measured.

Another ASPR provision (15-205.14) treats in part with food service supplied by the contractor for employees. "Food service" as defined by the provisions includes operating or furnishing facilities

for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services. It states that profits accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit and allocated to all activities served except "profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance." Here we get into a new but related area—the sponsoring and funding of employee welfare organizations. The use of the profits I have just mentioned, for this purpose, is of concern to the subcommittee because to the extent they are allocated to employee welfare organizations they are unavailable to reduce the contractor's overhead, thus in effect increasing the costs to the Government under the cost-plus contract.

From the study we have made to date, it appears that most of the money used to finance the operation of employee welfare organizations comes from vending machine profits. This can be a sizable amount, and in the case of one west coast contractor (North American Aviation, Inc., Anaheim, Calif.) is in excess of \$1 $\frac{1}{4}$ million annually. As I have already pointed out, the ASPR permits these profits to be turned over to such employee welfare organizations "in amounts reasonably useful for the benefit of the employees." The subcommittee is quite anxious to find out what this means, particularly to the Government auditors and negotiators in the field who must find in this, and similar language, the guidelines they need to make judgments which, if incorrect, could subject the Government to a heavy burden of unnecessary costs. Theoretically, the field of activities which might be considered "reasonably useful for the benefit of the employees" could extend to the limits of imagination and inventiveness. However, in practice, the limiting factor should be the sound judgment of the Government negotiators exercised within an established frame of reference sufficiently precise to protect the Government's interests.

Therefore, the subcommittee will take a hard look at the ASPR's to see if they meet this test and whether they conform to the legal authority which they are supposed to implement.

In order to understand how the pertinent ASPR provisions operate in practice, we will lay them alongside actual cases to see how they were used by Government personnel to assist them in forming judgments as to the allowability of particular costs.

On February 27 of this year, I requested the Comptroller General of the United States to assist the subcommittee by making a review of a representative cross-section of major defense contractors. This work has now been completed. We have also requested the Department of Defense and the Departments of the Army, Navy, and Air Force to assist us by supplying all pertinent records and by having present here today those persons within their organization most knowledgeable in the field of employee morale and recreational expenditures. We specifically requested the presence of those Government auditors and negotiators who could be responsive to any questions the subcommittee might have with respect to the allowance or disallowance of particular costs of this nature.

As I previously mentioned, it is the intention of the subcommittee to consider at this time only the ASPR provisions relating to the matter at hand and the performance of Government personnel with respect to these provisions. Therefore, no defense contractor witnesses will be called at this time. However, on July 2 I did send to those contractors that I felt might be mentioned by name during the course of these hearings notice of the time and place of the hearings and extended to them an invitation to have representatives present as observers if they cared to do so.

Our first witness will be Comptroller General Campbell, who will inform us of the results of the survey conducted for the subcommittee by the General Accounting Office.

The subcommittee is particularly pleased to have Mr. Campbell with us. Mr. Campbell, I want to express the appreciation of the subcommittee for the cooperation that you and your staff have given in the work of the subcommittee generally, but particularly on this subject. We are extremely glad to have you with us this morning personally to present this matter to the subcommittee.

I believe you have a prepared statement, which I understand you are going to present. If you will proceed, Mr. Campbell, with your statement, the subcommittee will be very glad to let you proceed without interruption until your statement has been completed.

STATEMENT OF HON. JOSEPH CAMPBELL, COMPTROLLER GENERAL OF THE UNITED STATES; ACCOMPANIED BY ROBERT F. KELLER, GENERAL COUNSEL; AND HAROLD H. RUBIN, ASSOCIATE DIRECTOR, DEFENSE ACCOUNTING AND AUDITING DIVISION, GENERAL ACCOUNTING OFFICE

Mr. CAMPBELL. Thank you, Mr. Chairman.

Mr. Chairman and members of the subcommittee, on February 17, 1964, you requested us to perform a survey of activities of defense contractors with respect to employee recreation and morale expenditures that are passed on to the Government. The request was made after it came to the subcommittee's attention that a major defense contractor, doing business almost exclusively with the Government, had provided a free visit to Disneyland for its employees and their families at a cost of over \$100,000 and that the Government might be expected to reimburse the contractor for this cost in the prices of defense contracts. Our report¹ was submitted to you today and we appear here to summarize our findings.

Our survey covered employee recreational and morale activities of 28 major defense contractors at 36 plant locations. The review of these activities generally was confined to those for the latest 1-year period for which information was available, annually 1962 or 1963. A detailed audit was not performed. We also examined Department of Defense regulations governing the allowability of costs included in prices of defense contracts and the interpretation and application of these regulations by the responsible contract auditors and negotiators of the Department of Defense.

¹ Report of the Comptroller General of the United States (B-153403) to the Subcommittee for Special Investigations, Committee on Armed Services, House of Representatives, "Survey of Activities of Selected Defense Contractors Relating to Employee Recreation and Morale, Department of Defense," July 1964.

SUMMARY OF FINDINGS

We found that, at each of the 36 plant locations selected for review, the contractor directly or indirectly provided funds for recreation and morale of employees. Major employee and morale expenditures at these locations involved picnics and outings, food services provided to employees and executives, parties, gifts of turkeys at holidays, and athletic and group activities. The total expenditures for these activities amounted to \$5.9 million.

Approximately \$3.5 million, or 59 percent, of the total expenditures for morale and recreation had been financed primarily by commission from vending machines located at the contractor or Government-owned plant facilities. The remaining \$2.4 million was financed by company funds; however, over 75 percent (\$1.9 million) of this amount has been or likely will be passed on to the Government.

The types of employee activities and the costs which will likely be borne by the Government are as follows:

	<i>Cost to the Government</i>
Picnics and outings.....	\$61, 000
Food service losses.....	809, 000
Parties.....	156, 000
Gifts of turkeys.....	425, 000
Athletic and club activities and related administration costs.....	416, 000
Total.....	1, 867, 000

I wish to point out to the subcommittee that some of the same contractors also operate sizable plants at locations not included in our review. Furthermore, many other important defense contractors were not covered by our survey. Consequently, the total amount of contractor employee recreation and morale expenditures absorbed by the Government is far greater than the \$1.9 million previously mentioned.

We found very little uniformity in the contractors' management and control of recreation and morale activities and expenditures. At 9 of the 36 contractors' plants that we surveyed, the entire cost of employee recreation and morale activities was financed primarily by the vending-machine income without any contractor expenditures. At the other 27 locations, we found that the contractors provided further financial support for such activities; a substantial portion of this cost was then prorated to Government contracts. We noted that most contractors set aside the income generated by employee activities, such as vending-machine income, and donated the funds to employee organizations for conducting recreation and morale activities. The funds in the custody of these organizations were used at the discretion of the organization management, generally without review or approval by the contractor or the Government. Some of these organizations accumulated cash and other assets in excess of \$1 million. We noted that many contractors incurred sizable losses in food-service operations—an employee activity comparable to vending-machine operations—and charged a substantial portion of these losses to the Government. However, funds from vending-machine income were more than sufficient to offset these losses in food operations had they been used for such purpose instead of being donated to employee organizations.

Expenditures for employee recreation and morale activities charged against Government contracts are subject to selective reviews by agency auditors, and allowability of such charges rests on the judgment of individual contracting officers with only limited guidance under the contract cost principles. We found that items questioned by agency auditors often were allowed by the contracting officers in negotiations of prices. It appears that the interpretations and applications of the armed services procurement regulation by agency personnel have resulted in significant variations as to the nature and extent of the costs allowed under Government contracts.

DEPARTMENT OF DEFENSE POLICIES

The Armed Services Procurement Regulation (ASPR) provides in section 15-205.10, and I quote, that "reasonable" costs of employee welfare and recreational activities incurred in accordance with the contractors' established practice or custom in the industry or area are allowable and that income generated from such activities shall be credited against such costs unless the income has been irrevocably set over to employee welfare organizations. However, in section 15-205.11 the regulation specifically declares that entertainment costs such as costs of amusement, diversion, and social activities are unallowable.

The regulation provides also that "reasonable" losses from the operation of such food services as cafeterias, dining rooms, and vending machines are allowable costs and the profits from such services shall be credited to contract costs, with the exception of profits irrevocably set over to an employee welfare organization of the contractor in amounts "reasonably" useful for the benefit of the employees.

It will be noted that the term "reasonable" is used repeatedly in the regulation. Determinations of reasonableness primarily involve judgments and opinions of individual auditing and contracting officials. In theory, the burden of the proof of reasonableness rests on the contractor. However, as indicated in our discussions with an agency contracting officer responsible for negotiations with certain contractors whose activities are discussed in the report, Government personnel are reluctant to disallow contractor expenditures for employee recreation or morale, unless the cost is clearly unreasonable. Before disallowing such costs, the contracting officer consults with the Judge Advocate General as to the legal precedents such as decisions of the Armed Services Board of Contract Appeals. Moreover, although decisions of the Board are subject to appeal to the Federal courts, and frequently are appealed by contractors where adverse rulings are made by the Board, similar appeals of adverse rulings are unlikely to be made by the Government since the Board is acting for the head of the agency. Under these circumstances, it is likely that borderline cases are decided in favor of the contractor or are considered as items for compromise in overhead negotiations.

I will now discuss some of the types of activities noted in our survey and will illustrate them with specific examples.

PICNICS AND OUTINGS

The outing to Disneyland by Aerojet-General employees falls under this category. During October 1963, the company arranged for its

employees located in the Los Angeles area and their families to spend an evening at Disneyland at a cost to the company of \$101,000. Parking, admission, rides, and dancing to the music of four bands were provided without cost to the participants. The outing aroused considerable interest when it became widely known that Aerojet's work is almost exclusively for the Government and that the Government might be expected to absorb the bulk of this cost. After question was raised as to the reasonableness of such a charge to the Government, Aerojet, in February 1964, stated that this cost would not be claimed for reimbursement under Government contracts and, in addition, withdrew a 1962 claim in the amount of \$33,000 involving a Disneyland outing by employees of Aerojet's Downey, Calif., plant. Aerojet has informed us that it considers this cost as reimbursable under ASPR provisions but that the claim was withdrawn "to put an end to unfavorable and biased publicity." According to Aerojet, the outing was a substitution for an annual picnic held in past years and the cost of such picnics has been allowed as reimbursable by the Navy. Although the cost for each person attending the 1963 Disneyland outing was slightly less than the cost per attendant at the picnic, the number who participated in the Disneyland outing was much larger, thereby increasing the total cost almost threefold.

The cost of an outing similar to the Disneyland visit has been allowed by the Department of the Navy at another contractor location. The Navy approved for reimbursement costs totaling \$35,000 for a 1961 outing by employees of Ling-Temco-Vought, Inc., Dallas, Tex., involving a free visit to Six Flags Over Texas—an enterprise comparable to Disneyland. The Navy justified this approval on the basis that:

* * * This outing was an opening event of Six Flags Over Texas and the expenditure of \$5.52 (\$35,000 by 6,333) per employee was not considered unreasonable for this event. * * *

Another example of costs for outings involves an annual crab feast held by the Martin Co., Denver, Colo., for invited supervisors of the company. We found that during 1963 Martin had flown crabs costing \$1,800 from Baltimore, Md., to Denver in a company aircraft. The cost of the round trip for Martin's DC-6 aircraft stationed at Denver totaled about \$5,600. The entire cost of the crab feast, including the air flight, was almost \$12,000. At the time of our survey, the Air Force had not yet completed its audit or negotiations of 1963 overhead costs which included costs of the feast. However, we found that the Air Force auditors did question the cost of beer and the rental of a pavilion in connection with the 1962 crab feast. We do not know what portion, if any, of the cost of the 1962 crab feast will be accepted by the contracting agencies inasmuch as negotiations of the 1962 overhead costs have not been completed.

FOOD SERVICE

At 13 of the 36 locations reviewed, the contractors had no recorded losses as a result of food services provided to employees, but 23 locations recorded losses totaling \$1,506,000. We found that at 7 of the 23 locations, the entire loss in food service operations had been offset against vending machine revenues. At the remaining 16 locations,

however, the entire loss or part of the loss was charged to company overhead, and, as a result, the Government will bear approximately \$809,000 of losses from the sale of food to employees. In several instances, we noted that the losses were caused by the furnishing of food to the contractors' executives without charge or at abnormally low prices whereas little loss was incurred, and sometimes small profits were made, on food furnished to the other employees.

The largest recorded cost to the Government for food service operations was found at the Sacramento, Calif., plant of Aerojet-General Corp. The food service operation, involving about 1,300,000 meals during the year ended November 30, 1963, sustained a loss of \$205,000, or 16 cents a meal. We do not know what portion, if any, of this loss will be accepted by the contracting agencies since the Air Force has not yet completed settlement of 1963 overhead costs. Our survey indicated that exceptionally low prices contributed to the loss incurred. For instance, we found that each week the cafeteria offered entrees with two vegetables at the following prices:

Wednesday, grilled New York or top sirloin steak—85 cents; Thursday, roast prime ribs of beef—75 cents; Friday, varying from week to week, lobster thermidor—75 cents; shrimp or lobster newburg—60 cents.

A sizable loss of \$145,000 in food service operations occurred during 1961 at Aerospace Corp., El Segundo, Calif., a nonprofit organization established at the request of the Air Force to obtain technical services exclusively for the Government. As shown by the Air Force audit advisory report, the \$145,000 loss consisted of \$27,000 attributable to the serving of gourmet-type meals at less than cost, and to food wastage, in the executive dining room; \$19,000 for coffee brewed by maids in individual coffee rooms; \$59,000 for food and refreshments for parties held at executives' homes, dinners for guests, banquets, luncheons, and department dinners; and \$40,000 for catering service. All of these costs, except for \$152, were accepted by the Air Force negotiator for inclusion in contract prices.

PARTIES

At 16 of the 36 locations that we visited, costs of parties were allocated to the Government under its contracts in an amount totaling approximately \$156,000. We found that these costs were primarily for Christmas parties and parties held for employees who had served a large number of years with the companies. Examples of these expenditures, noted at two contractor plants, are summarized as follows:

The largest expenditure noted for a single party substantially at the expense of the Government was made by Pratt & Whitney Aircraft Division, United Aircraft Corp., East Hartford, Conn. The company holds an annual banquet for employees having 25 years' service. In 1963, the cost of this party totaled \$18,433, including \$3,700 for such items as liquor, beer, cigarettes, cigars, and flowers, and \$2,160 for music and entertainment. We were informed by the Chief Navy Auditor at the site that the cost of liquor, beer, cigarettes, cigars, and flowers had been questioned by the auditors in their review of the banquet cost. After a deduction of the questioned cost, the Government will likely bear a cost of \$11,934 for this 1963 banquet.

The largest expenditure by a contractor in the category of parties was noted at Hughes Aircraft Co. We found that during 1962 the company had expenditures totaling \$53,000 for this type of activity including "morale" parties for Hughes employees and guests, parties held in private homes, retirement and farewell dinners, departmental Christmas parties, division dances, catered parties for employees and wives, cocktail parties, and theater parties. Although allowability of the costs related to company expenditures for parties and entertainment was questioned by Air Force auditors, Air Force negotiators reinstated these costs in the company's claim for reimbursement by the Government under cost-type contracts. In addition, we found that the Hughes employee organization supported by vending machine receipts had expenditures of \$28,000 for parties that included an annual Christmas party and dance, and theater parties.

Hughes informed us that its expenditures for parties are not considered to be entertainment expense and that it does not claim reimbursement for entertainment expense under Government cost-type contracts. The Armed Service Procurement Regulation, section 15-205.11 specifically provides that "costs of amusement, diversion, social activities and incidental costs relating thereto * * * are unallowable." It appears that cocktail parties, theater parties, and so forth, certainly come within the category of entertainment and are therefore unallowable unless they properly can qualify as employee morale or welfare activities under Armed Service Procurement Regulation 15-205.10.

You will recall that I mentioned earlier the reported effect of decisions of the Armed Services Board of Contract Appeals in establishing precedents as to reasonableness of contractor costs for employee recreation and morale purposes. A case in point is the Board decision on November 24, 1961, on a question involving the cost incurred by another contractor for a patio party. In this case the Government excluded certain items of cost from the contractors' overhead pool on the basis that they were entertainment costs. One of the items involved a cost of \$185 for a patio party given for employees of the company at the home of the company's president. The company contended that this cost was an employee welfare expenditure. The Board ruled in favor of the company, stating that the Board did not believe that the party was "purely social or for entertainment," but, rather, that it was designed to improve employer-employee relations.

Although the amount of cost involved in this case is relatively small, the precedent established could well have a significant impact on decisions of Government personnel negotiating defense contracts.

GIFTS OF TURKEYS

Contractors at 6 of the 36 locations visited spent a total of \$434,000 for annual gifts of turkeys. All six locations charged the entire costs of these gifts to company overhead. About \$9,000 of these expenditures are applicable to commercial work; the remaining \$425,000 represents cost to the Government. Aerojet-General Corp. was one of the companies which distributed free turkeys to employees at Christmastime. In 1963, the corporation purchased turkeys at a cost of \$238,000 for distribution at all of its plants. The net cost of turkeys charged to the Sacramento plant overhead in 1963 totaled \$143,000,

and this net cost presumably will be absorbed by the Government as has been the practice in the past.

On the other hand, our survey showed that gifts of turkeys were not made at any of the other 30 contractor locations.

ATHLETIC AND CLUB ACTIVITIES AND RELATED ADMINISTRATIVE COST

Cost of support given to athletic and recreation clubs and related administrative costs incurred at 17 of the 36 contractor locations will result in charges to the Government of about \$416,000.

We found that over 45 percent, or \$197,000, of the total cost to the Government for this category of employee activities at the selected locations involved expenditures by International Business Machines Corp. (IBM) at its plants in Owego, N.Y.; Kingston, N.Y.; and Bethesda, Md., and at its headquarters office in New York City. A substantial amount represents IBM's costs of operating three country clubs located at Sands Point, Poughkeepsie, and Endicott, N.Y. Two of the IBM plants included in our survey are mainly involved in Government defense contract work, but the overall operations of the corporation are primarily concerned with commercial sales.

APPLICATION OF VENDING MACHINE REVENUES TOWARD FINANCING EMPLOYEE MORALE, RECREATION, AND WELFARE ACTIVITIES

The major source of funds used in financing employee morale, recreation, and welfare activities is the substantial income received from the operation of vending machines at contractor and Government-owned plant facilities. The 36 contractor locations reviewed acquired \$4.5 million mainly in vending machine income, of which \$3 million was donated to employee organizations and \$1.5 million was retained by the contractors. Generally, funds received are used by the contractors and employee associations, as the case may be, to provide for morale, recreational, and social activities. We noted, however, a tendency to shift losses in food service operations to the contractors' operating expenses which are then substantially reimbursed by the Government.

This is illustrated in the case of North American Aviation, Inc. This company created a nonstock, nonprofit organization—North American Aid—to provide for the welfare and recreational needs of its employees. During 1962, vending machine commissions of \$1.3 million were transferred by the company to North American Aid, of which \$546,000 was spent. As of December 31, 1962, North American Aid has assets of \$750,000 in cash and Government securities and property valued at \$3.5 million. Although North American Aviation transferred vending machine revenues to North American Aid, losses in food services operations, resulting from free meals furnished to executives and from the pricing of food for other employees at less than cost, were absorbed by the company. During the fiscal year ended September 30, 1962, losses in food service operations totaled \$160,000 and \$127,000 of this amount was allowed by Air Force negotiators for inclusion in Government contracts.

Conversely, in the case of McDonnell Aircraft Corp., St. Louis, Mo., the company received revenues of \$269,000 from the operation of vend-

ing machines during the fiscal year ended June 30, 1963, and incurred costs totaling \$143,000 for employee activities, including all losses in cafeteria operations. The \$126,000, excess of revenue over expenditures, was credited to company overhead costs and, as a result, prices under Government contracts will be reduced.

In view of the large accumulations of cash and other assets held by autonomous employee organizations, such as North American Aid, that are supported by revenues from vending machines operated in the contractors' plants, and in some cases Government-owned plants, question arises as to the disposition of these assets upon dissolution of the organizations. We examined charters of incorporation of three employee associations to determine what provisions had been made in the event of dissolution and found that disposition of assets generally was left to the discretion of the board of directors.

DEPARTMENT OF DEFENSE COMMENTS ON OUR FINDINGS

Our preliminary findings in this survey were presented to the Department of Defense for comment on June 3, 1964. In reply, we were informed as follows:

It has never been the policy of the Department of Defense that certain employee morale and recreation costs are always allowable and certain other costs are always unallowable. Rather, it has been generally the policy that if the contractor has a well-balanced employee morale and recreation program which is equitable to all employees when considered in light of total employee expense under all conditions, the costs incurred are allowable if reasonable in amount.

Although we did not review in detail all considerations of negotiating personnel in establishing prices, certain conclusions concerning the agency review and determinations can be made.

During our survey we noted that activities of employee associations generally were not reviewed by the Government auditor or the negotiator. In certain cases there appeared to be some question as to whether the associations were subject to review. Inasmuch as significant amounts of recreation and morale expenditures are made by these employee associations, an overall appraisal of a contractor's program could not have been effectively made without consideration of activities of associations that are financed or subsidized by the contractor.

Also, as to the comment made by the Department of Defense that reasonable costs are allowed for a contractor's employee morale and recreation program which is equitable to all employees, we found that some of the contractors furnished food to their executives without charge or at abnormally low prices whereas the prices charged other personnel were approximately at cost, and that some of the parties were confined to the managerial level. In such cases, question arises as to whether the contractor's program is equitable to all employees.

It should be noted that the stated justifications for allowance of certain items discussed in this report do not refer to the contractor's overall program but instead seem to be confined to the specific items in question. For example, allowance of the cost of the outing for employees of Ling-Temco-Vought and their families to Six Flags Over Texas was justified by the Navy on the basis that it was an

opening event and that the expenditure of \$5.52 per employee was not considered unreasonable.

Although, as stated above, the Department of Defense has contended that its basic policy is to consider the contractor's overall recreation and morale program in determining amounts for approval as Government costs, the Department also has informed us that it recognizes the need for additional guidance in evaluating reasonableness of the overall cost and has initiated action to accomplish this objective.

In promulgating ASPR 15-205.10 referred to above, the Department of Defense has recognized that it is not unusual in private industry for employers to furnish certain employee welfare or morale expenditures in the area of recreation. On the other hand, there is now pending before the Committee on Government Operations, House of Representatives, bill H.R. 10410 which in its present form would make all recreational expenditures nonallowable. We believe it is essential that appropriate safeguards be established to prevent unnecessary and unreasonable expenditure of public funds. If welfare and recreational expenditures are to be authorized they should be defined and appropriate limitations prescribed.

CONCLUSION

As I have outlined, there are many different activities provided to employees of major defense contractors for recreation and morale purposes. And, as shown by our survey, substantial sums expended for these activities are included in the prices of defense contracts with these firms.

The extent to which such activities are funded from the public purse is largely dependent upon the individual decisions of many Government auditors and negotiators and upon the guidance provided through established regulations. As I have mentioned previously, however, the burden of proof that an item of cost is unreasonable rests, in effect, on the contracting officer. For the reasons stated earlier, it is likely that borderline cases are generally allowed in favor of the contractor or are considered as items for compromise in the overhead negotiations.

We believe it is apparent that some of the expenditures for employee recreation and morale are rather elaborate. Some involve substantial outlays. To the extent that a company is engaged almost exclusively in Government contract work with limited or no competition, and thus is in a position to pass such costs on to the Government, there is little incentive for the company to limit such expenditures. Therefore, it is essential that there be effective control to avoid unreasonable or unjustified unnecessary expenditures of public funds for these purposes. Whether this control or limitation should be provided by legislation is a matter of policy for the Congress to decide.

In particular, I see no justification for profits earned from vending machines to be assigned to employee associations for unlimited use when employee recreation and welfare costs, which otherwise could be covered by the vending machine income, are being charged against Government contracts.

That concludes my statement, Mr. Chairman, and we would be very glad to answer any questions you may have.

Mr. HARDY. I want to compliment you on your discussion of the subject. I have one or two questions.

On page 20 of your statement, you make the observation that "We believe it is apparent that some of the expenditures for employee recreation and morale are rather elaborate." Those are about as difficult terms to define as some of those the contracting officers were concerned with—I don't know what "rather elaborate" means. Doesn't that seem to be perhaps an understatement?

Mr. CAMPBELL. It is not our practice, Mr. Chairman, to overstate.

Mr. HARDY. Thank you.

Mr. Pike.

Mr. PIKE. Mr. Campbell, I would like to join with the chairman in saying that you certainly presented a fine statement and raised some very interesting examples.

As to the Department of Defense policy on looking at the overall cost or overall program of a contractor in employee morale affairs, do you think that the individual auditor working on an individual case or an individual contract is in any position to know what the overall program of the contractor is in this regard?

Mr. CAMPBELL. Well, Mr. Pike, I would say that it would be difficult for such individuals, with their kind of competence, to judge the adequacy of that kind of program.

Mr. PIKE. Isn't it in order to impose on the auditor auditing a contract a requirement to familiarize himself with the company's whole welfare and morale program in order to do his job?

Mr. CAMPBELL. I think, considering the circumstances in which he is working, not in the heart of the business operation, it would be very difficult for him to make a judgment as to the whole welfare program.

Mr. PIKE. I think it was the Hughes Aircraft Corp. which said that they considered that their Christmas parties, division dances, catered parties for employees and wives, cocktail parties and theater parties were not entertainment, and they said that they did not claim reimbursement for entertainment expense. What would they characterize as entertainment expense?

Mr. CAMPBELL. I don't know. We haven't asked that question.

Mr. RUBIN. Generally, the term "entertainment expense" is construed to mean entertainment of personnel other than the contractor's employees.

Mr. PIKE. In other words, according to Hughes, no matter how they entertain their employees, it is not entertainment expense?

Mr. RUBIN. We did not ask Hughes this direct question, but I gather in this particular case this is very likely the situation.

Mr. PIKE. That is all.

Mr. HARDY. Distinguishing, then, between entertainment expense and employee morale building. Is that the general idea?

Mr. RUBIN. Yes, sir.

Mr. HARDY. I would like to follow up on Mr. Pike's question about the determination of a contractor's overall program. I have noted, Mr. Campbell, in several places you have discussed specific expenditures which seem to be utilized more lavishly with respect to rank-and-file employees.

Now, I wonder whether in the analysis which you have made there was any comparison made of the expenditures in the area of govern-

mental contracting as compared with expenditures for similar purposes in connection with normal commercial business. Do you follow my question?

Mr. CAMPBELL. I think I follow your question, Mr. Chairman.

Mr. HARDY. Thinking in terms of a regular employee morale building program, wouldn't it seem logical to expect that a company would be as concerned about the morale of its employee engaged in commercial activities as the morale of the employees engaged in Government contracts?

Mr. CAMPBELL. I would have to venture a guess on that. I think that in general you would expect that the welfare programs would be directed at the commercial side of an organization rather than the Government contract work.

Mr. HARDY. But GAO has not undertaken to make any evaluation or comparison of expenditures in connection with commercial as compared with expenditures in Government?

Mr. CAMPBELL. We have split these amounts between what the Government will probably have to bear as against what the total cost was.

Mr. HARDY. That might be a right interesting thing to pursue, and maybe we will want to develop that as the hearing goes on.

Now, on page 8 of your statement, reference is made to the crab feast held by the Martin Co., and you have indicated a cost for the round trip of Martin's DC-6 aircraft at \$5,600. Was that the cost figure that was used in their own records?

Mr. RUBIN. No, sir; it was a calculation we made based on the experience of the company.

Mr. CAMPBELL. I don't think that calculation would be questioned. It is an approximate cost based on their experience.

Mr. HARDY. Well, was that amount included in the cost of the party that was allowed?

Mr. RUBIN. It was not recorded as a cost of the party, but we feel it is a cost related to the party, and this is the reason we have added it in as a total cost.

Mr. HARDY. What I am trying to get at, was there any reimbursement to cover that? Was it included in the overhead charges against the contract?

Mr. RUBIN. Yes; it was reimbursed, or will be. It is still under consideration, as a matter of fact.

Mr. HARDY. The \$5,600 for the use of the aircraft is included in the amount which you have indicated probably will be reimbursed?

Mr. CAMPBELL. \$12,000; yes, sir.

Mr. HARDY. Then about half of this \$12,000 is for the use of the aircraft?

Mr. CAMPBELL. Yes, sir.

Mr. HARDY. Do you have any information as to what the cost of those crabs would have been had they been transported by a commercial air carrier?

Mr. RUBIN. We understand it is about \$23 for each hundred pounds, as the commercial rate for shipment, air freight, of the crabs. I don't know—do we have the weight factor here—according to the information furnished by the seafood supplier, it was about 8,500 pounds.

Mr. HARDY. My arithmetic is not that fast.

Mr. CAMPBELL. That would be about 85 times 23—something less than \$2,000.

Mr. HARDY. Yes, just under \$2,000 as compared with a cost of \$5,600.

Mr. CAMPBELL. That is correct.

Mr. HARDY. I wouldn't think that they would normally expend that amount of money using their own aircraft when they could procure service of a scheduled aircraft carrier for that much less.

Turning to page 9 of your statement, Mr. Campbell, you say:

In several instances, we noted that the losses were caused by the furnishing of food to the contractors' executives without charge or at abnormally low prices whereas little loss was incurred, and sometimes small profits were made, on food furnished to the other employees.

Is that an accurate statement?

Mr. CAMPBELL. Yes, sir.

Mr. HARDY. The fact is the executives got free meals, but the people whose morale we have to boost—in other words, it is more important to boost the morale of the executives than the workers?

Mr. CAMPBELL. Sometimes that seems to have been the object.

Mr. HARDY. On page 10 of your statement, in connection with the Aerospace Corp., you have listed some items, and I don't know whether you care to shed further light on them, but it would be helpful if we could understand what we are talking about.

A total of \$27,000 of the loss was attributable to serving of gourmet-type meals at less than cost, and to food wastage. I don't know how the food wastage business comes in here.

Mr. CAMPBELL. In our report which was submitted to you today, Mr. Chairman, on page 14—

Mr. HARDY. Do you cover that in detail?

Mr. CAMPBELL. Yes; this matter is covered in some detail. With respect to the dining room, which showed a loss of \$145,000, of that loss \$27,000 was attributed to the dining room resulting from operating losses in conducting special dining rooms for executives and their guests, including the operation of the commander's dining room at the Arbor Vitae complex. We were informed that the commander's dining room was for the use of Air Force staff members at the grade of full colonel or above, and their guests at the site. According to the audit advisory report, the loss was largely attributable to the serving of gourmet-type meals at less than cost and to food wastage.

The second item had to do with the coffee maid service loss of about \$19,000.

Mr. HARDY. I was going to ask you about that—you said "brewed by a maid in individual coffeerooms." Have you got anybody that can describe the maids and the coffeerooms for us? I was interested in knowing what an individual coffeeroom is, and just what kind of maid service it provided.

Mr. CAMPBELL. This represents the loss involved in selling coffee to employees and Government personnel during the first few months of 1961. Fresh coffee was brewed by maids in individual coffeerooms at both complexes. Subsequently coffee vending machine profits were not offset against this cost. Does that answer your question?

Mr. HARDY. Not very well.

Did I understand, also, that this \$19,000 was just for a 3-month period rather than a 12-month period?

Mr. RUBIN. That is right; yes, sir.

Mr. HARDY. If we multiply that, it would be \$76,000 for maid service in individual coffeerooms in a year's time?

Mr. CAMPBELL. They discontinued the personal service in the early spring and went over to vending machines.

Mr. HARDY. They did what?

Mr. CAMPBELL. They went over to vending machines after that.

Mr. HARDY. And what did they do with all the maids? This is really interesting. I might apply for a job as one of your auditors.

Mr. CAMPBELL. We do get into some interesting situations.

Mr. HARDY. On page 16 of your statement, Mr. Campbell, there is an item in connection with the North American Aid, and in the last sentence in the main paragraph on the page you said:

During the fiscal year ended September 30, 1962, losses in food service operations totaled \$160,000, and \$127,000 of this amount was allowed by Air Force negotiators for inclusion in Government contracts.

The interesting thing about this is to compare that figure with the one up a little higher in that paragraph where it is pointed out that this nonprofit employees' organization had developed assets of \$3.5 million. Now, over what period of time did they develop those assets?

Mr. RUBIN. It has been over a period of years, Mr. Chairman. We don't know the exact length of time.

Mr. HARDY. Do you know how long this arrangement has been in effect, the North American Aid? Is it an old thing under which they were allowed to take the receipts from the vending machines?

Mr. CAMPBELL. We may have the date of incorporation in our papers.

Mr. RUBIN. We are checking that now, sir.

Mr. HARDY. It seems to me to be a rather strange sort of situation where an employee organization is permitted to retain revenues from vending machines and build up such a big backlog of assets, and at the same time \$127,000 is being charged to the Government contract for subsidizing meals furnished to employees. I am trying to see how this could occur, how they could build up such a big balance sheet, and it brings up a second question in my mind, and that is you have also referred to the distribution of these assets in case of liquidation. Who do they belong to? Who does the \$3.5 million belong to; do you know?

Mr. CAMPBELL. If it is a nonprofit, tax-exempt organization, it is in trust with the trustees of the organization, I believe.

Mr. HARDY. It belongs to the trustees of the organization, or the members or the employees?

Mr. CAMPBELL. Well, the members of the organization, who in turn would choose the trustee originally.

Mr. HARDY. It is sort of like the building and loan associations' reserve; I haven't been able to find out who owns them, and in this situation you have \$3.5 million that belongs to somebody; but who can get it?

Mr. CAMPBELL. That is a question.

Mr. HARDY. It seems rather strange that we can have a nonprofit organization that can build up this kind of assets.

Mr. CAMPBELL. Going back to your question on the incorporation, this organization has been in existence since 1941, or rather the original

articles of incorporation were filed in 1941. We do not know the extent of activity over the years. Apparently, and we would have to go into this further, substantial funds have flowed into these employee organizations from the Government purse.

Mr. HARDY. I notice from your schedule of vending-machine revenues that during a 12-month period in 1962 or 1963, I don't know specifically which date, North American Aviation had receipts of \$1,289,000 from vending machines, which was turned over entirely to the employee organization, and they expended only \$546,000 which made a net accumulation of \$743,000 on their 1 year's operation.

Mr. CAMPBELL. Then that answers your question, that this million dollars, roughly, of assets were created in the last year or so.

Mr. HARDY. Well, certainly in 1 year here, three-quarters of a million dollars of it. I think it would be interested to find out who that money belongs to and how the owners can get it.

Mr. RUBIN. Mr. Chairman, we have a discussion on the distribution of the assets in the event that this association were dissolved—

Mr. HARDY. Now you are talking about dissolution of the thing, but if it belongs to the present employees, a lot of the present employees are not going to be there when the thing is dissolved, and how do their heirs get it? They contributed to it. It seems to me the whole thing is a little bit cockeyed.

Mr. PIKE. If the chairman would yield, I would say it would be more accurate to say that all the taxpayers of the United States of American contributed to it.

Mr. HARDY. They contributed to it by this \$127,000, at least, and the other items that were allowed as overhead, it seems to me.

Mr. KELLER. Mr. Chairman, on page 27 of our report, we give three cases of these employees' organizations and show what the charter shows in those. One is Lockheed, another is North American, and Minnreg Veterans, Inc., which is an organization of Honeywell.

Mr. HARDY. If we are going to permit this kind of operation, I am just wondering if we shouldn't suggest to Ways and Means that they amend the tax provision.

Mr. Pike.

Mr. PIKE. Are any of the directors of the NA-Aid corporate officials of North American, or are they all employees of North American?

Mr. RUBIN. The directors on the board of North American Aid hold positions with North American Aviation as follows:

*Board of Directors of
North American Aid*

Position with North American Aviation, Inc.

W. H. Cann-----	Vice president and secretary.
C. W. Guy-----	Executive vice president (Rocketdyne Division).
K. L. Kellough-----	Recreation and welfare administrator.
N. F. Parker-----	Executive vice president (Autonetics Division).
W. F. Snelling-----	Executive vice president (Space and Information Systems Division).
E. D. Starkweather---	Vice president—personnel.
W. E. Swanson-----	Executive vice president (Los Angeles Division).
D. W. Werden-----	Corporate director—taxes and renegotiation.
J. W. Young-----	Vice president—quality and logistics.

Mr. CAMPBELL. Mr. Chairman and Mr. Pike, this organization, as other nonprofit organizations, must file with the Treasury Department a statement as to its activities, and those statements should be available to you.

Mr. PIKE. But when you have a so-called nonprofit organization getting receipts of a million and a quarter dollars a year and expending only \$500,000 a year, keeping \$750,000 in the kitty, the nonprofit organization is doing pretty well.

Mr. CAMPBELL. That is right.

Mr. PIKE. Then it is a question where the \$750,000 is going to go, whether it is taxable, and whether any benefit accrues either to the employees or to the Government from that fund?

Mr. CAMPBELL. Well, I think basically this thing is a tax problem. In other words, by having this money diverted into the nonprofit company, North American doesn't pay any tax—and that is a 52-percent saving; so it is tax free to the employees' organization.

Mr. PIKE. The employees welfare organization doesn't pay any tax, either?

Mr. CAMPBELL. That is right.

Mr. HARDY. The fact of the matter is you have a tax aspect to this whole proposition, because the extent to which these expenditures are permitted for alleged employee morale affects the tax of the corporation.

Mr. CAMPBELL. That is right.

Mr. PIKE. Mr. Campbell, do you know whether these provisions under which this vending machine money is turned over to the North American Aid Corp. is a part of the contract between North American and its employees?

Mr. CAMPBELL. In other words, whether the vending machine contract is with the employees' organization directly?

Mr. PIKE. No, whether it is a part of the basic union contract, say between North American and its employees.

Mr. RUBIN. We have been informed that North American's union agreements contain no provision for distribution of vending machine revenues to North American Aid.

Mr. PIKE. That is all I have, Mr. Chairman.

Mr. HARDY. Mr. Campbell, the committee wants to express appreciation again for your help in this matter. I feel sure that the efforts of you and your personnel will help us carry this inquiry forward in an objective way. We will put every effort we can on it. We certainly appreciate your appearance this morning.

Mr. CAMPBELL. Thank you, Mr. Chairman. I think you realize we would like more time in this area; it is something that requires more time and should be given a great deal more attention.

Mr. HARDY. It may be that we will be calling you later on.

Now the committee would like to call Mr. B. J. Abrahams, Auditor in Charge of the Navy Audit Office, Azusa, Calif. Will you come up, please, sir, and have a seat?

Mr. Abrahams, would you give the reporter your full name and address, and your title, and your present duties?

TESTIMONY OF BERTRAM J. ABRAHAMS, CHIEF AUDITOR, U.S. NAVY AUDIT OFFICE, AZUSA, CALIF., ASSIGNED TO AEROJET-GENERAL CORP.

Mr. ABRAHAMS. All right, sir. My name is Bertram J. Abrahams. Did you want my home address?

Mr. HARDY. Please.

Mr. ABRAHAM. 1150 Chantilly Road, Los Angeles, Calif. I am the Chief Auditor of the U.S. Navy Audit Office, Azusa.

Mr. HARDY. How long have you been in that position, Mr. Abrahams?

Mr. ABRAHAM. Since the 9th of July of 1963.

Mr. HARDY. How long have you been in auditing work?

Mr. ABRAHAM. I have been with the Navy audit organization for slightly over 4 years, and before that time I acted as an accountant in industry.

Mr. HARDY. Are you a CPA?

Mr. ABRAHAM. No, sir; I have passed the State exam for it, but—

Mr. HARDY. You didn't complete your qualifications?

Mr. ABRAHAM. Apparently not, sir.

Mr. REDDAN. What are your duties in your present position, Mr. Abrahams.

Mr. ABRAHAM. I have a staff of eight auditors and two clerks that are responsible for the audit at Aerojet's Azusa plant, at a division called Aetron, and at the home office of Aerojet-General Corp.

Mr. REDDAN. How many corporations or companies do you have cognizance of?

Mr. ABRAHAM. Actually, sir, only one, Aerojet.

Mr. REDDAN. And that is Aerojet-General?

Mr. ABRAHAM. Yes, sir.

Mr. REDDAN. Is your jurisdiction limited to any particular divisions or to the whole company?

Mr. ABRAHAM. Just to the Azusa plant, to Aetron, which is a division located near the Azusa plant and the corporate offices.

Mr. HARDY. Will you try to speak a little louder? I am having a little trouble.

Mr. ABRAHAM. I am sorry, sir.

Mr. REDDAN. Your jurisdiction doesn't run as far as Sacramento?

Mr. ABRAHAM. No, sir; it does not.

Mr. REDDAN. As you know, we are concerned this morning particularly with the expenditures for employee morale and welfare purposes. Could you tell the committee briefly what you do in auditing, examining and allowing or disallowing the claims for these items which come to you from the Aerojet?

Mr. ABRAHAM. Well, each year we receive an overhead claim from the company for overhead expenses, G. & A. expenses, home office expenses. The last claim we have received, incidentally, is for the year 1962. We then examine each of the accounts to the extent we believe necessary to determine the allocability of these costs under applicable parts of ASPR section 15.

I might add, sir, if we learn of a significant cost occurring in the current year—for example, the outing Aerojet had at Disneyland which has been previously mentioned here—we will not wait until yearend to find out what the expenditure is for and what the contractor expects to claim.

Mr. HARDY. That raises a question, Mr. Abrahams. You said the last claim of Aerojet was for 1962.

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. When do they normally come in—do they come in once a year?

Mr. ABRAHAMAS. I will get the exact date, sir, that we received the claim for 1962, which I think might help. We received Aerojet's formal claim in the fall of 1963, at which time we contacted the contractor and asked Aerojet to cooperate with us and provide a detailed analysis of certain accounts out there.

The 1963 claim, incidentally, is expected very shortly. We have started to work on 1963 overhead, even though we haven't yet received their claim.

Mr. HARDY. Is this claim on a calendar-year basis?

Mr. ABRAHAMAS. No, sir; it is for their fiscal year which starts December 1 and ends with the last day of November.

Mr. HARDY. So, for the year ending November 30, 1962, you didn't get their claim until sometime in the fall of 1963?

Mr. ABRAHAMAS. Yes, sir.

Mr. HARDY. I don't quite understand that. I would think the company auditors would have to complete their audit for internal purposes long before that time, and it looks to me like there might be a little difficulty in figuring out the earnings and dividends which might be available if you didn't find out how much was going to be allowed on your overhead, and didn't even submit your claim until a year after the fiscal year closed. Is that a usual practice throughout the industry, do you know?

Mr. ABRAHAMAS. Well, I don't know, sir, if I can answer that question accurately. I know that we began conferences with Aerojet management last fall to attempt to get on a more current basis, and we have scheduled and Aerojet has scheduled two complete audits for both the fiscal years 1962 and 1963 in this fiscal year, which ends November 30. We hope then to be able to start and complete the fiscal year 1964 audit in the spring of 1965.

Mr. HARDY. Well, you certainly would be more current. That would put you about 6 months after the end of the first of the year. At the present time, when do you expect to complete your audit of the 1962 claim?

Mr. ABRAHAMAS. Our detailed audit work, sir, is now basically done. There are a few more points that we do have to look into. We also have to get some technical help from the outside. We have asked for this help and it is forthcoming. For example, we need engineering advice, from the Department of the Navy, the Department of Air Force, and the Department of the Army. Once this advice has been received, which I expect shortly, we will have to confer with the contractor and go over items of cost which we have questioned, and make certain we have the straight story on them.

Mr. HARDY. Be certain what?

Mr. ABRAHAMAS. That we have the straight story, or the true facts.

Mr. HARDY. I wanted to understand what "straight story" meant.

Mr. ABRAHAMAS. I am sorry—that the information we obtained and used as a basis for questioning costs is true.

Mr. HARDY. So it will take you how long yet to wind up your 1962 business? It looks to me like there is a terrible lot of time involved here, and it surprises me that industries of this kind are almost a year behind in presenting their information to you, or presenting a claim, and then it takes you another year to get this thing determined. Un-

less you made interim payments, I would think the companies would be at a considerable disadvantage.

Mr. ABRAHAM. Well, we do do that, sir, at overhead rates which are significantly less than actual book rates.

Mr. HARDY. So, then, if you do that, there is no urgency, no feeling of urgency on their part, if they have gotten an allowance which is about what they have asked for they are in no hurry to settle and might actually have more than they are entitled to, so that they would be using the Government's money.

Mr. ABRAHAM. I think it is a very safe statement for me to make that they have been reimbursed less than they will get once these overhead rates are finalized.

Mr. HARDY. Then maybe that is because the negotiators are extra liberal in coming up with the final figure.

Mr. ABRAHAM. I don't think so, sir.

Mr. HARDY. You wouldn't be expected to think so.

Mr. Reddan.

Mr. REDDAN. In passing on these claims, the overhead claims, do you have any guidance other than the ASPR provisions?

Mr. ABRAHAM. Yes, sir; we receive guidance from the Auditor General of the Navy. We have guidance also from the DOD Contract Audit Manual and the Navy Auditor's Handbook.

Mr. REDDAN. What do you receive from the Navy, sir, that relates specifically to this particular type of transaction?

Mr. ABRAHAM. We do receive throughout the year a significant number of instructions from the Auditor General's office which we review very carefully. I would be hard put right now, though, to point out any one or more of them that had to do with the types of expenses which we are speaking about here. I am sure that there were some; it has just slipped my mind at this point.

Mr. REDDAN. Would you be good enough to supply the committee with any such material that you have received during the past 2 years?

Mr. ABRAHAM. Yes, sir.

Mr. REDDAN. Now, if you question an item, what procedure do you follow? How do you resolve the question?

Mr. ABRAHAM. We will first discuss the items that we have questioned with the contractor, as I stated before, to make certain that our facts are right. We then will question these costs, and we try to convince the contractor that these are costs that ought to be questioned under the clauses in his contracts which refer to ASPR section 15, part 2.

So far, for the last few years, at any rate, at Aerojet we have been successful in convincing the contractor that these are items of cost that ought to be questioned. If they differed with us, then we would have to disallow amounts of their claims for reimbursement, but this hasn't happened recently.

Mr. REDDAN. You stated several times, Mr. Abrahams, you go to the contractor to make sure the facts are correct, as I understand your testimony.

Mr. ABRAHAM. Yes, sir.

Mr. REDDAN. Now, what do you do in a case where there is an overhead item for a party, and you have to make a judgment whether this is for morale purposes or entertainment? How do you get your facts on that?

Mr. ABRAHAM. Well, we would first determine what the makeup of these costs is, to determine actually what their content is, and—

Mr. REDDAN. That is based on information which has already been supplied to you by the contractor, isn't it?

Mr. ABRAHAM. Yes.

Mr. REDDAN. So what additional facts do you get when you go back back to the contractor?

Mr. ABRAHAM. Well, it may often happen—in fact it does often happen—we receive certain information by review of journal voucher entries, let's say, or invoices that Aerojet has received from suppliers, and these will list certain brief facts. The facts listed may not be complete.

Basically, when we meet with the contractor to discuss certain items of cost that we have questioned, we say, "Now, this is what we have found out, and this is the information we have obtained from your records." If he then says this is not the whole story, of course, from that point on our attitude is, "Well, show me, if you can; if you can't, the costs will have to stay questioned."

Mr. REDDAN. What is the ingredient of a morale party which would make it different from entertainment, or vice versa? I am just wondering how you form that judgment.

Mr. ABRAHAM. One thing, of course, would be—and this would be an important factor—if this amount is expended for some kind of a recreational affair that is for employees only and their families. In other words, there are no participants there who are outsiders. If there was a mixture of employees and people from the outside, we would look at it as entertainment, as it would appear that the primary purpose of this expenditure of funds is not to provide activities of the type described in ASPR 15-205.10.

Mr. PIKE. You agree with the Hughes concept that so long as the function, whatever it may be, is limited to the employees—and I believe you said "and their families"—then it is a morale-improving matter which is allowable; but if it included outsiders, it would be entertainment?

Mr. ABRAHAM. This would certainly be a major point, sir. Also, I might add that we would also be concerned with other factors such as the reasonableness of the expense. This is a hairy point sometimes, but we try.

Mr. PIKE. Well, "reasonable" is a word that is meaningful only to the person who is making the determination. There is no objective criterion for "reasonable." Under the criteria which you set up, however, it seems to me there is no limit whatsoever to the type of function which can be provided as long as it is provided to the employees and their families. A cocktail party, in your book, is not entertainment—that is morale.

Mr. ABRAHAM. Fortunately that one hasn't come up, but we would be bound, I think, sir, by the definitions of these costs as stated in ASPR.

Mr. PIKE. Yes; but there aren't any definitions, and you have told me that you say that where it is for the employees and their families, this is morale and welfare, but it is not entertainment, and therefore a cocktail party for employees is allowable as a nonentertainment expense.

Mr. ABRAHAMAS. Well, if we had an affair such as that which you describe—and this hasn't happened at Aerojet since I have been there, anyway, or in the year before that—we would have to refer back to ASPR 15-205.10 and determine if the expenditure would fall into the categories described therein. Also, as to this question of whether or not a cost is reasonable, it isn't completely gray, sir; we can do certain things, and we do. For example, we can compare the amount spent for this type of cost this year with the years past. We can try to conduct a survey—

Mr. PIKE. Well, do you compare it with what is spent in other corporations or only what this corporation has spent in years past?

Mr. ABRAHAMAS. Both, sir.

Mr. PIKE. Well, now, let me give you a hypothetical case of the employees of Aerojet being invited—and only the employees and their wives, of Aerojet—being invited to spend a night at the Coconut Grove Restaurant in Los Angeles, and dance there and eat there and drink there, and the bill when it is presented is determined to be a reasonable bill. That is not entertainment?

Mr. ABRAHAMAS. I think, sir, that we would probably not be able to question it as being a cost other than an employee morale cost, but I think we would have some strong grounds for questioning a good part of the expense as being unreasonable.

Mr. PIKE. How do you determine which part of the expense you would question as being unreasonable? A night at the Coconut Grove is liable to be expensive, and you get a cut rate there.

Mr. ABRAHAMAS. It would be unreasonable, I think, from the standpoint of how much has been spent for employee welfare costs—

Mr. PIKE. Do you have any limit on the amount that can be spent for employee welfare cost and, if so, what is it—a percentage or a fixed amount?

Mr. ABRAHAMAS. Fixed amount? No, sir.

Mr. PIKE. A percentage—a percentage of the total contract. Is there any limit whatever, any hard limit whatsoever either in total amount per employee or percent of the cost of the contract that can be spent for these so-called welfare purposes?

Mr. ABRAHAMAS. Not written into the contracts themselves, no.

Mr. PIKE. Well, if there aren't any limits written into the contract, or into the ASPR's themselves, then the limit is established in the mind of each individual auditor; is that it?

Mr. ABRAHAMAS. With some active guidance from our Los Angeles headquarters office, who would be involved in this if there was a large amount expended.

Mr. PIKE. Have you ever been given a fixed limit or a percentage limit from this Los Angeles office?

Mr. ABRAHAMAS. No, sir.

Mr. PIKE. So you are still left pretty much on your own, aren't you?

Mr. ABRAHAMAS. In that sense, sir, yes.

Mr. PIKE. What limit, either percentage or fixed, have you established in your own mind as to where you are going to draw the line?

Mr. ABRAHAMAS. Well, sir, in the year 1963, I think this will probably be unnecessary, as the one large item of cost that is recorded on the contractor's books for social affairs is not going to be claimed by Aerojet.

Mr. PIKE. You are now talking about the Disneyland trip?

Mr. ABRAHAM. That is correct, sir.

Mr. PIKE. Well, isn't it a little sad that all this publicity had to come out before anything happened to make it unnecessary for you to make this determination, because the company decided that the publicity was so bad they would withdraw it?

Mr. ABRAHAM. This isn't actually, sir, what happened.

Mr. PIKE. Well, would you tell us what happened?

Mr. ABRAHAM. At the time that we first heard about this outing, which I believe was approximately 2 weeks before the actual event, I began to hold talks with Aerojet management.

Mr. PIKE. This would have been back in 1962?

Mr. ABRAHAM. 1963, sir.

Mr. PIKE. All right, 1963.

Mr. ABRAHAM. I asked them such questions as how much did they think it was going to cost; did they intend to claim this as a cost or not—

Mr. PIKE. Didn't you know that they would claim it as a cost? They had claimed a similar outing as a cost in 1962.

Mr. ABRAHAM. They claimed at the plants where I have audit cognizance, the cost of a company picnic held at a local park. Aerojet had an outing at Disneyland for a different plant.

Mr. PIKE. The Downey plant in 1962 claimed \$33,000 for a Disneyland outing; is that correct?

Mr. ABRAHAM. I believe that is the amount, sir.

Mr. PIKE. The Los Angeles office, the overall office, certainly knew about that, did they not?

Mr. ABRAHAM. I think so, sir, yes.

Mr. PIKE. Did you know about it?

Mr. ABRAHAM. No, sir, I didn't know about this, due to the fact that I do not audit at that plant. That plant is under a different audit group.

Mr. PIKE. You asked them how much they anticipated this Disneyland junket was going to be?

Mr. ABRAHAM. Yes, sir, and did they intend to claim all of the cost as reimbursable costs with the Department of Defense, or NASA, or AEC. They didn't provide at that point a firm estimate, although they did give an estimate. I have forgotten the amount of the estimate, but it was reasonably close to the amount they actually did expend. They said they did intend at that time to claim this cost. From that point on, even though we had not received their claim for the year 1963, we began our talks with Aerojet management.

Mr. PIKE. Well, did you tell them 2 weeks ahead of this affair, when they told you that the cost was going to be approximately \$100,000 and that they did intend to claim it, did you tell them that you intended to disallow it?

Mr. ABRAHAM. No, sir. As I recall, I told them that I thought that there would be a definite question raised, and I had a definite question in my own mind at the time, as to the reasonableness of the amount they expected to expend.

Mr. PIKE. But not as to the nature of the function, only as to the reasonableness of the amount?

Mr. ABRAHAM. Yes, sir.

Mr. PIKE. You did not consider a reasonably priced trip to Disneyland as entertainment?

Mr. ABRAHAMS. No, sir.

Mr. PIKE. That is all.

Mr. HARDY. If I could follow up on that just a little, what did you say was the date of the submission of the 1962 claim?

Mr. ABRAHAMS. It was in the month of September 1963, sir.

Mr. HARDY. I have before me a letter dated June 17, 1964, from Aerojet-General to the General Accounting Office, and it attaches a document dated October 29, 1963, which refers to both the Brookside Park picnic in 1962 and Disneyland in 1963. Aerojet-General states in this letter: "The attached report was presented to government personnel giving the reasons for selecting the Disneyland facility, including the fact that the growth of the company had made an outing at a public park impractical." You are not familiar with that?

Mr. ABRAHAMS. I have heard this statement being made by Aerojet, sir.

Mr. HARDY. I want to show you this document and ask you if you received it. It said it was sent to Government personnel, and it would seem to me you are one of the people who ought to have received it.

Mr. ABRAHAMS. I may have. This is months back, sir. I don't recall.

Mr. HARDY. This was October 1963.

Mr. ABRAHAMS. All right sir.

Mr. HARDY. Do you say, Mr. Abrahams, that you have no recollection of that document?

Mr. ABRAHAMS. I do recall hearing statements like this made to me by Aerojet management. I don't recall actually seeing this letter, but it is possible.

Mr. HARDY. This document looks to me as though it was submitted as an actual claim. I am not sure what the document intends to say, but it says they decided on Disneyland instead of a picnic, and it is obviously designed to support an application for payment. If it weren't, why would it go into the dollar cost and itemize it? What is the purpose of it? I am surprised that you don't know anything about it.

Mr. ABRAHAMS. Well, I am not stating that, sir. I am aware of the amount spent, and I am aware of Aerojet's thoughts as to why this would be an allowable expense.

Mr. REDDAN. What was the date of the Disneyland picnic in 1963?

Mr. ABRAHAMS. It was, I believe, in October of 1963, early in October.

Mr. REDDAN. And the document that the chairman has just referred to is dated what, sir?

Mr. ABRAHAMS. The 29th of October.

Mr. REDDAN. In looking at that document, would you say its purpose was to justify or support a claim for an overhead item in that amount?

Mr. ABRAHAMS. It looks to me, sir, like it is a document that was prepared to support an argument that the contractor might be having over costs like this, or perhaps this is even more likely, that it was prepared to provide an answer to some Government representative as to why these amounts were being spent, and how much was being spent.

Mr. HARDY. Well, they wouldn't have to justify it if they weren't going to claim it for allowance and reimbursement. Of course, it clearly was designed to support a claim for inclusion in the overhead account.

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. Otherwise there wouldn't be any reason in the world for them to do that. As an accountant, don't you know that?

Mr. ABRAHAM. Well——

Mr. HARDY. If I were an accountant, that would be my conclusion, anyway.

Mr. ABRAHAM. At that point in time, sir, Aerojet, I am sure, did intend to claim this as an item of cost. It was some months afterward when they agreed not to claim it.

Mr. HARDY. Well, let's go to something else here for a minute. In the course of your audit, did you examine also the uses made of the vending machine receipts?

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. Now, you testified, I believe, that the parties were excluded from inclusion in the allowable items in overhead; is that correct?

Mr. ABRAHAM. I believe, sir, that I stated that costs classified as being entertainment expense by the contractor are voluntarily excluded by the contractor from items of overhead included in the overhead claim.

Mr. HARDY. I am not sure I understand this spread sheet prepared by the General Accounting Office, but I have been somewhat interested in their schedule of recreation and morale expenditures. This spread sheet shows picnics and outings, and they refer to the Disneyland trip having been left out of this. Food service, \$2,000; parties, \$20,000; gifts of turkeys, \$41,000; athletic and club activities and related administrative costs, \$17,000, for a total of \$80,000 during this particular period. You are familiar with these items, I presume?

Mr. ABRAHAM. I do have here a draft of a report—I was on the wrong sheet, I am sorry. Yes, sir; I have got the schedule here.

Mr. HARDY. Now, on the sheet which shows vending machine revenues and uses, it shows a \$57,000 vending machine receipt for this particular plant, and that the entire \$57,000 was donated to the employee organization. Does your record show that?

Mr. ABRAHAM. I believe it is \$37,000, sir.

Mr. HARDY. It shows \$37,000 expended, and the other \$20,000 still held by that employee organization. That is what my sheet shows. Does yours show that?

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. Now, looking at still a third sheet, we get the manner in which these funds were provided, and if my conclusions are correct, the \$37,000 which was spent from the \$57,000 accumulated from vending machines went to pay the costs of parties, \$20,000; and \$17,000 for athletic and club activities costs. Does that jibe with your computation?

Mr. ABRAHAM. Sir, I don't know if I can answer that in that way. I do have here, for instance, for the years 1961, 1962, and the first 9 months of 1963, the source of all of the welfare club's income, and I also show for this same period what it was disbursed for.

Mr. HARDY. According to these sheets the General Accounting Office has prepared for us, and I will just give them to you as they appear on here, they show food loss of \$2,000, gifts and turkeys, \$41,000.

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. As having been paid for during this period by the contractor and presumably included in their overhead request, is that right?

Mr. ABRAHAM. For the year 1963, sir, it will be included in Aerojet's claim, once we get it, which we have not.

Mr. HARDY. Now, it shows that the other recreation and morale expenditures consisted of \$20,000 for parties and \$17,000 for athletic and club activities paid for from vending machine receipts.

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. And it further shows that the remaining \$20,000 was still held by the employee organization unexpended.

Now, my whole point in bringing this up is that you said the costs you disallowed as overhead were covered by the vending machine receipts.

Mr. ABRAHAM. In large part, certainly, sir, if not all, yes. The prime source of income for the employees welfare club is receipts from vending machines.

Mr. HARDY. What you are saying is that if those parties had been included in a claim for reimbursement in overhead, you would have denied it—that is what I understood your testimony to be, and if I am incorrect, please straighten me out.

Mr. ABRAHAM. This might be hard to state, sir, in that if these amounts—

Mr. HARDY. If they were recreation and not entertainment, you would have allowed them?

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. So you have to exercise your judgment as to whether it was for entertainment or morale?

Mr. ABRAHAM. Yes, sir.

Mr. HARDY. And I would presume you have to conclude that entertainment, per se, does not build morale?

Mr. ABRAHAM. As described in ASPR, yes, sir.

Mr. HARDY. Well, I have been entertained once or twice and it built my morale perceptibly for a short period of time.

Mr. REDDAN. Over what period of time have you been auditing the books of the welfare organization?

Mr. ABRAHAM. This is an area which we think needs review, and we do review it. We can, however, do most of our audit in the following manner: Aerojet has an active internal audit organization in their own plant. They review these costs themselves. We, as far as I know, as long as this club has gone, been in existence, have reviewed the working papers of Aerojet's auditors who review the income and expenses of this club, and if we think there are items that require additional review, we will do it ourselves.

Mr. REDDAN. Have you ever done that?

Mr. ABRAHAM. Speaking firsthand, in the year 1962—which is the audit that we are just now wrapping up—we felt this additional review was not necessary. What has happened in the years before, sir, in this area, I don't know.

Mr. REDDAN. I just wanted to get the record straight. I understood from your testimony that your office has audited the books of the welfare organization. Now I understand that I misunderstood you, and, as a matter of fact, you have never audited the books of the welfare organization, but you do look at the audit which is prepared by the company auditors. Is that right?

Mr. ABRAHAM. I would hate to make the statement, sir, that we have not ever audited—

Mr. REDDAN. But to the best of your knowledge.

Mr. ABRAHAM. In the year 1962, we did not.

Mr. REDDAN. And you are considering that right now?

Mr. ABRAHAM. Yes.

Mr. REDDAN. Do you know whether you did it for the year 1961?

Mr. ABRAHAM. I do not, sir; no.

Mr. REDDAN. Have you ever disallowed any items?

Mr. HARDY. Do you know of any ever having been disallowed?

Mr. ABRAHAM. Well, the costs for the operation of this club are not claimed by Aerojet.

Mr. HARDY. That being the case, what business have you got looking at it?

Mr. ABRAHAM. One reason is I think we are inclined to be at times slightly nosey, I guess, but we like to see what comes in and what goes out.

Mr. HARDY. You haven't done anything about it. So here you are looking at the books of the club that you are not going to do anything about even if you find anything in there, so what in the Sam Hill are you wasting your time for?

Mr. ABRAHAM. One thing that we are concerned with, and very much concerned with, is the club's sources of income, in the event there is a contribution to this club that does not come out of the employees' own bank accounts.

Mr. HARDY. The employees' what?

Mr. ABRAHAM. I am sorry, sir. This welfare club's sources of income have been dues paid by employee members out of their own pockets—

Mr. HARDY. To what does that amount?

Mr. ABRAHAM. In the year 1962, it was approximately \$22,000.

Mr. HARDY. The employees contributed \$22,000 out of their own pockets, but during the same period they got \$57,000 from vending machines?

Mr. ABRAHAM. No, sir, in that year they received approximately \$45,000 from vending machine income.

Mr. HARDY. Now, let's get back to what we were talking about a minute ago. The reason you are looking at these things, as a matter of fact, is that you are required to do it under the ASPR. Now, you had better study up on the ASPR. The reason that you have done it is because they are permitted to transfer company funds only for reasonable uses, isn't that right?

Mr. ABRAHAM. That is correct, sir; yes.

Mr. HARDY. Didn't the ASPR say that? How do you know they were used reasonably if you don't look at what they did with the money? Otherwise you have to take the entire \$57,000 they get out of the vending machines away from them, unless it is used for reason-

able purposes. Isn't that the reason you looked at it, yet you didn't know why you were doing it?

Mr. ABRAHAM. Well, sir, as I stated, we looked at this to try to ascertain—not to try to ascertain, but to ascertain—

Mr. HARDY. You did it, you say, because you were noseey, but you are required to do it by the ASPR. At least that is the way I read it.

Anyway, so far as you know, there has never been any exception taken to anything that has been done with company funds or with vending machine funds which were contributed to the club, no question raised about it?

Mr. ABRAHAM. Insofar as I know, sir; no. But as I stated at the start—

Mr. HARDY. There may have been no reason for it, and I don't want to suggest there was. I am trying to develop what the fact is.

Mr. ABRAHAM. I understand, sir.

Mr. HARDY. Mr. Pike.

Mr. PIKE. On a somewhat different subject, Mr. Abraham, of the total amount spent other than the Disneyland outing for the Azusa plant which was under your jurisdiction, roughly half was in the form of gifts and turkeys. Can you tell me how much of that was turkeys and what the other gifts were?

Mr. ABRAHAM. This would be—let's see, we are speaking about the year 1963, now, aren't we?

Mr. PIKE. I don't know. This is the statement of the GAO saying a 12-month period in 1962 or 1963. This is the year in which the total for gifts and turkeys at the Azusa plant of the Aerojet-General Corp., which is under your jurisdiction, amounted to \$41,000.

Mr. ABRAHAM. All right, sir. Our audit of the costs for that year as I stated before is not complete. We have started our review, and to the best of my knowledge at this point in time this amount was expended for turkeys given at Christmastime.

Mr. PIKE. Now, since the only criteria which you use is as long as the expense is for the benefit of their employees and families, what is the reasonable expense for turkeys to employees at Christmastime?

Mr. ABRAHAM. I would state, sir, that due to the contractor's long practice which, if I am not mistaken, dates back to the time it was founded, of each year giving a Christmas turkey to each employee, and as long as the price paid for each bird given to each employee appears to be a reasonable market price per pound, I would say that the amount booked by Aerojet in this case is a reasonable cost.

Mr. PIKE. We have only two companies listed on this sheet—Aerojet and Hughes Aircraft—and they both happen to be out in California. I am interested in knowing why it costs Aerojet \$8 per employee for a Christmas turkey and only costs Hughes \$5.50. This might sound like chickenfeed, but it happens to amount to a difference of over \$10,000 so far as Aerojet is concerned.

Mr. ABRAHAM. The only thing that I can think of here would be in the average weight, perhaps, of the birds themselves.

Mr. PIKE. But as far as you are concerned, there isn't going to be any limitation on the weight, and if Aerojet wants to give them \$8 turkeys, you are not going to pay any attention to whether that is reasonable or not?

Mr. ABRAHAM. Well, Aerojet always has given a turkey each year—

Mr. PIKE. A good-sized turkey.

Mr. ABRAHAMS. One that weighs approximately 20 pounds. This has been their practice.

Mr. PIKE. There is an awful lot of turkey in this program, Mr. Chairman, and I will stop right there.

Mr. HARDY. As a matter of fact, isn't it true that if the individual happened to be single, instead of giving them a turkey, they gave them \$8? Do you know whether that is so?

Mr. ABRAHAMS. Well—

Mr. HARDY. Either you know or you don't.

Mr. ABRAHAMS. I know that there have been cases of this at the plants where I have audit cognizance, but this has not been at the option, ever, of the employee, himself. If there happened to be a small group of men stationed miles away from the main plant where it would be impractical to send down a large bird like this—

Mr. HARDY. They don't send them down live, do they?

Mr. ABRAHAMS. No, they aren't alive—they are frozen, but in that case Aerojet will give cash instead when employees are stationed too far out from the plant. I know of no instance there where the employees had an option to take cash or meat.

Mr. HARDY. So that a bachelor stenographer who doesn't have any family, living by herself, had to take that 20-pound turkey whether she wanted it or not?

Mr. ABRAHAMS. Or not take it.

Mr. PIKE. Mr. Chairman, if I might say one more thing to put this in perspective. I suspect if Aerojet, instead of giving a Christmas turkey gave a Christmas bonus, there wouldn't be much question whether it was allowable as a company expense, would there?

Mr. ABRAHAMS. I would first want to go back and look over ASPR and other applicable instructions, but if they gave every employee a bonus of about \$7.50 or \$8, I can't honestly say, sir, what we would do about it at this time. We haven't been faced with that.

Mr. HARDY. It would be a little hard to include it as overhead, wouldn't it—or would it?

Mr. PIKE. I don't think so, Mr. Chairman. I think we have been a little unkind to Aerojet here. It seems to me that if they decided that for the month of December they were going to give all their employees a 1-percent raise, and that this was the salary they were going to pay—

Mr. HARDY. Wouldn't that have to go into direct labor?

Mr. PIKE. That is direct labor that costs the Government the same thing. I don't get too excited about the Christmas turkey thing, I really don't. I think it is kind of abusing the way that these different companies use different techniques—this is what I think is wrong. I think that there is no uniformity to it whatsoever. I think it is unfair to the companies—I don't think they know what they can legitimately do or what they may not legitimately do. I think the regulations are fuzzy and hazy—

Mr. HARDY. Feathery.

Mr. PIKE. Yes, very feathery. The test of reasonableness which you have in your mind I don't think really amounts to anything, and I think that the regulations are lousy, and I don't know but what maybe the companies as well as the Government would be better off if we cut it all out and let it go to direct labor costs and stop this.

Mr. HARDY. I suppose we could make a recommendation of that kind.

Mr. Reddan.

Mr. REDDAN. Just one question. Did you approve the 1962 Disneyland trip—the cost of that?

Mr. ABRAHAM. The 1962 Disneyland trip was included in the Aerojet Corp. Downey plant overhead claim for the year 1962. That plant is not under my cognizance.

Mr. REDDAN. Oh, I am sorry.

Mr. ABRAHAM. But before the audit was completed, Aerojet withdrew that claim.

Mr. HARDY. Just one other question. I asked you some questions earlier about the length of time it takes to complete one of these audits that you make. You indicate that you only have eight auditors, I believe it is eight subordinates. Is a part of the delay due to the lack of personnel, is it due to incompetence of the personnel, or due to other facts, in your opinion?

Mr. ABRAHAM. Are we speaking about the year 1962?

Mr. HARDY. That is right.

Mr. ABRAHAM. All right, sir. A group of things happened. One thing, it would help, naturally, if we had more auditors. Of course, this also has to be weighed against the cost of hiring more auditors, but, yes, it would help me. Second, we have in the last 6 months spent well over half of our time, our audit hour time, in having to do audit work other than overhead audit—such things as pricings and reviews of costs claimed in other areas and cost reduction reviews, and these things take time.

Also, too, one major item now holding up our 1962 overhead audit is the review of the company aircraft operations for 1962. We had just started a review of a large group of contractor-prepared worksheets which may provide a good starting point and decrease our audit time, when the contractor came and got them all back because he had to ship them all up to the GAO in Sacramento. We haven't gotten them back yet.

Mr. HARDY. You can blame that on us, but if you had done this more promptly you would have it out of the way before GAO got to it, because they haven't been in it very long.

It seems to me a shame to be this far behind in an audit, we are talking here about an audit for the fiscal year ended November 30, 1962. You are almost 2 years behind in getting this thing out, and it doesn't make any sense to me at all either from the Government standpoint or from the standpoint of the company. It seems to me it is not fair.

If there is something wrong with your personnel situation, maybe some steps ought to be taken to straighten that out. If it is just due to somebody's delaying tactics, or if Aerojet didn't supply you with information soon enough, it looks to me like you might have a responsibility to look into that a little yourself.

Mr. ABRAHAM. I have been, sir.

Mr. HARDY. So we don't have this thing continuing forever. It is not a good situation at all.

Let the committee stand adjourned to reconvene at 2 o'clock.

(Whereupon, at 12:20 p.m., the subcommittee adjourned until 2 p.m., the same day.)

AFTERNOON SESSION

Mr. HARDY. The subcommittee will come to order.

I think we would like to have Mr. J. A. Mahoney and Mr. L. R. Wold come up now, please.

Mr. Mahoney, will you give the reporter your name, your present title, and what you do, and then if Mr. Wold will do the same thing.

TESTIMONY OF JOHN A. MAHONEY, RESIDENT AUDITOR, AND LEONARD R. WOLD, CHIEF, CONTRACTS DIVISION, AIR FORCE PLANT REPRESENTATIVE'S OFFICE, SACRAMENTO, CALIF., ASSIGNED TO AEROJET-GENERAL CORP.

Mr. MAHONEY. John A. Mahoney, 4805 Thor Way, Carmichael, Calif., U.S. Air Force resident auditor, Aerojet-General Corp., Sacramento, Calif.

Mr. HARDY. How long have you been doing that work, Mr. Mahoney?

Mr. MAHONEY. Twelve years.

Mr. HARDY. And are you a CPA?

Mr. MAHONEY. No, sir.

Mr. HARDY. Mr. Wold, will you give us similar information, please, sir?

Mr. WOLD. Leonard R. Wold, 4356 Morpheus Lane, Sacramento, Calif., chief of the contracts division, Air Force plant representative's office, Aerojet-General Corp., Sacramento.

Mr. HARDY. How long have you been in that job, Mr. Wold?

Mr. WOLD. Approximately 16 months, sir.

Mr. HARDY. And what was your previous work?

Mr. WOLD. I was administrative contracting officer in the same office.

Mr. HARDY. This was just a promotion?

Mr. WOLD. Yes, sir.

Mr. HARDY. Mr. Reddan.

Mr. REDDAN. Mr. Wold, is there a chain of command between you and Mr. Mahoney? In your office setup, do you report to him or does he report to you?

Mr. WOLD. No, sir; we are under two separate commands.

Mr. REDDAN. Do you in any way supervise or oversee the end product of Mr. Mahoney's shop?

Mr. WOLD. I do not supervise it. I do review it.

Mr. HARDY. Review it for what? We have been using this term "review" around here. I review a newspaper, but it doesn't do anybody any good but me.

Mr. WOLD. Mr. Mahoney and I work together, sir, in the final settlement of prior year overhead in reviewing and determining disallowances and allowances of costs.

Mr. HARDY. After you review his work, just what do you do? Do you get together and confer, or what?

Mr. WOLD. Yes, sir; we have what is known in the Sacramento plant as a method of settlement of prior year overhead by audit determination, a method whereby the auditor, after he has received the contractor's claim, reviews the contractor's accounts and determines those items which are unallowable.

Mr. HARDY. Mr. Mahoney does the auditing and he submits his reports to you. Then you decide from his report what you propose to allow and what you propose to disallow. Is that right?

Mr. WOLD. That is correct.

Mr. HARDY. What brings you into contact with him? You already have his report, it is furnished, an audit report furnished to you for your guidance in administration of the contract; is that right, or what is it for?

Mr. WOLD. It is not an audit report as such, sir. I would like to refer this to Mr. Mahoney, as to actually what his report is.

Mr. HARDY. What is it?

Mr. MAHONEY. We have a set of workpapers showing what tests we have made, what our conclusions are or possibly what our tentative conclusions are in some areas. I bring them in to Mr. Wold, sit down with him, and say "This is what we found."

Mr. HARDY. You bring them in and sit down with him, or do you just send them to him?

Mr. MAHONEY. We bring them in, usually, by way of introduction, and when we leave, he may request us to leave some of the papers or all of them.

Mr. HARDY. If this is not an audit report, just what is it?

Mr. MAHONEY. Well, very technically in our language an audit report is a formal report that is signed and has certain procedures of distribution and that kind of thing. This audit reporting comes into being in one type—

Mr. HARDY. This is not what that is?

Mr. MAHONEY. That is correct; it is not.

Mr. HARDY. All right, what is this, then? What do you call this thing that you turn in there? If it is not an audit report, what in the Sam Hill is it?

Mr. MAHONEY. Workpapers which become the basis of a discussion.

Mr. HARDY. I am still having a little trouble. What does your job description call for you to do? What do you do?

Mr. MAHONEY. We review, among other things—

Mr. HARDY. You are reviewing and Mr. Wold is reviewing, now.

Mr. MAHONEY. I am sorry.

Mr. HARDY. Well, that is all right, but I don't know what it is. They don't mean the same things, apparently—the same word but it doesn't mean the same thing.

Mr. MAHONEY. We examine the contractor's accounts, the underlying transactions; we make tests of the system.

Mr. HARDY. Can you supply a copy of your job description?

Mr. MAHONEY. Yes, sir; I can. I don't have it with me.

Mr. HARDY. And I would like to have yours, too, Mr. Wold. I would like to know what you are supposed to do—if you won't tell me what you are supposed to do, at least in language that I can readily understand.

(The Department of the Air Force subsequently submitted the following job descriptions for Messrs. Mahoney and Wold:)

PRINCIPAL DUTIES OF JOHN A. MAHONEY, AIR FORCE RESIDENT AUDITOR, AT AEROJET-GENERAL CORP., SACRAMENTO, CALIF.

As resident auditor is responsible for audit activities under Air Force, Army, Navy, and other governmental contracts held by the Aerojet-General Corp.,

Sacramento, Calif. Plans, manages, and, through subordinate supervisors, directs complex audits of incurred costs and evaluation of forward pricing proposals. These efforts involve a wide range of contract values up to multi-million-dollar-type contracts including incentive formulas for a variety of missile and space propulsion systems. The magnitude of audit operations currently involve the examination of annual costs in excess of \$425 million under approximately 400 contracts for all services. Supervision is exercised over 22 qualified professional auditors and 2 clerical personnel.

Major duties encompass the following:

(a) In an independent professional capacity advise contracting officers on financial and accounting matters.

(b) Ascertain allowability and allocability of costs claimed, giving consideration to ASPR provisions, contractual terms, and generally accepted accounting principles.

(c) Evaluate proposals for repricing incentive contracts, contract changes, and forward pricing for new contracts.

(d) Survey contractor's financial management practices and procedures.

(e) Determine adequacy of contractor's internal controls.

(f) Selectively examine transactions and/or observe cost practices. In this connection, auditors may employ scientific sampling, professional judgment, automatic data processing programs, advanced correlation analyses techniques, etc., to evaluate existing or proposed changes to existing conditions.

(g) Seek, through responsible administrative contracting officers, corrections of deficiencies such as weak administrative controls, defective accounting systems, poor methods of cost estimating, and other aspects of contractor management which may warrant aggressive cost reduction efforts.

The auditor's services to Air Force procurement are advisory in nature. As in public accounting, the concept of full disclosure of material facts is employed. Certain overhead accounts, for example, are much more sensitive as to their allowability under Government contracts. Travel expense accounts may contain unallowable entertainment and use of first-class airplane transportation where more economical accommodations are available. Facts of this nature are reported to and closely coordinated with contracting officers for their consideration in settlement of overhead claims.

PRINCIPAL DUTIES OF LEONARD R. WOLD, CHIEF, CONTRACT DIVISION, AT
AEROJET-GENERAL CORP., SACRAMENTO, CALIF.

As Chief of the Contract Division and principal warranted ACO, has total managerial responsibility for all contract administration functional activities and decisions. Plans and manages, and through subordinate supervisors, directs the work of two branches: the Contract Branch and Pricing, and the Financial Analysis Branch. Duties involve administration of 105 Government contracts with an annual cost in excess of \$223 million.

The more important duties of this position as a principal administrative contracting officer are:

(a) Review and approve wage and salary schedules within limitations established by any Federal wage or stabilization board in connection with cost-reimbursement contracts.

(b) Approve employee insurance plans and costs connected therewith.

(c) Approve contractors accounting system for cost-reimbursement-type supply contracts. (Rates are accepted by Air Force, Army, Navy, and NASA.)

(d) Negotiate provisional projected overhead rates for bidding purposes. (Rates negotiated are accepted by Air Force, Army, Navy, and NASA.)

In the performance of aforementioned duties there is a coordination between the principal ACO and the resident Air Force auditor. This coordination is maintained particularly in cost areas relating to (c) and (d) above. For example, in the settlement of prior year overhead by the "audit determination" method, the contractor submits his claim for reimbursement and the Air Force auditor examines in detail the various accounts which constitute the claim and set out those items which he deems questionable or unallowable. The result of the auditor's examination and analysis are provided the principal ACO. Specific items set out by the auditor as well as other items which come to the attention of the principal ACO, are evaluated by the principal ACO for determination of allowability; i.e., reasonableness and allocability. Additional assistance, as appropriate, is provided the principal ACO by other Air Force divisions and offices

such as production quality control, JAG, and other interested activities in arriving at his determination. When the principal ACO has arrived at his position (determination) on the questionable and unallowable items of cost, he and the auditor meet with the contractor to explain the reasons for disallowance and to obtain the contractor's response. Following the meeting a "notice of cost suspended or disapproval" (DD form 396) is issued listing all unallowable costs which are set off against the contractor's claim. Any resulting dispute is subject to appeal by the contractor in accordance with contract terms.

Mr. REDDAN. Who makes the final determination in allowances or disallowances between you two gentlemen?

Mr. WOLD. I make the final determination.

Mr. REDDAN. So that in the chain of command, if there were a chain, you would be the superior officer, is that right?

Mr. WOLD. You might say that, sir.

Mr. REDDAN. Well, would you say that?

Mr. WOLD. I believe this is in the contract provisions, sir, that the contracting officer will make the determination of allowability.

Mr. HARDY. The contracting officer does have that responsibility. The only thing that presumably Mr. Mahoney is doing is furnishing you with the tools on which you are supposed to act?

Mr. WOLD. That is correct. He is my financial adviser, so to speak.

Mr. REDDAN. Now, do you know whether or not other Air Force teams operate on this audit determination basis?

Mr. WOLD. I understand there are several others that work on that basis, sir.

Mr. REDDAN. If you didn't operate on that basis, what basis would you operate on?

Mr. WOLD. We would work under the negotiated method set forth in part 3, section 7 of ASPR, I believe it is, sir.

Mr. HARDY. I am having a hard time hearing. Can you speak a little louder?

Mr. REDDAN. Who makes the determination as to what system you shall follow?

Mr. WOLD. The contract dictates this, sir.

Mr. REDDAN. And who dictates the terms of the contract?

Mr. WOLD. Procuring activity and public law, ASPR.

Mr. REDDAN. In this case it would be the Air Force?

Mr. WOLD. Yes, sir.

Mr. REDDAN. Now, does the ASPR specifically provide for a system known as audit determination?

Mr. WOLD. It does speak of this in section 3, part 7. I believe it does refer—and if I may, I will read that portion—

Mr. REDDAN. The thing I am trying to find out, Mr. Wold, is why some teams operate in one fashion and other teams operate in another. You say it is dictated by the contract document or the procuring authority, and in this case the Air Force apparently establishes different methods at different locations, and I am just trying to understand why that is so.

Mr. WOLD. Well, sir, I have never worked under the triservices, or negotiated method. I believe that a contractor is selected to go under this type of audit determination—I shouldn't call it audit determination, but this type of negotiated overhead.

Mr. REDDAN. Do you know whether this has any advantages over the other system?

Mr. WOLD. I have heard pros and cons on it, sir, but I do not know.

Mr. REDDAN. You are located at the Sacramento office?

Mr. WOLD. Yes, sir.

Mr. REDDAN. Are you familiar with the activities and operations of the employee welfare organization in the Sacramento organization?

Mr. WOLD. Yes, sir.

Mr. REDDAN. Do you audit the records and the activities of that group?

Mr. WOLD. I do not audit them, sir.

Mr. MAHONEY. I would like to point out that I am the auditor, Mr. Reddan.

Mr. REDDAN. Do you audit them, Mr. Mahoney?

Mr. MAHONEY. Our setup is a little bit different there in that the welfare and recreation club is not the one that receives the vending machine receipts. It is the company. The company does not turn them over. However, they do spend the money on behalf of the employees. There is a welfare and recreation club that is a small activity supported by dues, but we do not examine the books of the welfare and recreation club.

Mr. HARDY. Is that supported at all by contributions from the corporation?

Mr. MAHONEY. They do furnish the facilities for their meetings and activities.

Mr. HARDY. There is no financial contribution from the corporation?

Mr. MAHONEY. Other than the facilities; no.

Mr. HARDY. How does the corporation handle the receipts from the vending machines?

Mr. MAHONEY. The receipts are credited to the overhead account. The expenditures on behalf of welfare and recreation are also charged to that account, so it is not turned over.

Mr. HARDY. And do they balance out?

Mr. MAHONEY. In 1963, there was an excess of \$20,000 which was not spent which was credited to overhead.

Mr. HARDY. In the sheet that I have before me prepared by the General Accounting Office, it shows that total receipts from vending machines in this particular 12-month period was \$315,000, and it shows expenditures for recreation by the contractor at \$315,000. Now, is that the total that the contractor expended for recreation?

Mr. MAHONEY. That is substantially what they spent for recreation. However, there was some additional receipts which I don't believe your table shows. We had receipts—

Mr. HARDY. Well, this was purely from vending machines that I was talking about there.

Mr. MAHONEY. There is also an item from the industrial lunch wagons.

Mr. HARDY. What is that?

Mr. MAHONEY. Industrial lunch wagons. They have a license to drive in the plant and sell sandwiches outside the gates. They contribute about \$9,000, and there was some miscellaneous receipts that amounted to about the same amount, so that was a total credit to the overhead account in 1963 of about \$20,000.

Mr. HARDY. What happened to that?

Mr. MAHONEY. That was credited to the overhead account, and was credited along and commingled along with the rest of the overhead costs and distributed to contracts.

Mr. HARDY. Well, in the schedule of the recreation and morale expenses, this tabulation shows a loss on food service of \$205,000. Are you familiar with these figures?

Mr. MAHONEY. Yes, sir; that is substantially correct.

Mr. HARDY. It shows gifts and turkeys, \$143,000. Athletic and club activities, \$311,000, or a total of \$359,000.

Now, what is the relationship between this figure and the \$315,000 that was collected from the vending machines?

Mr. MAHONEY. The cafeteria loss represents the indirect expenses of operating the cafeteria. The cafeteria made \$14,000 on the food alone, and the labor cost of serving it. Then added to that are the depreciation, the maintenance costs, supplies, and other costs which can be, under some accounting methods, allocated to the food service. All of those costs went into the indirect accounts.

Mr. HARDY. Mr. Reddan.

Mr. REDDAN. Mr. Mahoney, Aerojet submits to you a document known as "Cafeteria Income Statement," is that right, sir?

Mr. MAHONEY. We receive it; yes.

Mr. REDDAN. Do you have the statement there for the month of November of 1963?

Mr. MAHONEY. Yes.

Mr. REDDAN. What does that show for 1963 as of November with respect to profit or loss?

Mr. MAHONEY. The one I have is not quite \$205,000. Is that the one you have—it shows \$199,000?

Mr. REDDAN. The one I have before me here shows a profit of \$71,877.

Mr. MAHONEY. I am sorry, I don't have that.

Mr. HARDY. Maybe we don't have yours.

Mr. MAHONEY. No; I think probably we are talking about the same one, but I have the most current one. Mine is labeled "AGC Form 1322."

Mr. REDDAN. Mr. Woods is showing you the document to which I was referring.

Mr. MAHONEY. I am sorry; I didn't have that with me.

Mr. REDDAN. Do you have a copy of that with you, sir?

Mr. MAHONEY. Yes; Mr. Wold has it.

Mr. REDDAN. Referring to that column which gives the position of the company in the cafeteria income as of November, what does that show as to profit or loss?

Mr. MAHONEY. It shows a net profit current year to date of \$71,877.

Mr. REDDAN. Did you make any audit of the cafeteria income at the time you received this statement?

Mr. MAHONEY. I believe it is a matter of record that we have not completed our audit yet, but I am aware of the report, and generally what goes into it; yes, sir.

Mr. REDDAN. Were you advised by the company as to the policy with respect to pricing of cafeteria items?

Mr. MAHONEY. I am not able to state whether I was advised by the company, but we have their policy, yes, sir.

Mr. REDDAN. I have before me a document dated December 1, 1963, entitled "Cafeteria," which was issued by the Controller Division of Aerojet-General. Do you have that document with, sir?

Mr. MAHONEY. Yes.

Mr. REDDAN. Under paragraph 2, would you please read the provision with respect to prices?

Mr. MAHONEY. "Prices are designed to provide a break-even operation."

Mr. REDDAN. Have you made any audit to determine whether or not this policy was being adhered to in the cafeteria pricing?

Mr. MAHONEY. Sir, there is a difference—if I could quote the company, and I would prefer they would do that, but if I might quote them, they say in this break-even they are there referring to the food cost and the labor cost in serving it.

Mr. REDDAN. Well, what did you think they meant—not what they told you, but what did you think they meant?

Mr. MAHONEY. I take—

Mr. HARDY. You are an accountant, you know how the numbers are kept, and Aerojet-General knows how to keep them, too.

Mr. MAHONEY. Yes, sir; but there are many different ways of treating the same thing in accounting.

Mr. HARDY. But you don't come up with a \$71,000 profit on the one hand, and then turn around and say, "No, I am sorry, we have a \$219,000 loss." There is something funny about that kind of operation.

Mr. MAHONEY. It is no surprise to us, sir, we are perfectly aware of this.

Mr. HARDY. You are aware of this?

Mr. MAHONEY. Yes.

Mr. HARDY. But you didn't say anything to Aerojet-General about it until after GAO called your attention to it back in June of this year. It doesn't make any difference to you, is that what you are saying?

Mr. MAHONEY. I don't agree, sir, that that is a true statement.

Mr. HARDY. Well, there is a memorandum written by Mr. Wold, maybe he knew about it, to Aerojet-General dated June 19, 1964, which calls attention to this sort of situation, and there are some rather revealing comments in that memorandum which you wrote, Mr. Wold.

Mr. WOLD. Yes, sir.

Mr. HARDY. Why did you write that?

Mr. WOLD. Sir, the first I became aware of the loss was when I received the GAO report.

Mr. HARDY. Now, Mr. Mahoney is sitting down there saying he knew it all the time, and you just told us that you talked to Mr. Mahoney about these things. It looks to me like your communications have broken down, or you are not talking about the same thing—one. Frankly, I don't appreciate this kind of testimony gentlemen. Mr. Mahoney knew all about this all the time, but you didn't. I think this is a rather revealing document.

Do you have a copy of your communication dated June 19 to Aerojet-General?

Mr. WOLD. Yes, sir.

Mr. HARDY. Would you mind reading it into the record, please, sir?

Mr. WOLD. Yes, sir.

Mr. HARDY. Your testimony doesn't do you credit, Mr. Mahoney, on this point, in my book.

Mr. WOLD. This is a letter, entitled "Cafeteria Income Statement," to Mr. M. D. Joelson, comptroller, Aerojet-General Corp., Sacramento, dated June 19, 1964:

1. A recent GAO survey made on the operation of your cafeteria places the value of your monthly cafeteria income statement in a questionable area. The GAO survey for the year ending November 30, 1963, shows your cafeteria operation at a net loss of \$219,000, which is approximately 20 percent of your cost of cafeteria sales. Yet, in reviewing your monthly cafeteria income statement, the conclusion would be that for fiscal year 1963 your cafeteria operation was conducted at a slight profit. It is apparent that the total cost of operating the cafeteria is not reflected in your cafeteria income statement.

2. Where ASPR 15-205.14 provides: Reasonable losses from an operation from such services are allowable * * *, it is certainly questioned by this office why a "loss" method of operation should be sustained where it could be avoided. In this same vein, it is noted that your corporate accounting policy states: "Prices are designed to provide a break-even operation."

3. In comparing the GAO survey with your monthly statements, it is apparent that such items as maintenance, overhead (utilities, tax, depreciation, etc.) and all employee fringe benefits are not included or considered in your total operating expenses in your cafeteria income statement. In order for this statement to be an effective management tool and a medium for controlling cafeteria operation cost, this statement should portray the true picture of your cafeteria operation. It is, therefore, requested that favorable consideration be given by your office to issuing future monthly statements depicting the total true cost of operating the cafeteria and the net profit and loss resulting therefrom. It is also requested that a year-to-date operating statement be provided this office for fiscal year 1964 depicting the total cost of cafeteria operations through June 30, 1964.

4. This item will come under close scrutiny by this office in future overhead bidding rate negotiations, as well as settlement of prior-year overhead, and if not controlled may result in overhead disallowances.

Mr. MAHONEY. Mr. Chairman, may I state something here—

Mr. HARDY. Yes, if you can state something to clear up your position on this, because it doesn't look good to me.

Mr. MAHONEY. The contractor's accounting records which are available for us to examine contain the complete costing of the cafeteria, including the direct and the indirect costs. The statement which Mr. Wold received was a partial takeoff of that, but the contractor's records do have the complete cost record.

Mr. HARDY. Well, it apparently didn't mean anything to you. If it did, you have failed to give us any evidence of it, and you certainly didn't convey it to Mr. Wold.

Mr. MAHONEY. Sir, our 1963 is not yet settled, and at the proper time we certainly intend to discuss this together with the other items of the 1963 overhead.

Mr. HARDY. Are you suggesting that there was a different method of accounting in 1962 which has been settled, or has it been settled?

Mr. MAHONEY. 1962 has not, either.

Mr. HARDY. You are as far behind as the gentleman who was here this morning.

Mr. MAHONEY. I am afraid so, sir.

Mr. REDDAN. How about 1961?

Mr. MAHONEY. For 1961, the same system was followed. I asked it; I was aware of the amount of the loss, and I did not question it. Mr. Wold was not the ACO at that time, but I did not question the amount.

Mr. REDDAN. Did you tell his predecessor in office about the amount?

Mr. MAHONEY. The matter was discussed, yes.

Mr. HARDY. This matter of \$205,000 is of no consequence to you. This bothers me and bothers me seriously, and you, an auditor—

Mr. MAHONEY. I am sorry if I conveyed the feeling it was of no consequence to me—

Mr. HARDY. Well, you sure did.

Mr. MAHONEY. Because it certainly is of consequence.

Mr. PIKE. In 1961, the audit of which has been completed, did it show a food-service loss?

Mr. MAHONEY. Yes, of \$168,000.

Mr. PIKE. Was the food-service loss shown at that time on the monthly statements of the corporation which you got, the same monthly statements regarding which Mr. Wold just wrote them recently?

Mr. MAHONEY. It was the same as it is now. The contractor's records—in other words, there is a separate column in the ledger which shows "Cafeteria," and that has all the costs. However, the statement, this particular statement, shows only the direct costs of the cafeteria in operation.

Mr. PIKE. So in 1961, as in 1962 and 1963, the contractor in his monthly statements was not showing this loss which the GAO picked up recently?

Mr. MAHONEY. Not in the monthly statement; that is correct.

Mr. PIKE. And as this loss was entered at the end of the year, was it listed as a food-service loss, or were these indirect expenses put into the general overhead of the company; depreciation, and so forth?

Mr. MAHONEY. It was separately identified, but in the general ledger with all the other cost objectives.

Mr. PIKE. So you didn't show a food service loss of that kind in this manner?

Mr. MAHONEY. You would have to look for it, yes.

Mr. PIKE. And unless you knew it was there, you wouldn't find it even if you looked for it.

Mr. MAHONEY. You would have to know how to look for it.

Mr. HARDY. The entire amount of this loss is reflected in the claim for reimbursement in overhead, isn't it?

Mr. MAHONEY. For 1961; yes, that is correct.

Mr. HARDY. Oh, for 1961, 1962, or 1963—as a matter of fact, you expect to have this \$205,000 that we are talking about now to be included in their overhead costs.

Mr. MAHONEY. Well, the contractor hasn't submitted it, sir, so that would only be conjecture.

Mr. HARDY. I said you would expect—based on past experience. He did submit one for 1962, didn't he?

Mr. MAHONEY. Yes.

Mr. HARDY. And he did include that amount in there, did he not?

Mr. MAHONEY. Yes, sir.

Mr. HARDY. Go ahead.

Mr. REDDAN. I would like to come again to the matter of the Christmas turkeys. It is my understanding that Aerojet bought the turkeys for the entire organization through the Sacramento office. Is that correct, sir?

Mr. WOLD. I am only aware that they bought turkeys, Mr. Reddan, for the Sacramento plant.

Mr. REDDAN. They purchased approximately \$238,000 worth of turkeys through the Sacramento plant. Do you have the figures on that?

Mr. WOLD. I believe that is correct.

Mr. MAHONEY. I am sorry, I didn't hear the question.

Mr. REDDAN. I say the information I have is that \$238,000 worth of turkeys for distribution at Christmas time were purchased last year through the Sacramento office of Aerojet.

Mr. MAHONEY. I think that is just the total amount purchased by the corporation, but I don't know whether they were all purchased there or purchased separately, and that represents the total.

Mr. REDDAN. Do you know the dollar volume of the turkeys distributed in the Sacramento plant?

Mr. MAHONEY. Yes, sir. In 1963, there were 18,862 employees who received turkeys at Sacramento.

Mr. REDDAN. How many, sir?

Mr. MAHONEY. 18,862.

Mr. REDDAN. And do you know how many turkeys were purchased for distribution in Sacramento?

Mr. MAHONEY. I am sorry. The 18,862 were distributed. Those that remained after distribution were disposed of.

Mr. REDDAN. Do you know how many were not distributed to employees?

Mr. MAHONEY. I am not sure I understand. Do you mean those that were distributed to others, or those that were returned for credit?

Mr. REDDAN. As I understand, these were purchased for the employees—the turkeys were purchased originally as a morale-building effort by Aerojet. Now I want to know if they bought more turkeys than they needed, and, if so, what did they do with them.

Mr. MAHONEY. It is my understanding that they ordered the turkeys considerably in advance in anticipation of a certain personnel level at that time, so that they did not come out precisely; there were some additional. I believe your report shows there were some additional turkeys distributed to nonemployees, and I do not have that figure for 1963. There were other turkeys which were sold, I believe your report says, to a supermarket.

Mr. REDDAN. Do you know whether or not the turkeys were sold at cost or below cost—that is, the turkeys which were sold to the supermarkets?

Mr. MAHONEY. I believe it was somewhat less than they paid for them.

Mr. REDDAN. Do you have any figures on that?

Mr. MAHONEY. I am sorry, I don't. I think it was in the neighborhood of 4 or 5 cents a pound.

Mr. REDDAN. 4 or 5 cents a pound below what they paid?

Mr. MAHONEY. Yes.

Mr. REDDAN. Do you know the size of the turkeys? Were these 20-pound turkeys?

Mr. MAHONEY. Yes.

Mr. REDDAN. So it would be approximately a dollar.

Mr. MAHONEY. Yes. I am trying to remember that.

Mr. REDDAN. Could you submit those figures?

Mr. MAHONEY. Yes, sir.

Mr. HARDY. I believe you said that 18,862 turkeys were distributed. Now, does that represent the entire employee roll at the time?

Mr. MAHONEY. No, sir; there were 392 other employees who received cash.

Mr. HARDY. How much cash did they receive?

Mr. MAHONEY. The record shows—and this does not jibe—I am giving you the contractor's figure. They say it was \$996.

Mr. HARDY. \$996 for 392 people—that is less than \$3 apiece. They didn't get much.

Mr. MAHONEY. I don't believe that figure is correct.

Mr. HARDY. They would have been better off to take the turkeys.

Mr. MAHONEY. These were people who were unable to pick up the turkeys because they were off-site or weren't at work that particular day.

Mr. HARDY. How did they get the \$3 apiece?

Mr. MAHONEY. They were paid by check.

Mr. HARDY. I mean if they weren't there to get the turkeys, they couldn't have gotten the check.

Mr. MAHONEY. The people that were located at various sites there; there were people in all parts of the country—they mailed checks to some of those that couldn't pick up one in person.

Mr. HARDY. So they mailed them a check. Mr. Reddan says he heard somewhere it was around \$7 apiece. If it was \$7 apiece, it would amount to more than the \$996.

Mr. MAHONEY. Yes, it would. These figures were furnished to me by the contractor.

Mr. PIKE. Is this representative, Mr. Mahoney, of the type figures that are furnished to you by the contractor?

Mr. MAHONEY. I would not say so, sir, no.

Mr. PIKE. I would hope not.

Mr. HARDY. I want to inquire about this athletic and club activities and related administrative cost of \$311,000. What does that represent?

Mr. MAHONEY. This is the cost of operating the recreation center at the Sacramento site.

Mr. HARDY. What is it, a country club?

Mr. MAHONEY. I would kind of liken it more to, say, an officers' or NCO club at a base, without the bar, without the food.

Mr. HARDY. You mean they don't have a bar?

Mr. MAHONEY. No, sir.

Mr. HARDY. What do they do for their refreshments? What do they do for their liquid refreshment?

Mr. MAHONEY. They have Coke machines. It is on company property, and there is a company rule against alcohol on the company premises.

Mr. HARDY. No alcohol on the company premises at all?

Mr. MAHONEY. None officially. I couldn't be sure there wasn't some, people being what they are.

Mr. HARDY. This total expense apparently was included in the amount which was expected to be reimbursed by the Government, the total cost of running the club—if this is what this \$311,000 is, \$205,000 which turned out to be the loss, depreciation, maintenance, and what

have you on food services, and the \$143,000 worth of turkeys—all of that is included in what they expect to be submitted as a claim.

Mr. MAHONEY. Less the amount of the proceeds from the vending machines, sir.

Mr. HARDY. Since the total amount from vending machines went into the company for reuse, here, the entire remainder of the cost is included in the amount to be reimbursed.

We will take a brief recess while we go answer the rollcall. We will be back very shortly, when we would like to have Mr. Krantz and Mr. Deardorff.

Thank you very much, gentlemen.

(A short recess was taken.)

Mr. PIKE. Mr. Hardy has asked me to proceed with this hearing. He will be back in just a couple of minutes.

Do we have Mr. Krantz and Mr. Deardorff here now?

Mr. KRANTZ. Yes, sir.

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. Would you start, both of you, by giving your residences and your proper titles to the stenographer?

TESTIMONY OF CHARLES E. DEARDORFF, PROCUREMENT ANALYST, HEADQUARTERS, AIR FORCE SYSTEMS COMMAND, WASHINGTON, D.C.; AND MARTIN KRANTZ, AIR FORCE RESIDENT AUDITOR, CULVER CITY, CALIF., ASSIGNED TO HUGHES AIRCRAFT CORP.

Mr. DEARDORFF. Charles E. Deardorff. I am a procurement analyst at Headquarters, AFSC. My residence address is 6116 Calvin Court, Oxon Hill, Md.

Mr. KRANTZ. I am Martin Krantz, Air Force resident auditor assigned to Hughes' Culver City plant. My address is 15863 Vincennes Street, Sepulveda, Calif.

Mr. PIKE. Are you a CPA, Mr. Krantz?

Mr. KRANTZ. Yes, sir.

Mr. PIKE. And you, Mr. Deardorff?

Mr. DEARDORFF. No, sir.

Mr. PIKE. Mr. Reddan.

Mr. REDDAN. Are you two located in the same office?

Mr. DEARDORFF. No, sir.

Mr. REDDAN. Where is your office, Mr. Deardorff?

Mr. DEARDORFF. My office is at Andrews Air Force Base.

Mr. REDDAN. And where is your office, Mr. Krantz?

Mr. KRANTZ. At the Hughes' Culver City plant, sir.

Mr. REDDAN. Let me ask, Mr. Deardorff, what plant do you have cognizance of?

Mr. DEARDORFF. Well, sir. I am associated with the tri-service overhead rate negotiations. As such, my office has cognizance of tri-service negotiations with all of the contractors who may be on the tri-service overhead rate list. However, my office is responsible for conducting meetings only for those which are assigned to it as compared to those assigned to the Army or to the Navy.

The assignment of these is generally on the basis of the amount of business that each of the services has in the contractor's plant, and the predominant service usually sponsors the negotiation.

Mr. REDDAN. One of these companies is the Hughes Aircraft Corp.?

Mr. DEARDORFF. That is right, sir.

Mr. REDDAN. Would you explain briefly for the record what you mean by "tri-service"?

Mr. DEARDORFF. Yes, sir. Under tri-service, in certain instances we find it better to use the negotiated, so-called negotiated overhead rate procedure. This is set forth in ASPR 3-700. The contractors are selected for this, and, looking at 3-700, they are selected on the basis to effect uniformity of approach in cases where more than one contract or more than one military department is involved, or to effect economy in administrative effort, or to promote timely settlement of reimbursement claims.

When we find these conditions to be met, we would select that contractor for addition to the tri-service list. At that time, subsequent contracts would be written to include the tri-service overhead rate negotiation clause instead of the audit determination clause.

The method of handling these is slightly different from audit determination in that at the end of the contractor's fiscal year, he submits a claim. This is submitted to the auditor. The auditor conducts an audit of the claim, and prepares from that an audit report, and generally portions of schedules of this report are furnished to the contractor to permit him to review the questioned items. He will prepare a rebuttal—and this may be in writing—and submit that to us. At that time we will then set up a meeting to conduct the overhead rate negotiations.

All three services are invited to attend these negotiations. There will generally be a representative from each of the three services at the negotiation meeting. This is a formal meeting conducted with the contractor with the purpose of settling the items that have been set out for questioning by the auditor, as well as any others that may have come to the attention of the negotiators.

The determinations of allowable costs are made by the three negotiators working together. They are not necessarily and in fact are not the opinion of one individual, but are the opinion of the three or the majority of the three individuals.

Following completion of these negotiations, when we have reached final settlement with the contractor, the chairman—and in the case of Hughes, that would be me—will prepare a memorandum which will refer to the audit report and to the business conducted, and indicate the items that have been reinstated and the amounts.

Mr. REDDAN. What happens if you and the company can't agree?

Mr. DEARDORFF. If we are unable to agree, it would be then necessary for us to make our determination of cost and notify the contractor of that determination.

Mr. REDDAN. And then what does he do?

Mr. DEARDORFF. The contractor may accept that, or, of course, he may then enter into a dispute.

Mr. REDDAN. In which event he would go to the Board of Contract Appeals?

Mr. DEARDORFF. That is correct, sir.

Mr. REDDAN. Now, when you have agreed among yourselves—talking now about the negotiators—as to items for disallowance, at that

time do you have any discussion or communication with the Judge Advocate General's Office on these items?

Mr. DEARDORFF. We could go to the Staff Judge Advocate General about an item about which we had some question. Obviously, we could not take all items to the Staff Judge Advocate General.

Mr. REDDAN. You mean a question about what?

Mr. DEARDORFF. Well, sir, if we had not seen this type of cost before at this contractor's plant, or at other contractors' plants, we would perhaps feel the need to ask the Staff Judge Advocate General for some help and guidance in the area before making our final decision.

Mr. REDDAN. What is the Judge Advocate General's responsibility in that area?

Mr. DEARDORFF. He would be advisory.

Mr. REDDAN. But he doesn't make decisions?

Mr. DEARDORFF. No, sir.

Mr. PIKE. Mr. Deardorff, in the process of making these decisions, there is nothing in the negotiated rates section of the ASPR which changes any of the other ASPR provisions about employee welfare and entertainment; is there?

Mr. DEARDORFF. No, sir.

Mr. PIKE. You are still bound by the same ASPR provisions that everybody else is bound by throughout the country in determining what is allocable to overhead and what is not in this field of employee morale and entertainment?

Mr. DEARDORFF. Yes, sir; that is correct.

Mr. REDDAN. Mr. Deardorff, how long have you been handling the Hughes Aircraft Co.?

Mr. DEARDORFF. I believe the first one, the first negotiation with Hughes on overhead rates that I attended was the one for the 1961 fiscal year, which is a calendar year.

Mr. REDDAN. Do you have anything besides the ASPR provisions for your guidance in making determinations as to allowances or disallowances of expenditures for morale purposes?

Mr. DEARDORFF. No, sir. There is nothing other than the judgment of the individuals and the experience of the individuals who are present at the meeting.

Mr. REDDAN. What is the basis for your judgment? That is what I am trying to find out. Obviously you don't attend these functions yourself; or do you attend any of these morale functions?

Mr. DEARDORFF. No, sir.

Mr. REDDAN. How do you make the determination, sir?

Mr. DEARDORFF. The items that have been set out by the auditor are discussed in substantial detail, using the workpapers that the auditor may have as a result of his investigations, using, also, any information that may be available from our own administrative contracting officer or the other military people located at the contractor's plant.

As well, of course, we hear the presentation of the contractor and discuss with him the various aspects of these items that have been questioned, and from that, using our judgment, we make this determination.

Mr. REDDAN. I have before me a schedule which is entitled "Analysis of Account No. 852, Morale Activity, Engineering Burden Center,

GLA-6110, Hughes Aircraft, Culver City, Calif., 1962 Overhead Claim." I will ask you, Mr. Krantz, did you prepare this document?

Mr. KRANTZ. That document was prepared by the contractor for our analysis. The arrangement we have is that he prepares it and we review what he prepares.

Mr. REDDAN. This is only their analysis of their own operation of their morale account?

Mr. KRANTZ. Yes, sir.

Mr. PIKE. Mr. Reddan, before we get into that, Mr. Deardorff, in reading the purposes set up in ASPR 3-700 of the negotiated final overhead rates, it mentions—and I think you mentioned—to promote the timely settlement of reimbursement of claims. A little earlier we got some testimony to the effect that as far as Aerojet was concerned, the settlement was perhaps 2 years behind. Are you doing any better with Hughes, using your triservice system?

Mr. DEARDORFF. We had the original negotiation with Hughes in September of 1963 to settle the 1962 overhead rates. We have not been able to reach complete agreement. There are still some open items, and we are now approaching the place where we must make a determination.

Mr. PIKE. You said you had your first meeting in September of 1963 on the 1962 overhead claim?

Mr. DEARDORFF. That is right, sir.

Mr. PIKE. Was that a calendar 1962 claim?

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. When did you receive that calendar 1962 claim from Hughes?

Mr. DEARDORFF. Well, I would have received the audit report, sir, and this was what I was concerned with, rather than the claim. The auditor receives and reviews the claim before we take up any negotiation.

Mr. PIKE. Have you received the 1963 claim from Hughes yet?

Mr. KRANTZ. Yes, sir.

Mr. PIKE. So Hughes has submitted a 1962 claim and a 1963 claim, but you haven't finished settling the 1962 claim yet, is that it?

Mr. DEARDORFF. That is correct, sir.

Mr. PIKE. The timely settlement doesn't seem to be much more timely under one system than the other. Would that be a fair statement to make?

Mr. DEARDORFF. It could very well be, sir. I think that across the board we may get more timely settlements using this procedure than by using the audit determination procedures.

Mr. PIKE. Can you tell me what items you and Hughes are deadlocked on on their 1962 claim which has prevented the audit being completed?

Mr. DEARDORFF. Well, there was an item of public relations, an item of patent department expenses, and an item called "Corollary Cost."

Mr. PIKE. None of these comes within the heading of employee morale and welfare and recreation items.

Mr. DEARDORFF. No, sir.

Mr. PIKE. But all of them are under the general heading of "overhead"?

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. How long have these four issues been the focal points of this audit?

Mr. DEARDORFF. I am not sure I understand your question, sir.

Mr. PIKE. Well, these are the four issues which prevent the audit from being completed, as I understood your previous answer.

Mr. DEARDORFF. That is right, sir.

Mr. PIKE. Well, how long have these four issues prevented the audit from being completed?

Mr. DEARDORFF. Since September, sir.

Mr. PIKE. Since last September?

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. How many meetings have you had with Hughes on it?

Mr. DEARDORFF. In addition to the original formal meeting, there have been, I believe, two informal meetings and several telephone calls, sir.

Mr. PIKE. I am concerned, as the chairman was earlier, with an audit that just sort of hangs there. I have been enough in business myself to know that it is nice to get these things tied up. It doesn't seem to me that the auditing procedures of the Air Force in this regard are going to result in any different result than what we got out in California. One of these days the GAO is going to come in and check on some item, and then suddenly a lot of auditing is going to be done in a hurry, and it will get done, but it doesn't seem to me that the timely purpose set forth so eloquently in the ASPR has really been accomplished in connection with auditing Hughes Aircraft's claim.

That is all I have, Mr. Chairman.

Mr. REDDAN. Mr. Krantz, I have before me a document which is identified as "Audit Report No. 636-WE16-062-353," which is, I believe, the 1961 audit report for the Hughes Aircraft Co.

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. In there, did you question certain items which would fall in the category of "morale and welfare"?

Mr. KRANTZ. Yes, sir; I did.

Mr. REDDAN. Would you identify those for the committee, sir?

Mr. KRANTZ. Sir, exhibit B, page 3 of 9, item 13—

Mr. REDDAN. Just a moment, sir. What item did you question there?

Mr. KRANTZ. Item 13.

Mr. HARDY. Did these other items on the page really not constitute a questioning by you?

Mr. KRANTZ. No, sir. Actually this is a recommendation for consideration to the Air Force negotiator, in this case Mr. Deardorff. I might point out, sir, this is an advisory report.

Mr. HARDY. How about item 9?

Mr. KRANTZ. What is the question, sir?

Mr. HARDY. I was looking at item No. 9, but that is not one of these morale items.

Mr. KRANTZ. No, sir.

Mr. HARDY. On this item 13, you recommended a reduction of \$33,600. Is that what that means?

Mr. KRANTZ. What was that, sir?

Mr. HARDY. I am trying to understand what this item 13 means. Does this mean you recommended disallowance of \$33,600?

Mr. KRANTZ. This means, sir, I set this amount out for the consideration of the Air Force negotiator at the time of negotiation.

Mr. REDDAN. To be reduced by that amount?

Mr. KRANTZ. For him to consider it and make the determination whether it should be reduced by that amount or some other amount.

Mr. HARDY. Of course, you don't have the authority to say it should be reduced by anything.

Mr. KRANTZ. That is correct.

Mr. HARDY. If you hadn't thought there was at least a possibility of reducing it by this amount, why did you put that in?

Mr. KRANTZ. There was a question in my mind about the amount, and that is why I set it out, sir.

Mr. HARDY. Were there any other items that you questioned?

Mr. KRANTZ. In connection with employee morale?

Mr. HARDY. That is right.

Mr. KRANTZ. No, sir.

Mr. REDDAN. Where did you get your information for item 13, the items which added up to the \$33,600?

Mr. KRANTZ. The information was derived from schedules submitted by the contractor. We picked the months that we would ask them to review for us. He submits the analysis of the accounts, and then we review what he has done.

Mr. REDDAN. Is that similar to the analysis that I just showed you a moment ago?

Mr. KRANTZ. I believe the analysis you have, sir, is for the year 1962, and the audit report we are looking at is for the year 1961.

Mr. REDDAN. It is similar to this?

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. Do you have a copy of the 1961 analysis?

Mr. KRANTZ. No, sir; I don't have that analysis with me.

Mr. REDDAN. Is there one available?

Mr. KRANTZ. I could get it for you.

Mr. REDDAN. Would you submit that to the committee, please, sir.

Mr. KRANTZ. I don't have it now, but I will do that.

Mr. HARDY. Did I understand you to say this was determined on the basis of schedules for certain months which were submitted?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. Then they didn't submit schedules for the entire year or for the entire period?

Mr. KRANTZ. No, sir.

Mr. HARDY. This was a spot check, then.

Mr. KRANTZ. It is a selective test; yes, sir.

Mr. HARDY. Being a spot check, does this mean you found \$33,600 worth of items in these particular few months, or is that a projection for the whole year?

Mr. KRANTZ. No, sir; this is a projection for the whole year.

Mr. HARDY. I think it may be interesting—and maybe we can figure it out when we get this submission, but it would be interesting to know specifically what you did find in these—how many months?

Mr. KRANTZ. I believe 1961 was also 4 months, sir. I am not sure, but I think that is what was done.

Mr. HARDY. That being the case, presumably this represents a trebling of the amount that you found in question.

Mr. KRANTZ. Substantially, that is correct, sir.

Mr. HARDY. But you don't audit the entire year's figures?

Mr. KRANTZ. No, sir.

Mr. HARDY. Well, that being the case, do you select the months for them to send you, or do you just take what they send you?

Mr. KRANTZ. No, sir; we select the months, and tell them which months we would like them to look at for us.

Mr. HARDY. On what basis do you select the months?

Mr. KRANTZ. On a judgmental basis, and we usually include the month of December for the purpose of picking up—we feel that is a special month where many of the parties may occur. Otherwise, the other months are just on a judgmental basis.

Mr. REDDAN. What did you do with your audit report, sir?

Mr. KRANTZ. The audit report is addressed to Mr. Deardorff's office, is sent to him with a copy to the Air Force contracting officer at Hughes Aircraft Co.

Mr. REDDAN. And did you receive that report, Mr. Deardorff?

Mr. DEARDORFF. Yes, sir.

Mr. REDDAN. And based on that, a report of negotiated overhead allowance was finally issued by your office?

Mr. DEARDORFF. That is right, sir.

Mr. REDDAN. And how did you handle item 13 that Mr. Krantz was just referring to?

Mr. DEARDORFF. This particular item, referring to the negotiation report, we reinstated \$30,200 of the \$33,600.

Mr. HARDY. How did you figure that \$30,200? Let's see how you worked that one out.

Mr. DEARDORFF. Sir, I don't have with me the 1961 backup data. May I submit that later?

Mr. HARDY. Well, I think we are probably going to have to have it, but we will probably need some testimony along with it. This was a judgmental proposition, and unless you went into all the 12 months, I don't know how you could arrive at the \$30,200. We just had testimony that that was a projection. How in the world do you determine what would be a reasonable projection?

Mr. DEARDORFF. Well, sir, it is possible that the reinstatement reflects some adjustment of that projection, but I don't know exactly what the reason might have been for this partial disallowance.

Mr. HARDY. Actually, all you disallowed was \$3,400.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Don't you think that there is reasonable cause for an explanation of why you allowed \$30,200?

Mr. DEARDORFF. Well, sir, the reason we allowed the \$30,200 was that we felt it was a reasonable expense for—

Mr. HARDY. Well, I think you are going to have to get into the specific items and tell us why they were reasonable.

Mr. DEARDORFF. Yes, sir. The reason that we thought these items were reasonable was simply that this had been the contractor's established practice in having affairs of this type, and in our examination, as we reviewed these at the time of the negotiation, it was apparent to the three negotiators there that this was the specific purpose for which these affairs, these parties were held.

Mr. HARDY. Well, your statement is "questioned as parties, dinners, and entertainment." Now, entertainment I thought was specifically not allowed.

Mr. DEARDORFF. Sir, this is not entertainment in the sense of entertainment—

Mr. HARDY. Now you are defining "entertainment," and you will be defining "reasonable," and we are going to have a lot of judgmental factors that come into this. I think we are going to have to have you back.

Mr. DEARDORFF. Very good, sir.

Mr. HARDY. We are going to have to go into this thing a little more deeply, because we will have to find out just exactly why you permitted this much. I don't know—maybe you have got a reason for it, but I think we have to understand it.

Mr. DEARDORFF. Well, sir, I think that we might be able to clear the item up right now.

Mr. HARDY. Well, fine, if you can.

Mr. DEARDORFF. This company has for some period of time followed a practice of having individual parties for their employees. Some of these are at the homes of supervisors. The company's position is that they feel that smaller parties with a supervisor are of more value to them than having some larger affair for the entire organization. For this reason, they have followed this procedure. Now, in reviewing these and looking at these types of affairs, the three negotiators could find no reason to question these costs as being for the purpose of employee morale, and therefore these costs were reinstated.

Mr. HARDY. You determined that this had been the pattern of practice over the years?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. How did you determine that?

Mr. DEARDORFF. Hughes has followed this for all of the years that I have been negotiating with the company, sir.

Mr. HARDY. And how many years is that?

Mr. DEARDORFF. Since the 1960 overhead, sir.

Mr. HARDY. All right, since 1960, and all of the time you have been negotiating under the same ASPR?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. How do you know what the previous pattern was?

Mr. DEARDORFF. This information would be available, sir—

Mr. HARDY. I am not asking where it is available; I am asking where you got it.

Mr. DEARDORFF. From my auditors and other Air Force personnel in the plant.

Mr. HARDY. Can you testify specifically as to why you got the information about this item, and how do you know it? I don't know—maybe you have been making mistakes all the time, or maybe it is not a mistake.

Mr. DEARDORFF. No, sir; I don't believe it is a mistake.

Mr. HARDY. But you haven't satisfied me yet that you had reasonable basis to believe that this had been the practice.

Mr. DEARDORFF. Perhaps the auditor might be able to help in this respect, sir.

Mr. HARDY. I am talking about where you got it.

Mr. DEARDORFF. Sir, at the time of the negotiations, these parties are discussed in detail, and all of the detailed information which is available from the auditor, is available from the ACO—administrative contracting officer, that is, at the plant, the contractor, himself—

Mr. HARDY. Now, somewhere in the back of my head I have a recollection that there was a statement attributed to you that Hughes had just started this concept of having these parties in the home, and now you are testifying before this committee they had been going on for years and that you knew it.

Now, I think maybe we had better straighten this out. I want you to produce the evidence of your knowledge that this has been the pattern in existence for a period of time. That is the basis on which you approved it. You approved it in 1960. What did your predecessors do, or do you know?

Mr. DEARDORFF. Well, sir, if you want something very specific, perhaps it will be—

Mr. HARDY. Well, you are going to have to get something more specific than guesswork, to suit me.

Mr. DEARDORFF. I will be glad to check back and find out exactly how long this practice has been going on. There is no document that I have in my possession that says Hughes Aircraft has followed this procedure for so many years.

Mr. HARDY. So then I have to conclude that you made this decision in the beginning without knowing whether it was true or not.

Mr. DEARDORFF. No, sir; I don't believe that is correct, sir.

Mr. HARDY. Well, then, you are going to have to show me how you knew it.

Mr. DEARDORFF. Sir, it would have been a matter of discussion at the time of the negotiation.

Mr. HARDY. Discussion. How about a matter of verification, or are you concerned with verification?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. I am not at all sure this has been going on any length of time.

Let me ask you another question. Does this same pattern apply to Hughes' commercial business?

Mr. DEARDORFF. I don't believe Hughes has any substantial commercial business.

Mr. HARDY. So that this is all Government, and has been going on as related to CPFF contracts. Does Hughes have fixed-price contracts?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Do they do the same thing with those, and, if so, how do they pay them—out of their profit?

I think you would be well advised to have found out about those before you passed on them. Now, it may be that you are right.

Mr. DEARDORFF. Sir, the same accounting practices would be used by Hughes for all their contracting, regardless of type.

Mr. HARDY. I am going to read you a statement which was in a memorandum prepared by Mr. Woods after his conversation with you just a short while ago:

When he was interviewed, Deardorff explained that the frequency of the Hughes morale functions in 1962 represented an innovation wherein the company disbursed funds to upper middle supervisory personnel to finance small group functions rather than one or two large affairs.

Do you deny telling Mr. Woods that?

Mr. DEARDORFF. Sir, I think there is a misunderstanding.

Mr. HARDY. Maybe there is, and we had better clear it up.

Mr. DEARDORFF. The first time that I was in a Hughes negotiation, this was a new experience to me, this type of a morale party, or this type of expenditure for morale, and what I was attempting to convey to these gentlemen, to Mr. Woods, was that Hughes indicated that this was a more modern approach, a new approach, sir.

Mr. HARDY. Well, let's pass this over until you can come up with something that will support the testimony that you have given. I think in all fairness to you the committee wants to give you that opportunity, because I don't know whether any such evidence exists. Maybe it does.

Mr. DEARDORFF. Well, sir, I can't say here at this moment with certainty that I positively had knowledge at the first negotiation for the 1960 overhead—I can't say now specifically what I had knowledge of, because this was some time ago, but I will certainly find out at least what the situation was prior to 1960.

Mr. HARDY. This is the kind of thing that brought about this whole procedure—nobody knows what motivated that judgment. You don't know what motivated your own. You don't know whether or not there was a pattern, but you based your decision on that when, in fact, it may not have existed. You don't know whether it existed or not—at least that is what I conclude from your testimony. So what have you done? You have allowed an item that maybe shouldn't have been included. It may have been justified, I don't know, but my point is you don't know, either.

Mr. REDDAN. With respect to 1962, Mr. Krantz, you have already identified the analysis of the morale account which you received from Hughes Aircraft.

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. In your audit report for 1962, what items in the morale area did you question in that report?

Mr. KRANTZ. Exhibit B, page 8, item 14-B, identified as account 852 in the amount of \$22,300.

There is one other item, sir, in the same exhibit, page 19, item 41-B, also identified as account 852.

Mr. REDDAN. Page what?

Mr. KRANTZ. Page 19 of 23.

Mr. REDDAN. Which item?

Mr. KRANTZ. Item 41-B, "Christmas parties," account 852.

Mr. REDDAN. Item 14-D—what is the category of those items?

Mr. KRANTZ. Those are business conferences, and that is another account, but has no relationship whatsoever to employee morale and welfare.

Mr. HARDY. However, it is an item that goes into overhead at the same time that this employee morale goes in?

Mr. KRANTZ. Yes, sir; it is.

Mr. HARDY. I think we are going to have to take a look at it collaterally, because it seems to me there is some question as to how those conferences are involved.

With specific reference to your exhibit B, page 8, item 14-B, you have got business conference expenses claimed, \$225,600. On sched-

ule B-3, page 1, item 2-B, where it has three conferences in 1 day with the same person, are these included in the \$225,000 in 14-D?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. Did you follow that up any further to see how one man could have had three dinner conferences on the same day costing \$24, \$25, and \$13, respectively?

Mr. KRANTZ. Sir, there was a question in our mind and that is why we set it out. We thought this was rather unlikely.

Mr. HARDY. And you have several other instances similar to that where the same individual would have more than one dinner conference on the same day?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. He either ate a whole lot or drank a whole lot, I would think, but let's get back to this employee business.

Mr. REDDAN. That report came to you, too, Mr. Deardorff?

Mr. DEARDORFF. Yes, sir.

Mr. REDDAN. And what was your disposition of those questioned items?

Mr. DEARDORFF. Sir, I am afraid we are confused. You were asking about schedule B-3?

Mr. REDDAN. Schedule B, item 14.

Mr. DEARDORFF. Exhibit B?

Mr. REDDAN. Exhibit B, item 14-B.

Mr. HARDY. Page 8 of exhibit B.

Mr. DEARDORFF. Item D?

Mr. HARDY. We are talking about B and D, both, but let's talk about B first, "Parties for employees, not including Christmas parties, \$22,300." What did you do with that?

Mr. DEARDORFF. Item B, \$22,300, was reinstated in full.

Mr. HARDY. Now, what did that consist of? If that was reinstated in full, I think perhaps we can find out your reason for this.

Mr. DEARDORFF. Yes, sir; this item was reinstated in full after review of these activities during the negotiations that took place. The three Government negotiators felt that these were for the purpose of morale, that they had been conducted by the company for that purpose, and we saw no expenses other than—

Mr. HARDY. I have before me a document which is purported to be an itemization of these particular items. Are you familiar with it? It is Hughes Aircraft Co., analysis of account No. 852, schedule A-9.

Mr. REDDAN. Mr. Krantz, I believe you have it in your workpapers.

Mr. KRANTZ. Are you looking at the engineering—

Mr. REDDAN. This is the analysis submitted to you by the Hughes Co.

Mr. HARDY. First let me ask you if this is an itemization of the \$22,300 that we have been talking about?

Mr. KRANTZ. This is an itemization of the sample that was selected of the 4 months. This would represent the 4 months' sample, sir, and the \$22,300 would be the projection of that sample.

Mr. REDDAN. What was the total amount of the claim by Hughes Aircraft for 1962 for employee morale expenditures?

Mr. KRANTZ. About \$53,000, sir.

Mr. REDDAN. \$53,000?

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. Did they submit any supporting documents along with that claim?

Mr. KRANTZ. That is the support for that particular cost, sir.

Mr. REDDAN. Well, this only supports a part of it, as I understand.

Mr. KRANTZ. That is support for the entire amount of the sample that was selected.

Mr. REDDAN. Yes, this is the sample, but this doesn't total up to the full amount of the claim, as I understand it.

Mr. KRANTZ. No; but the 12 months would total up to the full amount of the claim.

Mr. REDDAN. You mean if you multiply this by 3?

What I am trying to find out, Mr. Krantz, is whether or not the company submitted any support for their total claim for expenditures for employee morale, which I understand you to say, for 1962, was \$53,000. Is that right?

Mr. KRANTZ. Well, sir, I am not sure that we were on the same wavelength. They do support this entire amount in their records, the account that we look at supports this amount of \$53,000.

Then the month we selected—and usually there will be high months, including December—will be a portion of that \$53,000, and we analyze the account.

Mr. REDDAN. You examine the supporting records of the company?

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. Then why did you have to submit your analysis? Did you analyze the records?

Mr. KRANTZ. This is the examination we make of the records—this consists of the examination.

Mr. HARDY. I have just added up these figures, and I am not trying to be accurate, but it comes out to approximately \$15,160 for the month of February, June, November, and December.

Mr. KRANTZ. Sir, I would have to know which burden center you are looking at. There are several schedules.

Mr. HARDY. I am looking at: schedule A-9, analysis of account No. 852.

Mr. KRANTZ. This audit report covers several divisions. The schedule A-9, sir, that you are looking at, is field service and support. There are other divisions in the schedules that were submitted, engineering burden center and El Segundo division.

Mr. REDDAN. This is the engineering burden schedule we have here.

Mr. KRANTZ. Oh, they are all A-9.

Mr. HARDY. This is the engineering burden center. What it is I don't know, but that is what it says.

Mr. KRANTZ. There are other burden centers. That is only one portion of it.

Mr. HARDY. All right, let's just talk about this one; this gives us enough. I don't think we need look at anything further than this. This adds up to \$15,160, and I didn't add the odd dollars, for 4 months.

Now you come up with a figure of \$22,300 for the entire year, and this represents only one center. This is the engineering burden center only. I don't know what the total figure would have been. Do you know what their total claim was?

Mr. KRANTZ. The total claim, sir, for this particular item, \$53,000.

Mr. PIKE. Mr. Chairman.

Mr. HARDY. Yes; go ahead, I am not doing any good.

Mr. PIKE. We have gotten into this question of morale, and you told me earlier, I think, Mr. Deardorff, that you are bound by these basic definitions in ASPR's paragraph 15-205.10 and 205.11, as to what that concept is.

Mr. DEARDORFF. Yes.

Mr. PIKE. Yet all of these items we are talking about here have been for parties and dinners at restaurants, and it seems to me that when we read paragraph 15-205.11, and it says "Cost of amusement, diversion, social activities and incidental costs relating thereto, such as meals, are unallowable," and I have left out some of the other things which are unallowable, how do you get around that into saying that meals and parties are allowable?

Mr. DEARDORFF. Yes, sir; you will see there also a reference in parens: "(But see 15-205.10 and 15-205.43)."

Mr. PIKE. Well. I haven't read 43, but here is 205.10:

Reasonable costs of health and welfare activities such as—
And then it says:

health and welfare activities, such as house publications, health or first-aid clinics, recreational activities, and employee counseling services incurred in accordance with the contractor's established practice or custom—

And so forth.

Now, do you consider that you can use a cocktail party as an example of a health and welfare activity?

Mr. DEARDORFF. No, sir; I think that would be in the area of a recreational activity.

Mr. PIKE. Wait a minute. A recreational activity is used as an example of health and welfare activities. To me this means something in the line of athletics, perhaps. When you say a "health and welfare activity, such as house publications, health or first-aid clinics, recreational activities, and employee counseling services," the recreational activity is not a cost of health and welfare activity, but is an example of it. Now, can you make a cocktail party into an example of a health and welfare activity, in your mind?

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. Do you think that the cocktail party, as such, is beneficial to your health or to your welfare?

Mr. DEARDORFF. Sir, I think it is an employee morale type expense that we have been accepting.

Mr. PIKE. Well, I know you have been accepting it. If you hadn't been accepting it, we wouldn't all be gathered in this cheery meeting here today. This is the whole purpose of this hearing. The question is, Should you have been accepting it? Obviously you have been accepting it, and that is why we are here.

My question is how do you make a cocktail party into a health and welfare activity?

Mr. DEARDORFF. Under the present ASPR, sir, and following the precedents that have been established, I believe that we would have to accept something of this type as a welfare recreational—

Mr. PIKE. In other words, you think that a dinner at a restaurant, drinks and dinner at a restaurant come closer to recreational activities than they come to meals?

Mr. DEARDORFF. It depends on the purpose, sir.

Mr. PIKE. I am going by the language. The language here doesn't talk about the purpose of it. It takes about reasonable costs of health and welfare activities are allowable. Social activities, such as meals, are unallowable.

You find a cocktail party and a dinner at a restaurant to be a health and welfare activity; you do not find it to be a meal or a social activity.

Mr. DEARDORFF. We have not construed it to be entertainment, sir, when it was for the purpose of employee morale.

Mr. PIKE. Well, I think if you had, we might all have saved ourselves the trouble.

Mr. HARDY. If I may get back to one or two specifics in this schedule A-9, which we have been looking at, and this is analysis of account 852, morale, I notice specifically on here—and I presume you all analyzed these before you came in with your recommendation—that there is a retirement party, two different retirement parties held for the same fellow who was retiring.

Now, how do you justify that under morale? One of them apparently was in February, if I read this correctly. This was a gentleman by the name of Lockmiller. I don't know when he retired, but for the month of December there was a party for him—I don't know whether it is the same party or not, but it was a right good-sized party. Oh, yes, in one case he had a hundred people present, and on the other, just 40.

Now, is that "morale building," to give two retirement parties for the same fellow?

Mr. DEARDORFF. I think it could be, sir.

Mr. HARDY. You think it could?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Well, go ahead and justify your mistakes. Let's look at another. There is a whole flock of these things here, and it is really amazing. You made a distinction—and I hope you will distinguish between these for me—you made a distinction between the morale building things and the conferences.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Now, I find in June there was a dinner for five executives and their wives regarding reorganization. I don't know how that gets to be morale building, but maybe you can explain it. This is regarding reorganization, and I don't know what kind of reorganization it is, but it is interesting. The second item in June, on the sheet that I have, do you see that? I don't believe you are going to give any better explanation of that one than you did of the other one. Can't you find it?

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Can you outline the morale factor in that for me? It is not a big item, just \$64, but if it typifies the way you have been deciding these things, it may have some significance.

Mr. DEARDORFF. Well, obviously, sir, as you point out, it does not say—it says "reorganization," it does not say "morale."

Mr. HARDY. That is right, that is what it says, but it is charged in there under morale, isn't it?

Mr. DEARDORFF. It is included in that account, sir.

Mr. HARDY. It sure is. Now, will you distinguish between that one for me—I don't know, that might as well have been a business conference, is that correct?

Mr. DEARDORFF. It might have been.

Mr. HARDY. Can you distinguish between that one and these business conferences that you listed, at Chip's Restaurant, at the Cockatoo Inn, the Derby, and other restaurants at costs running from \$6 to \$10 a piece, and dinners at the Beverly Hills Hotel, at Petite Jean—I think that is the way you pronounce it—and the Pink Pussy Cat?

Mr. DEARDORFF. Are you reading now—

Mr. HARDY. I am reading now from schedule B-3. I want to distinguish between these terms. Can you tell me the difference?

Mr. DEARDORFF. Sir, it is possible that this may have been a business lunch. I honestly don't know, sir.

Mr. HARDY. That you don't.

Mr. DEARDORFF. Perhaps it could even—

Mr. HARDY. As a matter of fact, all of these could have been on here erroneously, so far as you know?

Mr. DEARDORFF. No, sir, I don't believe so.

Mr. HARDY. This one apparently falls in that category.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. And you should have examined this thing. Mr. Krantz had it.

Mr. DEARDORFF. Yes, sir, we did.

Mr. HARDY. But you approved it.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. How do I know the rest of them aren't just as cockeyed? There isn't any way in the world to know. The lassitude with which this thing has operated speaks mightily poorly of our whole manner of administering these contracts.

Go ahead, Mr. Reddan.

Mr. REDDAN. Mr. Krantz, to come for a moment to the vending machine profits, the schedule that I have before me shows that the Hughes Aircraft Corp., Culver City plant, had total vending machine receipts of \$111,000 during the 12-month period in 1962, and they donated this entire amount to the employees recreation and welfare association. Are those figures substantially correct, sir?

Mr. KRANTZ. The figures are correct, sir, but the statement that it was donated I think might stand a little clarification.

Mr. REDDAN. All right, would you clarify it for us, sir?

Mr. KRANTZ. The agreement is between the Hughes employees association and the vending machine company, and this income goes directly to them, and the entire amount did go to them.

Mr. REDDAN. I am sorry, I didn't hear.

Mr. KRANTZ. It is not donated by the Hughes Aircraft Co. The agreement is between the association and the vending machines company, and the income goes directly to them, and the entire amount of \$111,000 did go to them.

Mr. HARDY. Of course, they couldn't do that without agreement of Hughes Aircraft.

Mr. KRANTZ. That is correct.

Mr. REDDAN. They don't have to renew the agreement each year. The arrangement was made some years ago.

Mr. KRANTZ. Yes, sir.

Mr. HARDY. As a matter of fact, since Hughes Aircraft has to be a party to it to permit this, they could certainly control it, if they saw fit to do it, couldn't they?

Mr. KRANTZ. I am afraid I couldn't answer that, sir.

Mr. HARDY. Well, it is on their premises, isn't it?

Mr. KRANTZ. That is right.

Mr. HARDY. So you are not suggesting that they don't have control over the location of vending machines on their premises?

Mr. KRANTZ. Yes, sir, but what I can't answer is the fact that they can control the income.

Mr. HARDY. If they can control the location, they can control the installation—they can eliminate them.

Mr. KRANTZ. Yes, sir.

Mr. HARDY. So to that extent they do have control.

Mr. KRANTZ. Yes, sir.

Mr. REDDAN. Have you ever audited the books and examined into the activities of the employee welfare organization?

Mr. KRANTZ. No, sir.

Mr. REDDAN. Do you consider under the ASPR that the activities of that club are in any way the business of the Government, or concern of the Government?

Mr. KRANTZ. Yes, sir, I believe they are.

Mr. REDDAN. Then why wouldn't their activities be examined by your office?

Mr. KRANTZ. Back in June of 1961, sir, at a meeting of the plant auditors at Hughes Aircraft Co., the decision was made that the expenses that the Government has to reimburse the contractor for in connection with employee morale would be one that we could set out for the negotiators' consideration, but the decision at that time was that we could not look at the association books. However, since the GAO report, I think that perhaps we can, and we intend to look at it.

Mr. HARDY. Who made that decision?

Mr. KRANTZ. Which one?

Mr. HARDY. That you can't look at the books.

Mr. KRANTZ. Back in 1961?

Mr. HARDY. Yes.

Mr. KRANTZ. It was at a meeting at the plant of Hughes Aircraft.

Mr. HARDY. Who made the decision? Did you agree to it?

Mr. KRANTZ. Yes, sir; I did.

Mr. HARDY. So you made the decision. How did you have the right to make such a decision?

Mr. KRANTZ. I believe, sir, that is one of the determinations I have to make in connection with my responsibilities.

Mr. HARDY. In other words, you have the right to circumscribe or circumvent the ASPR's?

Mr. KRANTZ. At the time I made the decision, sir, I did not think I was—

Mr. HARDY. I am not asking whether you thought you were circumscribing them or not. As a matter of fact, the ASPR's do require you to make an examination of these, don't they?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. And you agreed not to do it?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. How could you do that?

Mr. KRANTZ. It was a decision I made at the time, sir.

Mr. HARDY. So you made an erroneous decision, or made one contrary to the ASPR's.

Mr. KRANTZ. Yes, sir.

Mr. HARDY. Did any of your superiors know about that?

Mr. KRANTZ. I don't know, sir.

Mr. HARDY. But it was your decision not to audit the books; you acquiesced in the demand of whom? Who said you can't look at these books, and you agreed to it?

Mr. KRANTZ. No one said I couldn't look at it, sir.

Mr. HARDY. So you just voluntarily said, "I am not going to bother to look at the employee association records on these vending machines?"

Mr. KRANTZ. It was the decision at that time that we probably would have an extreme difficulty in what is a difficult area of being able to substantiate this type of expense where we would have to determine reasonableness, and we thought we might have a better position in a case where we were actually paying for the cost of it.

Mr. HARDY. You haven't satisfied me on the basis for that decision.

Is that association a nonprofit association?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. Is it under determination from the Internal Revenue Service?

Mr. KRANTZ. What was that?

Mr. HARDY. Does it have from the Internal Revenue Service a status as a nonprofit association?

Mr. KRANTZ. To the best of my knowledge it has, sir.

Mr. HARDY. Do you know?

Mr. KRANTZ. I was so informed by the company.

Mr. HARDY. Do you know whether the Hughes Aircraft Co. classifies the vending machine receipts as a donation to a nonprofit corporation?

Mr. KRANTZ. No, sir; I don't. The Hughes Aircraft Co.?

Mr. HARDY. That is right.

Mr. KRANTZ. They don't receive it, sir.

Mr. HARDY. I didn't ask you that. I understood from your testimony that they don't receive it, but it is received on their property, is it not?

Mr. KRANTZ. Yes, sir.

Mr. HARDY. Do you know, as a matter of fact, whether Hughes does consider this, the amount of the vending machine receipts, to be a contribution to a nonprofit organization?

Mr. KRANTZ. No, sir; I don't know.

Mr. HARDY. Mr. Reddan.

Mr. REDDAN. Now, another item on the schedules before me, Mr. Krantz, would indicate that in the 12-month period we have been discussing here Hughes Aircraft has incurred a loss of \$74,000 on food service. Is that figure substantially correct, sir?

Mr. KRANTZ. \$74,000?

Mr. REDDAN. Yes.

Mr. KRANTZ. Sir, which schedule are you talking about?

Mr. REDDAN. I am talking now about these GAO schedules which were submitted to us this morning.

Mr. KRANTZ. The schedule I have, sir, shows \$80,000, and that is substantially correct.

Mr. REDDAN. Now, my question is this, and I will address it to both you and Mr. Deardorff. The ASPR provision which relates to the food service states that the profits from the food service may be—perhaps I had better read it. It says:

Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of the contractor's performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated to all activities served.

Now, what I want to ask you is, do you make any judgment as to when a profit arises out of food service? In other words, is there anything in the ASPR's which will permit you to separate vending machine operations from cafeteria operations, or does the ASPR as it is written require you to consider the profits and losses from one to offset the profits and losses of the other before they can be distributed to welfare organizations?

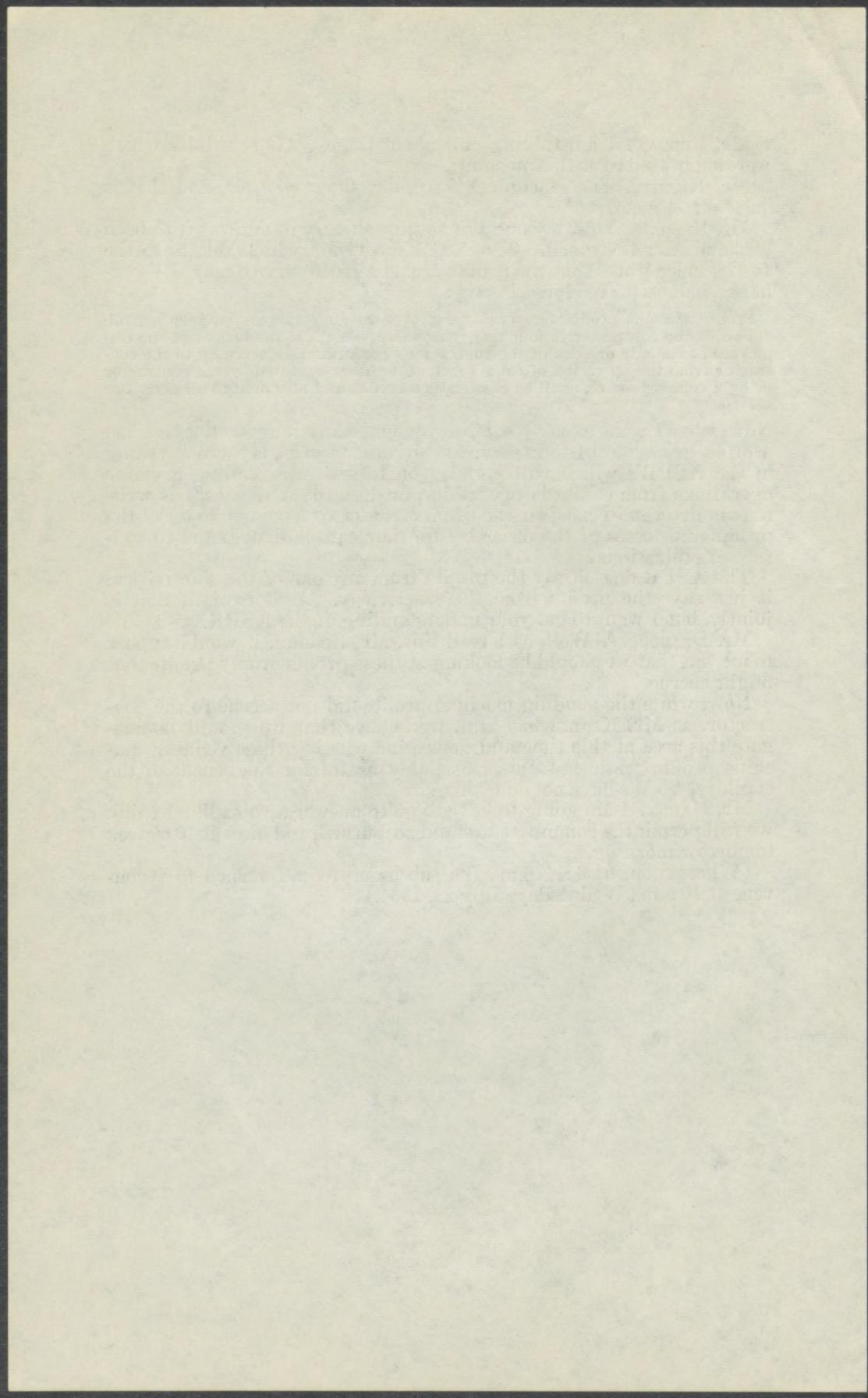
The ASPR doesn't say the profits from any one of these activities; it just says the profits from these activities. As I read it, that is jointly, but I want to get your understanding of the ASPR.

Mr. DEARDORFF. Well, as I read this, Mr. Reddan, it would appear to me, sir, that we should be looking at these profits or any profits that might accrue.

Now, while the vending machine profits did not accrue to the contractor, as Mr. Krantz has said, we believe that we should investigate this area at this time and determine whether these vending machine profits are in amounts reasonably useful for the benefit of the employees. We have not done this, sir.

Mr. HARDY. I am going to have to go to answer a rollcall. I think we will permit the committee to stand adjourned, and meet at 10 o'clock tomorrow morning.

(Whereupon, at 4:14 p.m., the subcommittee adjourned to reconvene at 10 a.m., Wednesday, July 22, 1964.)



COST OF MORALE AND RECREATION BENEFITS FOR DEFENSE CONTRACTOR EMPLOYEES

WEDNESDAY, JULY 22, 1964

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
SUBCOMMITTEE FOR SPECIAL INVESTIGATIONS,
Washington, D.C.

The subcommittee met at 10 a.m., pursuant to adjournment, in room 304, House Office Building, Hon. Porter Hardy, Jr. (chairman of the subcommittee) presiding.

Members present: Hon. Porter Hardy, Jr., and Hon. Otis G. Pike.

Staff members present: John T. M. Reddan, special counsel; Walton Woods, staff investigator; Phyllis M. Seymour, secretary.

Mr. HARDY. The committee will come to order.

This is a continuation of the hearing begun yesterday.

We would like to have as our witnesses this morning, Mr. Harold Parsons and Mr. Deardorff, if you gentlemen will take seats at the table, please.

TESTIMONY OF HAROLD D. PARSONS, AIR FORCE RESIDENT AUDITOR, ANAHEIM, CALIF., ASSIGNED TO NORTH AMERICAN AVIATION, INC.; AND CHARLES E. DEARDORFF, PROCUREMENT ANALYST, HEADQUARTERS, AIR FORCE SYSTEMS COMMAND, WASHINGTON, D.C.

Mr. REDDAN. Mr. Deardorff, you identified yourself for the record yesterday.

Mr. PARSONS, will you do so now, please—just give the reporter your name, address, and position?

Mr. PARSONS. Harold D. Parsons, 5009 Paseo Del Pavon, Torrence, Calif.

Mr. REDDAN. And what is your present position, sir?

Mr. PARSONS. I am the Air Force resident auditor of North American Aviation's home office.

Mr. REDDAN. How long have you held that position?

Mr. PARSONS. About a year and a half.

Mr. REDDAN. And prior to that time?

Mr. PARSONS. Prior to that time, I was resident auditor for Northrop Corp.

Mr. REDDAN. For how long?

Mr. PARSONS. Two years.

Mr. REDDAN. You are an accountant?

Mr. PARSONS. I am a certified public accountant.

Mr. REDDAN. Mr. Parsons, I would like to direct your attention to the audit report for 1962 for North American Aviation, and direct your attention particularly to the cost of the operation of the executive dining room.

Mr. PARSONS. Yes, sir.

Mr. REDDAN. Would you tell the committee, please, sir, what your recommendation was with respect to the cost of the operation of the dining room, and any information you might have as to the manner in which the dining room was operated?

Mr. PARSONS. Well, sir, the report covers the Autonetics Division, the general offices, the Los Angeles Division, and Rocketdyne, Canoga Park, that is the division offices. We set out actually the whole amount and the whole cost of the executive dining rooms at those installations.

Mr. REDDAN. Did your report also cover the cafeteria costs?

Mr. PARSONS. Yes, sir; we have in connection with that the cafeteria losses which apply to the Autonetics Division, the general offices, and Rocketdyne, Canoga Park. These are the divisions that sustained a loss in that area.

Mr. REDDAN. What was the loss on the executive dining room?

Mr. PARSONS. The total loss set out on the executive dining room was \$65,574.

Mr. REDDAN. What was the cost of the meals served in the executive dining room?

Mr. PARSONS. We have two statistical things here in the executive dining room. The cost of the executive dining room at Autonetics, the cost per meal was 42 cents; in the general offices was 81 cents; the Los Angeles Division, 43 cents; and the Rocketdyne Division was 42 cents.

Mr. HARDY. Well, now, is that the executive—

Mr. PARSONS. This is for executive employees.

Mr. REDDAN. Was any charge made for the cost of the meals in the executive dining rooms?

Mr. PARSONS. At these divisions we are talking about, no, sir. There were only charges made for the Columbus Division which is not included in here.

Mr. HARDY. Let me see if I understand what you are saying. You gave Autonetics 42 cents a meal. Is that the actual cost of the food?

Mr. PARSONS. This is the cost of the food plus the cost of the depreciation of the restaurant-type equipment.

Mr. HARDY. Well, they ought to do business all over.

Mr. PIKE. Mr. Chairman.

Mr. HARDY. Mr. Pike.

Mr. PIKE. Does that include any depreciation of the capital overhead of the area in which the restaurant is located?

Mr. PARSONS. This, sir, does not include what we term "occupancy cost." This is the general area cost where these are located.

Mr. PIKE. So a portion of the capital expense of the dining room is just listed as regular depreciation and is allowed as an overhead item?

Mr. PARSONS. This is true.

Mr. PIKE. So the cost which you have reflected on these meals does not represent the full cost of operating the restaurant on these premises?

Mr. PARSONS. This is right. That is what we call the food service cost, itself.

Mr. PIKE. Thank you.

Mr. REDDAN. I notice in the last column of exhibit A, the summary sheet you refer to in your audit, the column entitled "Cents Recovered Per \$1 of Meal Cost (Excluding Occupancy)," and then you have a column headed "Executive" and one headed "Employee."

Mr. PARSONS. Yes, sir.

Mr. REDDAN. There are no figures in the executive column; there is a note 2 which says, "Columbus executives contribute \$1 per meal to offset executive dining room costs."

Mr. PARSONS. This means there was no money recovered on these others. And while I am about it, I made an error I would like to correct. These figures I gave you on the cost of the executive dining rooms was the cost of the cafeteria.

Mr. PIKE. Yes, quite a difference.

Mr. PARSONS. Yes, sir.

Mr. HARDY. That is what I was going to get back to—the figures that you gave a minute ago, starting with the 42 cents, are not the executive dining room costs; they are the cafeteria—

Mr. PARSONS. Yes, sir.

Mr. HARDY. Which was patronized by the employees?

Mr. PARSONS. Yes, sir.

Mr. HARDY. Now compare them, if you will, with the cost in the executive dining room.

Mr. PARSONS. We have, sir, as you can see. In the general office the cost was \$3.16, in the Los Angeles Division was \$3—

Mr. REDDAN. Let's see. The general offices, the executive cost of a meal in the executive dining room was \$3.16?

Mr. PARSONS. Yes, sir.

Mr. REDDAN. Now in the employees' cafeteria at that location?

Mr. PARSONS. It was 81 cents.

Mr. REDDAN. How about at the Los Angeles Division?

Mr. PARSONS. \$3 was the cost of the executive dining room. It was 43 cents in the cafeteria.

Mr. REDDAN. And Rocketdyne?

Mr. PARSONS. Rocketdyne was \$3.42, and 42 cents in the executive dining room. Then we also have the Space and Information Divisions on here, the last one, which was \$1.75 in the executive dining room, and 30 cents in the cafeteria.

Mr. HARDY. Well, now, let's carry this a little bit further. Let's take the Rocketdyne. Your executive meals cost \$3.14 apiece; is that right?

Mr. PARSONS. Yes, sir.

Mr. HARDY. The employee meals in the cafeteria cost 42 cents apiece?

Mr. PARSONS. Yes, sir.

Mr. HARDY. Now, with respect to the executive meals that cost \$3.14, they didn't charge anything for them?

Mr. PARSONS. This is true.

Mr. HARDY. The executives didn't have to pay for their \$3 meals, but the employees paid 92 cents for their 42-cent meals?

Mr. PARSONS. No, sir; this was 92 cents recovered out of every dollar that they expended for food cost.

Mr. HARDY. Then I had misread that, so they recovered 92 percent of the 42 cents?

Mr. PARSONS. That is right.

Mr. HARDY. So it cost them about 40 cents a meal.

One reason I didn't quite understand that—on the cafeteria at Rocketdyne, they had a profit?

Mr. PARSONS. The cafeteria at Rocketdyne?

Mr. HARDY. Yes.

Mr. PARSONS. No, sir.

Mr. PIKE. Mr. Chairman, I don't understand what "cents recovered" means—recovered from whom, by whom, and how?

Mr. PARSONS. This is for every dollar that is expended for the cost of food, in this instance they would get 92 cents of it back on the sale of food.

Mr. PIKE. In other words, they charge all but 8 cents of the cost of a meal to the employee out of every dollar?

Mr. PARSONS. That is the way it works out; yes, sir.

Mr. PIKE. You would gather, then that executive morale is perhaps more important in this particular location than employee morale.

Mr. PARSONS. Well, sir, I am not qualified to answer that.

Mr. HARDY. Who ate in the executive dining room?

Mr. PARSONS. Well, basically it is for what they term the "executives," which would take the junior executives and the regular on up to the top people. I think it is restricted to directors of departments.

Mr. HARDY. Directors of departments?

Mr. PARSONS. Yes, sir.

Mr. HARDY. Well, now, how about—did you gentlemen ever get the opportunity to eat in there?

Mr. PARSONS. No, sir.

Mr. HARDY. Were you ever invited?

Mr. PARSONS. No, sir.

Mr. HARDY. Were you ever invited to eat in there?

Mr. DEARDORFF. No, sir.

Mr. HARDY. How about the military personnel assigned out there or that visited there—do you know what the practice was?

Mr. PARSONS. I do not, sir, I am not aware of them.

Mr. REDDAN. What was your recommendation with respect to those costs?

Mr. PARSONS. Well, we questioned these losses, both in the executive dining room, and set them out basically for determination of reasonableness by the Triservice Committee.

Mr. HARDY. Well, now, has examination been made with respect to those?

Mr. PARSONS. Yes, sir.

Mr. HARDY. What was the determination?

Mr. PARSONS. According to my figures here, the executive dining room, 50 percent of it was allowed in this case, and the employees cafeteria was accepted.

Mr. HARDY. Who made that determination?

Mr. PARSONS. The Triservice Committee, sir.

Mr. HARDY. Who is the Triservice Committee?

Mr. PARSONS. Mr. Deardorff is chairman of this negotiation.

Mr. HARDY. Did you make it by yourself, Mr. Deardorff?

Mr. DEARDORFF. No, sir.

Mr. HARDY. Who helped you?

Mr. DEARDORFF. I had help from the members from the other two services.

Mr. HARDY. And who are they?

Mr. DEARDORFF. Mr. Laxer of the Bureau of Weapons, of the Navy; Mr. Blinkenberg from the Army.

Mr. HARDY. Do you have anything to indicate the process of reasonableness by which you arrived at the 50 percent?

Mr. DEARDORFF. There is not a document, sir. This item was discussed by the committee, and the reinstatement was based on the judgment of the committee.

Mr. HARDY. In other words, the judgment of the committee—this is a rather blanket thing. We are running into the same problem we had yesterday, and I wish we could be a little more specific.

The judgment of the committee was that the taxpayers of the United States should pay \$1.50 of the cost of furnishing the meals at Los Angeles to the executives, and \$1.58 of the cost of furnishing the meals to the executives of the general offices.

Mr. DEARDORFF. Sir, we were attempting to interpret the ASPR in this case which indicates that reasonable losses would be allowable. We felt it was not reasonable to allow these gentlemen three free meals at the cafeteria.

Mr. HARDY. But you allowed it, you figured it was reasonable.

Mr. DEARDORFF. It was a judgment factor, sir.

Mr. HARDY. Do you do that all over in the military services? Aren't you high enough on the totem pole that the Air Force ought to provide half of your meal cost?

Mr. DEARDORFF. No, sir.

Mr. HARDY. Strange reasoning. Do you have a private dining room available to you somewhere? Does the Air Force provide one for you fellows? You are pretty high up the line.

Mr. DEARDORFF. No, sir; they don't.

Mr. HARDY. Then we will have to change the pay bill.

Mr. PIKE. Mr. Chairman.

Now, there were no cocktails involved in this, nothing of a social nature involved in this. You tell me you are going by the ASPR regulation. I read you section 15-205.10: "Entertainment costs," and skipping a lot of words, "such as meals are unallowable." How do you get to allow a meal?

Mr. DEARDORFF. Sir, I don't believe this fits under that particular portion of the ASPR. I believe it fits under 15-205.14, which provides that the reasonable amounts of these costs, these losses, would be acceptable.

Mr. PIKE. Well, I don't know whether I have section 14 or not, but would you read the whole section?

Mr. DEARDORFF. Yes, sir.

15-205.14. Food service and dormitory costs and credit. Food and dormitory services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations or similar types of services for the contractor's employees at or near the contractor's facilities. Reasonable losses from the operation of such services are allowable if they are allocated to all activities served. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit and allocated to all activities served.

Mr. PIKE. Now, when you read that whole section, and they talk about losses and they talk about profits, don't you get from it some connotation that they ought to charge for the meals?

Mr. DEARDORFF. Yes, sir; I do.

Mr. PIKE. And when they don't charge a dime for the meals, do you think that they are operating this cafeteria in keeping with the spirit of this section that you have just read to me?

Mr. DEARDORFF. No, sir.

Mr. PIKE. Don't you think that this section is aimed at providing meals at or near the break-even point for a factory?

Mr. DEARDORFF. I believe, sir, that this section intends that if it is possible, the cafeterias and lunchrooms should be operated so as not to incur a loss.

Mr. PIKE. You have two sentences regarding losses and profits. The first one says reasonable losses should be allowed; the second one says that profits shall be done such and such with.

As I read this, it means to me that a reasonable effort shall be made to operate the cafeteria on a break-even operation, and when you operate a cafeteria with no efforts whatsoever to break even, or no possibility of making a profit, I think that the operation is wrong, and I simply don't understand how you did allow a no-charge cafeteria to come under this particular section.

Mr. DEARDORFF. Sir, we didn't feel it was proper to allow a no-charge cafeteria or lunchroom to come under this section completely. We felt that since there had been some loss in the operation of the cafeteria, which was a much larger operation and served many more people and had, in effect, a better opportunity to break even—we felt that—

Mr. PIKE. I am not talking about the cafeteria, I used the wrong word. I am talking about the executive dining room. The cafeteria, I think I agree, was operated in keeping with the spirit of the regulation.

Let me ask you this: If the executives' dining room had operated at a cost of \$3 per meal and had charged the employees \$1.50 per meal, you would have thought this was a proper operation and they should be allowed the other \$1.50 at the taxpayers' expense?

Mr. DEARDORFF. I believe we would.

Mr. PIKE. Well, that is exactly what you did.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. Let's follow this one step further. What was the total amount of food costs which were charged into this overhead account?

Mr. DEARDORFF. This total questioned cost—

Mr. PARSONS. This would be the total cost, the \$139,000, for these particular divisions.

Mr. HARDY. That is what I am talking about, for these divisions. The \$139,000 was actually charged back to the taxpayers under this judgmental factor.

Mr. PARSONS. This is right, sir.

Mr. HARDY. At the same time that was happening, \$1,289,000 in vending receipts were being turned over to the North American Aid, and while that was taking place, they expended \$567,000 and built up their reserves or accumulation by \$743,000, which also were receipts on company property.

Now, I don't see how you separate out a vending machine and say we are going to let you keep all the revenues from this and subsidize

all your losses on the other. If you can explain any logical reason for treating this in this fashion, the committee would very much appreciate having it.

Mr. DEARDORFF. Sir, as I told Mr. Woods earlier, the Tri-Service committee was not aware of these costs accumulating in this North American Aid organization. We do believe that these costs should be investigated in the light of the ASPR as it is stated here. We believe that it is necessary to look at these costs to see whether they are reasonable in amount for the purposes intended. We have not done this, sir, and we intend to do it.

Mr. HARDY. Well, we have looked at it for you, now.

Mr. DEARDORFF. Yes, sir.

Mr. HARDY. This, to me, is just absolutely preposterous. The so-called employee association—I don't know what it is, who owns it; we haven't established that yet. I don't know who this \$742,000 belongs to that was accumulated during the same period of time that you were charging over \$130,000 to the taxpayers and permitting them to build up a reserve or accumulation of \$742,000. And you people who are auditing this are supposed to know what you are doing, and approving the inclusion of these amounts in reimbursable overhead. This, to me, is preposterous.

Mr. REDDAN. Mr. Parsons, did you ever audit the welfare organization?

Mr. PARSONS. No, sir.

Mr. REDDAN. Did you ever receive any report as to what they were doing with their money?

Mr. PARSONS. Not before the GAO report; no, sir.

Mr. REDDAN. Just one more question, Mr. Deardorff, before we leave this. You had, I believe, in your negotiation of the Hughes dining room account, a loss in the executive dining room there, also?

Mr. DEARDORFF. Yes, sir.

Mr. REDDAN. Was any charge made for meals in the Hughes executive dining room?

Mr. DEARDORFF. May I refer to the auditor for this answer, sir?

Mr. REDDAN. Surely.

FURTHER TESTIMONY OF MARTIN KRANTZ, AIR FORCE RESIDENT AUDITOR, ASSIGNED TO HUGHES AIRCRAFT CO., CULVER CITY, CALIF.

Mr. KRANTZ. Would you like me to come up?

Mr. HARDY. Either way.

Mr. DEARDORFF. Was there any charge?

Mr. KRANTZ. Yes, Hughes Aircraft Co. does charge their executives for eating in the dining room—they pay a charge.

Mr. REDDAN. Do you know the percentage of costs?

Mr. KRANTZ. No, sir; but the new agreement which started at the end of 1962 charges between 75 cents and \$1.50, depending on the type of meal.

Mr. DEARDORFF. That was in 1962?

Mr. KRANTZ. That started in September of 1962, and they charged before that, but I don't have the charge prior to that—it was somewhere in that neighborhood.

Mr. REDDAN. And what did you do with the loss on the Hughes dining room?

Mr. DEARDORFF. We reinstated the cafeteria losses, and we reinstated 50 percent of the dining room, the executive dining room losses.

Mr. REDDAN. How does that decision compare with the one in the North American case? As I understand you, you allowed 50 percent of the loss in the Hughes dining room—the loss incurred over and above the price paid by the executives—and in the North American case you allowed 50 percent of the total cost of the meals. How do you reconcile that?

Mr. DEARDORFF. No, sir; we allowed the same thing at Hughes that we did at North American, on the same basis.

Mr. PIKE. You allowed 50 percent in both cases, but in one case the executives were paying something for their meals, and in the other case the executives were paying nothing for their meals, so the consistency of your policy is that you are going to allow 50 percent regardless of whether the executives pay anything for it or not.

Mr. DEARDORFF. Not necessarily, sir. We also were concerned with the type of food service and the relative value of this food.

Mr. PIKE. Do you mean to tell me you went into the relative value of the meals served at Hughes and at North American?

Mr. DEARDORFF. We discussed the types of food service and the relative costs.

Mr. PIKE. Well, what, in your discussion, led you to the conclusion that the Hughes people should pay something toward their meals and the North American executives should pay nothing toward their meals, and you were going to allow 50 percent of the loss, anyway?

Mr. DEARDORFF. Well, the matter, of course, again was one of judgment—

Mr. PIKE. Based on the type of the meals?

Mr. DEARDORFF. Based upon the amount of loss, the type of meals, the cafeteria or type dining room that they had, what was going into the losses, and so far as possible we attempted, as we always do in each case, to discuss the item during our negotiations in as complete detail as possible so that we understand.

Mr. PIKE. Well, Mr. Deardorff, isn't the fact of the matter that after you all got down and sat around the table you said the equivalent of, "Well, roughly, we will give you half of it."

Mr. DEARDORFF. This was the final result.

Mr. PIKE. Did you really go into the quality of the meals and type of means served at these different plants?

Mr. DEARDORFF. We were concerned, sir, that those meals were not unusual in type as to things that were being served to the executives.

Mr. PIKE. This is basically not a breakfast or dinner operation—this is a lunch operation; is it not?

Mr. DEARDORFF. That is right, sir.

Mr. PIKE. So at the North American plant you were involved with roughly a \$3 plus luncheon. What were you involved with at the Hughes plant?

Mr. DEARDORFF. I don't have the the information on that, sir.

Mr. PIKE. Mr. Krantz, can you tell us what the cost of the luncheons at the Hughes plants were?

Mr. KRANTZ. They ran, sir, from \$4.10 to \$5.10.

Mr. PIKE. And the people there are now paying from 75 cents to a dollar for them?

Mr. KRANTZ. 75 cents to \$1.50.

Mr. PIKE. And do you know what they were paying at the time of this \$4 to \$5 cost? The same for a \$4 or \$5 lunch—they were paying from 75 cents to \$1.50, so roughly the Government gets stuck with about the same amount or a little bit more in the case of Hughes than it did in the case of North American, is that correct, Mr. Deardorff?

Mr. DEARDORFF. Yes, sir.

Mr. PIKE. Would it be your opinion, Mr. Deardorff, that a \$5 luncheon is a reasonable luncheon?

Mr. DEARDORFF. Sir, the \$5 must be related to things over and above the actual food, itself.

Mr. PIKE. Oh, yes, but we have already discovered that the food costs themselves and the cost of serving them don't amount to the whole expense of running these cafeterias, anyway, and we have already put part of the cost in general depreciation overhead and charged that off to the Government under another category.

I will repeat my question: Do you think that \$5 is a reasonable partial cost for a luncheon?

Mr. DEARDORFF. It might be, sir.

Mr. PIKE. I thought that that was the way that the auditors were looking at this, and I just wanted to have it confirmed for the record. That is all I have.

Mr. REDDAN. That is all I have of these witnesses.

Mr. PIKE. That is all, gentlemen, you are excused.

Next we will hear from Mr. Klement Anderson, Mr. W. Knudsen and Mr. Ralph J. Mathews.

TESTIMONY OF KLEMENT ANDERSON, CHIEF, ADMINISTRATION DIVISION; WILLIAM KNUDSEN, AUDITOR, AND RALPH J. MATHEWS, RESIDENT AUDITOR, AIR FORCE PLANT REPRESENTATIVE'S OFFICE, DENVER, COLO., ASSIGNED TO MARTIN CO.

Mr. HARDY. Will you gentlemen identify yourselves, give the reporter your names and addresses, please, and also your current responsibility?

Mr. ANDERSON. I am Mr. Klement Anderson. My address is 6700 South Pennsylvania Street, Littleton, Colo. I am the chief of the administration division of the plant representative's office at Martin, Denver. I am responsible for the functions of the division which consists of three branches—the contract branch, the price and cost analysis branch, and the incentive monitor branch.

Mr. HARDY. Thank you, Mr. Anderson.

Mr. Knudsen?

Mr. KNUDSEN. My name is William Knudsen, 1682 South Glencoe, Denver, Colo. I am an auditor—I am not the assistant to Mr. Anderson as quoted on the witness list. I am assistant to Mr. Mathews, who is resident auditor of the Martin Co. at Denver.

Mr. HARDY. Thank you very much.

Mr. Mathews, I guess we got this reversed, but you will straighten it out for us.

Mr. MATHEWS. I am Ralph J. Mathews, 2139 East Floyd Place, Englewood, Colo. I am the USAF resident auditor, Martin-Marietta Corp., Denver Division. As resident auditor, I am responsible for the conduct of the audit operations at the Denver division.

Mr. HARDY. How many auditors do you have in your operation, Mr. Mathews?

Mr. MATHEWS. We have 13, sir—including myself, it would be 14 for our office.

Mr. HARDY. Are you a CPA?

Mr. MATHEWS. No, I am not.

Mr. HARDY. Do you have any in your organization?

Mr. MATHEWS. Yes, sir.

Mr. HARDY. All right, go ahead.

Mr. REDDAN. Mr. Mathews, I would like to direct your attention to your 1962 audit report, and specifically the item in there which you questioned with respect to the crab feast for the year ending December of 1962. Do you have that before you, sir?

Mr. MATHEWS. Yes, sir.

Mr. REDDAN. Is this crab feast an annual affair at the Martin plant in Denver?

Mr. MATHEWS. 1962 was the first year, sir. One was also held in 1963.

Mr. REDDAN. Now, with respect to the 1962 feast, what was the total cost of that?

Mr. MATHEWS. The total cost of the 1962 crab feast, as identified by the contractor's manager of cafeteria operations, was \$4,410.69.

Mr. REDDAN. What were the items which made up that figure, sir?

Mr. MATHEWS. Food and clams, \$1,430.50.

Mr. REDDAN. What was that again?

Mr. MATHEWS. I am sorry—crabs and clams, \$1,430.50. Beef for barbecuing, \$435. Crabcakes, soup, salad, vegetables, bread, and sundry items, \$299.51, for a subtotal of \$2,165.01. The labor cost of cafeteria personnel in the preparation and serving of the food is stated as \$695.71. Expendable supplies, including paper goods, uniforms, decorations, rental of food warmers, losses of silverware, and mileage of cafeteria personnel, \$420.92. The rental of the amusement park pavilion, \$200, even. Beer kegs, cups, ice and service charge, \$929.05, which gives a total of \$4,410.69.

Mr. HARDY. Then the transportation of the crabs and clams was included in the figure?

Mr. MATHEWS. No, sir, it was not.

Mr. HARDY. Then that doesn't represent the total cost of the crab feast.

Mr. MATHEWS. No, sir, that is correct.

Mr. HARDY. What other items of cost actually properly attributable to this crab feast are not included in this \$4,100 figure you have given?

Mr. MATHEWS. The crabs and the clams were flown in a leased DC-6 aircraft from Baltimore to Denver.

Mr. HARDY. What was the cost of that?

Mr. MATHEWS. We are looking into and endeavoring to develop costs attributable to this flight, and we have made some determinations with regard to what we think the cost might be, but the costs as we have computed them on the basis of prorating the cost of the operation

of the aircraft—a straight proration—we have determined to be \$6,318.

Mr. HARDY. Well, now, you said that was a leased aircraft.

Mr. MATHEWS. Yes, sir.

Mr. HARDY. What else did it fly beside these crabs and the clams?

Mr. MATHEWS. The aircraft flew cargo having the weight of 6,535 pounds, and it also flew on this trip five passengers.

Mr. HARDY. Were they going to the crab feast?

Mr. MATHEWS. I can't say, sir.

Mr. HARDY. Well, were they company employees?

Mr. MATHEWS. Yes, to the best of my knowledge.

Mr. HARDY. You don't know whether this plane may have had as its specific mission picking up those people and bringing them to the feast along with the crabs, or maybe they were attendants for the crabs? Seriously, do you know who they were?

Mr. MATHEWS. No, sir, I do not have the names of the passengers.

Mr. HARDY. Did you inquire as to what particular mission they were serving? They were company employees, I believe you said.

Mr. MATHEWS. Yes, sir; to the best of my knowledge, they were.

Mr. HARDY. How much did the crabs and the clams weigh?

Mr. MATHEWS. The weight as estimated by the contractor is 3,600 pounds.

Mr. REDDAN. Now, this is the 1962 crab feast you are talking about?

Mr. MATHEWS. Yes, sir; all my remarks were addressed to that.

Mr. HARDY. In other words, the rest of the cargo was something under a thousand pounds. Of what did that consist?

Mr. MATHEWS. Sir, the weights that I have here—the cargo was 6,535 pounds—

Mr. HARDY. The crabs and the claims you said were 3,600.

Mr. MATHEWS. Yes, sir.

Mr. HARDY. My arithmetic is still pretty good—a little less than 3,800 pounds.

Mr. MATHEWS. Excuse me, sir, may I make a correction, please? The weight of 6,535 pounds that I gave you was the weight of cargo carried on the round trip, Denver to Baltimore, and if I may have a moment I will give you the weight of the hardware from Baltimore to Denver.

Mr. HARDY. That was cargo going both ways?

Mr. MATHEWS. Yes, sir; round trip cargo. It would be 5,168 pounds, sir.

Mr. HARDY. Now what is that? Is that the cargo that it took to Baltimore?

Mr. MATHEWS. No, sir; this would be the return cargo.

Mr. HARDY. That is the cargo that came back from Baltimore. In other words, you take off 3,600 pounds for your crabs and clams—

Mr. MATHEWS. Yes, sir.

Mr. HARDY. And you get 1,560 pounds of other cargo; is that right?

Mr. MATHEWS. By deducting 3,600 pounds from 8,768, which was the total weight of the cargo in the aircraft, including the crabs, I arrive at a number of 5,168.

Mr. HARDY. Well, I got 5,168, too, but I don't know what it represents.

Mr. MATHEWS. This represents, sir, various shipments of missile hardware applicable to contracts being performed by the Denver division of the Martin Co.

Mr. PIKE. Mr. Chairman, would you yield?

Mr. HARDY. Surely.

Mr. PIKE. Now, I am sure that Martin would feel that this was missile hardware being shipped out to Denver. Did you check the actual bill of lading for this flight? Do you know that this was the balance of that cargo going from Baltimore out to Denver?

Mr. MATHEWS. Yes, sir; there is a bill of lading covering this flight.

Mr. PIKE. And you checked that?

Mr. MATHEWS. I did not check it at the time that the 1962 overhead audit report was prepared, sir.

Mr. PIKE. You have subsequently checked it?

Mr. MATHEWS. Yes, sir; that is correct.

Mr. PIKE. And you are in a position to say of your own knowledge that all of the cargo on that plane other than the crabs was missile hardware going from Baltimore to Denver? There wasn't any beer on the plane?

Mr. HARDY. There are some nice breweries in Baltimore.

Mr. MATHEWS. No, sir; not to my knowledge.

Mr. PIKE. Well, the cargo bill of lading for that plane showed nothing—you are telling us of your own general knowledge—except missile hardware and some 3,680 pounds of crabs?

Mr. MATHEWS. The bill of lading supporting the shipment of the missile hardware shows reference to various shipping documents which detail parts. To my knowledge, there was no document made up that describes the crabs as to the number of containers, but with respect to there being anything else on the plane, on the basis of the documentation which has been provided to me, I have no knowledge of there being anything else on that plane, sir.

Mr. PIKE. And did the documentation which was provided to you show you who the personnel were who were going on this trip?

Mr. MATHEWS. No, sir. I do not have that documentation.

Mr. PIKE. So you did not check into whether or not people were being transported from Baltimore to Denver for the crab feast?

Mr. MATHEWS. No, sir; we have not checked that.

I do wish to point out that we have not at this moment completed our marshaling of the facts related to this.

Mr. PIKE. This doesn't come as any shock to me, I might say. We have yet to find any one of these 1962 items, the audit on which has been completed.

Mr. DEARDORFF. North American has been completed, sir.

Mr. PIKE. Then I take it all back—I want to congratulate the Government for having completed two audits on North American.

Mr. HARDY. I think, if you will permit, on that I understood the audit had been completed on this thing, unless it has been reopened. Haven't you completed your audit on this, the 1962 one?

Mr. MATHEWS. Yes, sir; indeed we have, and we issued a report. However—

Mr. HARDY. Your report would indicate that in connection with the crab feast you disapproved the cost of beer of \$540; is that right?

Mr. MATHEWS. Sir, there is another item immediately above the \$540 which is also—

Mr. HARDY. Yes, that I am going to come to next, rental of the pavilion for \$557, which you disapproved. Is there something else, too?

Mr. MATHEWS. Sir, there is something else included in there. There is a service charge for the serving of the beer.

Mr. HARDY. And that is included in the \$557?

Mr. MATHEWS. Yes.

Mr. HARDY. Because the pavilion didn't cost but \$200.

Mr. MATHEWS. Yes, sir; that is correct.

Mr. HARDY. So then I take it that \$357 of that represents the cost of serving of beer?

Mr. MATHEWS. Yes, sir; that is right.

Mr. PIKE. But you did not question the cost of transporting the crabs from Baltimore to Denver?

Mr. MATHEWS. At the time this report was prepared, sir, we were not aware of the fact that the crabs had been flown in the aircraft.

Mr. PIKE. Well, you knew that a great, great many crabs got from Baltimore out to Denver, somehow, and regardless of whether they were flown or harnessed or how they got there, there was a transportation charge of some kind for getting a lot of crabs from Baltimore out to Denver. Did you look into how the crabs were transported before you closed this audit?

Mr. MATHEWS. No, sir, we did not.

Mr. HARDY. Let's get back to this cost business a little bit. What was the total cost of this plane? You say it was a leased plane. What was the total invoice for the leasing of the plane?

Mr. MATHEWS. In 1962, the leasing rate was \$20,000 per month, a flat rate, and commencing in September there was an additional charge of \$1,000 per month for a spare—I beg pardon, that is September of 1963—an additional charge of \$10 per flight hour. That is the lease cost of operating the plane, or I mean the cost of the lease, excuse me.

Mr. HARDY. In other words, this plane was leased for \$20,000 for a month, and the fact it made this extra trip to Baltimore didn't cost any more?

Mr. MATHEWS. With respect to the lease charges, that is correct, sir. There would be out-of-pocket expense in connection with any flight of the aircraft, but on the lease, no, sir, there would not be any additional cost.

Mr. HARDY. They had a leased plane there, and it wasn't doing anything so they sent it to Baltimore. Now, what was it—

Mr. PIKE. They were picking up some perishable missile parts, Mr. Chairman.

Mr. HARDY. The operating cost of one of these aircraft is pretty heavy.

Mr. MATHEWS. Yes, sir; it is a substantial amount of money.

Mr. HARDY. I think we are running around in circles here, now. We are not having too much luck in tying down what is the amount of transportation cost actually attributable to this crab feast, but I want to get to one other thing, now.

I don't know whether this is your responsibility or Mr. Anderson's. How do you arrive at allowing this expense for the purpose of employee morale, health, and welfare under ASPR 15-205.10?

Mr. ANDERSON. Well, on the crab feast, as yet, we have made no determination.

Mr. HARDY. You mean even so far as the 1962 one is concerned?

Mr. ANDERSON. That is right, we have not finished the negotiation of the 1962 overhead. In fact, we have not had our discussions with the contractor.

Mr. PIKE. I thought this audit, the 1962 audit, was completed.

Mr. HARDY. The audit is completed, he is contract administrator, but he says now he hasn't gotten around to tending to his homework.

Mr. PIKE. In other words, the audit is completed as far as the auditor is concerned, but as far as negotiating with Martin what you are going to do with the audit, you haven't completed that yet.

Mr. ANDERSON. That is correct.

Mr. PIKE. Then you are in the same position as these other companies were insofar as the completion of these audits is concerned.

Thank you, Mr. Chairman.

Mr. HARDY. Haven't you drawn up some tentative schedule? I notice insofar as the audit is concerned there was recommended to be disallowed about \$1,100 on this crab feast.

Mr. ANDERSON. Yes, sir.

Mr. HARDY. You have actually pretty well arrived at what your position is going to be?

Mr. ANDERSON. On the crab feast?

Mr. HARDY. Yes.

Mr. ANDERSON. No, sir.

Mr. HARDY. Well, I am glad to find that out.

Mr. REDDAN. The ASPR states that:

Reasonable costs of * * * recreational activities * * * incurred in accordance with a contractor's established practice or custom or area, for * * * employee-employer relations, employee morale, and employee performance, are allowable.

Now, as I understand it, this was a practice established in 1961.

Mr. ANDERSON. That is right.

Mr. REDDAN. I am just wondering how you interpret the ASPR, how you measure the present activity in terms of the ASPR. Is this one of the things which the ASPR permits?

Mr. ANDERSON. I would feel it would permit it to the degree it is reasonable, but we have not passed judgment on it as yet. It would be part of his employee morale or recreation program. We have looked at this and found that the total program ran—and I had some figures on this—for the years 1959 and 1960, \$3 per employee. In 1961, it ran \$3.43. In 1962, it ran \$3.93.

Mr. PIKE. You are interpreting, then, ASPR Nos. 15-205.10 and 15-205.11, and you come to the conclusion that a crab feast comes under the heading of a health and welfare activity, and does not come under the heading of a meal; is that correct?

Mr. ANDERSON. As I stated before, we have not made a final decision on it. I believe it is eligible for consideration under 15-205.10.

Mr. PIKE. Now, 15-205.10, and I am sorry, Mr. Chairman, if I keep coming back to this—

reasonable costs of health and welfare activities such as house publications, health or first-aid clinics, recreational activities, and employee counseling services—

and you find that a crab feast comes within that, and those are allowable; you do not find that a crab feast comes within entertainment costs, which are described as "costs of amusement, diversion, social activities and incidental costs relating to such as meals" are unallowable; is that correct?

Mr. ANDERSON. Well, again, as I have stated. I have not made a final decision on it.

Mr. PIKE. No, but you have given us your opinion that a crab feast is not a meal but is a recreational activity of the type referred to in health and welfare activities such as house publications, health or first-aid clinics, recreational activities, and employee counseling services.

Mr. ANDERSON. The reason I say I feel it warrants consideration is that the picnic that is held annually falls in the recreational program, and I would say this parallels the picnic, to a degree. It was an outing type of affair.

Mr. PIKE. It was, indeed, and you find an outing-type affair not to be a social activity but a recreational activity, or a health and welfare activity, and you find a crab feast is not a meal; is that correct?

Mr. ANDERSON. I believe we get into a very technical position in defining a meal.

Mr. PIKE. Well, you can make it as technical as you want, but to me a meal was always something that you ate, and a recreational activity was not necessarily something that you ate.

Mr. HARDY. Did I understand that you considered the crab feast was sort of a substitute for a picnic?

Mr. ANDERSON. It was in addition to the picnic.

Mr. HARDY. Oh, it was in addition to the picnic?

Mr. ANDERSON. Yes, the picnic is eligible for all employees. The crab feast was down to the department managers' level.

Mr. HARDY. Foremen?

Mr. ANDERSON. Leadmen, foremen.

Mr. HARDY. Supervisory personnel?

Mr. ANDERSON. That is right.

Mr. HARDY. They were the only ones that went to the crab feast?

Mr. ANDERSON. That is right.

Mr. HARDY. What had they been doing before? Had they been having some sort of frolic before? They didn't have a picnic?

Mr. ANDERSON. They were eligible to attend the picnic.

Mr. HARDY. Oh, they went to the picnic, but they wanted to give them something extra?

Mr. ANDERSON. That is right.

Mr. HARDY. And is this the first time they gave them something extra?

Mr. ANDERSON. To my knowledge, of this type, yes.

Mr. HARDY. So you spread the cost among all employees and came up with an average of \$3.92, although they weren't permitted to have any crabs. They didn't have any crabs at the picnic?

Mr. ANDERSON. In calculating the cost, yes, it was spread across all employees.

Mr. REDDAN. Have you done anything with respect to the 1963 crab feast, as yet?

Mr. MATHEWS. Sir, may I speak to the airplane cost for a moment?

Mr. REDDAN. Yes, surely. Now, this is 1962 you are talking—

Mr. MATHEWS. This is 1962, and I have had a chance to think here for a moment, and in connection with your asking me how much did it cost to transport these crabs, I believe I told you \$6,318. That is our estimate with regard to the cost of the flight, the round-trip flight, I might add, Denver to Baltimore and return.

Now, in trying to get a proration of these costs as between the people, the passengers, and the cargo carried in the plane, we made a proration on the basis of the weights. The money assessable against the crabs and the clams amounts to \$1,769.

Mr. HARDY. That might be a valid approach to it, unless you concluded that actually this aircraft was sent over there just to get these crabs, and because it was coming back they let these folks come along to the crab feast.

Now, of course, there are a lot of elements that go into this, and I realize some are intangible and difficult for an auditor to button up, but there are a lot of possibilities. It is entirely possible that this entire cost really should be charged to the crab feast. On the other hand, it is entirely possible that maybe it shouldn't. I don't know how you can arrive at it.

This might shed a little light on that particular point. In 1963 there was a prearrangement that the crabs would be ready, and they were going to send a plane over to pick them up, apparently, because this was done a week ahead, and on the face of this cafeteria purchase order I would draw the conclusion that the plane was sent over specifically to pick the crabs up, and if it carried anything else it was purely coincidental. Maybe as an auditor you wouldn't arrive at that conclusion, but as a layman, I would, unless I had something to convince me otherwise. I don't know how you could determine that isn't what actually happened in 1962 also.

Mr. MATHEWS. Sir, may I make one additional point?

Mr. HARDY. Yes.

Mr. MATHEWS. With respect to the operation of the leased aircraft, I would like to invite your attention to our audit report for that year, wherein we set out the entire costs of the operation of it for the consideration of the contracting officer.

Mr. HARDY. Well, now, what has been the practice in the past? At least there had been a leased aircraft previously, hadn't there, and had it been allowed in overhead?

Mr. MATHEWS. To my knowledge, we have not had the leased aircraft assigned to the Denver division; no, sir. The other aircraft that the company has are controlled from the corporate office, and is a corporate expense.

Mr. HARDY. I don't follow you. What you are saying is that you have suggested that the entire cost of the leased aircraft be the subject of negotiations?

Mr. MATHEWS. Well, we feel that because of the significance of the sums involved that it is an item proper for consideration by the contracting officer, and we do not feel that we have the capability as auditors to determine the need and the necessity and to make the appraisal as to the utilization—

Mr. HARDY. That is not your business, anyhow.

Mr. MATHEWS (continuing). Of the aircraft. That is why we set it out.

Mr. HARDY. That is not your business, anyhow; that is up to the contract administrator.

Mr. MATHEWS. Yes, sir.

Mr. HARDY. But do I understand that the year 1962 is the only year in which the leased aircraft came under consideration here for inclusion in overhead?

Mr. MATHEWS. To the best of my knowledge, sir, this is correct.

Mr. HARDY. So in 1962 they went into a leasing program and leased this aircraft for \$20,000 a month. Now, the determination had not been made as to whether it would be permitted as overhead. Insofar as the crab feast is concerned, since this question has arisen, the amount of the cost attributable to the transporting of the crabs is a matter of interest.

However, if it hadn't been for this inquiry, the whole question would have been one as to whether the lease cost of the plane should be included in reimbursable overhead; is that right?

Mr. ANDERSON. If I might make a comment to help clear this up. The determination on the leasing of the aircraft was after considerable discussion between the contractor at the Air Force representative's office and the Ballistics Division headquarters at Norton Air Force Base. They were attempting, because of the critical need of moving materials between the various sites, to get an aircraft. There was none available, so they authorized—

Mr. HARDY. There had been prior approval, then?

Mr. ANDERSON. There had been prior approval to lease the airplane.

Mr. HARDY. So that had been cleared, that was going to be included in the reimbursable overhead.

Mr. ANDERSON. The problem now still remaining is to determine did they effectively use the airplane for this period of time.

Mr. HARDY. What about the operating cost? Presumably the \$20,000 only covered the lease of the aircraft and the operating cost was in addition. Is that correct?

Mr. ANDERSON. That is correct.

Mr. HARDY. So you would have had, in addition to—insofar as the crab feast itself was concerned—a pro rata share of the \$20,000 for that month, whatever that might amount to, you would have the actual operating cost of the aircraft.

Mr. MATHEWS. Yes, sir; that is correct.

Mr. HARDY. This was a DC-6. Do you know what the hourly operating cost is?

Mr. MATHEWS. We have computed the cost for 1962 at \$486 per flight hour.

Mr. HARDY. Well, what is the flying time?

Mr. MATHEWS. Approximately 6½ hours, average, from Baltimore to Denver, sir.

Mr. HARDY. In other words, \$3,000 purely for operation?

Mr. MATHEWS. This would include the total cost—the lease, and—

Mr. HARDY. Now wait a minute—\$486 is your total cost of your lease and operation of a DC-6 aircraft? Boy, you had better go into business. Is that right—your lease and your operating cost?

Mr. MATHEWS. Yes, sir; \$486 per hour.

- Mr. HARDY. That is a surprise to me.
- Mr. MATHEWS. Per flight hour.
- Mr. HARDY. Per flight hour?
- Mr. MATHEWS. Yes, sir.
- Mr. HARDY. That includes your lease and your operating cost?
- Mr. MATHEWS. The lease, the insurance, the gasoline, the oil—
- Mr. HARDY. And the crew?
- Mr. MATHEWS. And the pilots' salary, or I should say the members of the crew.
- Mr. HARDY. Well, I will have to check that out with GAO. Let's go ahead with something else.
- Mr. REDDAN. With respect to the 1963 crab feast, was a company plane used to transport the crabs in that particular case?
- Mr. MATHEWS. Yes, sir.
- Mr. REDDAN. This was not a leased plane?
- Mr. MATHEWS. Oh, I am sorry. It was the same aircraft.
- Mr. REDDAN. Did it belong to the Martin Co.?
- Mr. MATHEWS. No, sir; this was leased.
- Mr. REDDAN. That was leased in 1963 also?
- Mr. MATHEWS. Yes, sir; it was the same plane. It was leased in 1962 and in 1963.
- Mr. ANDERSON. The lease was extended—it continued.
- Mr. REDDAN. Have you gone into the 1963 feast at all?
- Mr. MATHEWS. We have been gathering information on it; yes, sir.
- Mr. REDDAN. Do you have the vouchers, the supporting vouchers on the cost of that feast?
- Mr. MATHEWS. Yes, sir; I have an itemization of the cost.
- Mr. REDDAN. What was the cost of the crabs?
- Mr. MATHEWS. The crabs and the clams, \$1,784.
- Mr. REDDAN. Do you know what the shipping weight was?
- Mr. MATHEWS. The shipping weight has been estimated by the contractor at 3,900 pounds.
- Mr. REDDAN. At how much?
- Mr. MATHEWS. 3,900 pounds, sir.
- Mr. REDDAN. Was that iced?
- Mr. MATHEWS. Yes, sir.
- Mr. REDDAN. That is about 5,000 pounds away from the figure that he gave us. Is this the Tilghman Packing Co. of Baltimore?
- Mr. MATHEWS. Yes, sir, they were the supplier.
- Mr. REDDAN. And with whom did you talk over there to get the shipping weight?
- Mr. MATHEWS. I did not talk with the Tilghman Packing Co., sir.
- Mr. REDDAN. How did you get your information, sir?
- Mr. MATHEWS. We went to the contractor's cafeteria manager, and he, with other contractor's representatives, compiled this estimate.
- Mr. REDDAN. Well, now, this raises another question in my mind, sir, on your 1962. Where did you get your shipping weights for that flight?
- Mr. MATHEWS. For the crabs and clams, sir?
- Mr. REDDAN. Yes.
- Mr. MATHEWS. We got this from the contractor, also.
- Mr. HARDY. And you arrived at the weight of the missile parts by subtracting the weight that he gave you for the crabs and the clams from the total weight, is that right?

Mr. MATHEWS. Yes, sir. With respect to the weight, I would like to offer this comment. The contractor's representative advises me that under the regulations they must operate in flying the aircraft, the pilot must have the certified weight with respect to all cargo that is placed on the plane, so the cargo weight that is shown in the log is the total weight of whatever cargo is in the plane.

Mr. HARDY. You have the total weight of what the aircraft carried, so far as cargo is concerned. I can understand that. But how do you know what it consisted of?

Mr. MATHEWS. Well, with regard to the missile parts, sir, there are shipping documents, and on the face of these shipping documents there is a stamp which shows the weight of the items in that particular carton.

Mr. HARDY. That is what I want to understand. That is the way that you determined the weight of the missile parts, by adding the weights on this shipping order, rather than by just subtracting the weight of the crabs from the total weight of the cargo?

Mr. MATHEWS. Well, sir, we didn't feel that we were competent to do any estimating in the matter of the weights, of the crabs.

Mr. HARDY. Didn't the manifest show what the weight of the crabs was?

Mr. MATHEWS. No, sir. There is no entry on the manifest that shows the weight of the crabs.

Mr. HARDY. But there is something that shows the total weight of the cargo.

Mr. MATHEWS. Yes, sir, the total is shown, that is right.

Mr. HARDY. If you had the weight shown of all of the other cargo, all you had to do was add that up and subtract it from the total, and you would have the weight of the crabs. But you didn't do that; you went to the cafeteria manager and asked what was the weight of the crabs. Isn't that what you did?

Actually, do you have a tabulation showing the actual weight of the nonseafood cargo?

Mr. MATHEWS. Yes, sir, I have a tabulation.

Mr. REDDAN. Is this for 1962 or 1963?

Mr. MATHEWS. I have made up a tabulation for 1963, and we have the shipping documents for 1962.

Mr. HARDY. Well, now, if you have the tabulation—wait a minute, now. You have the actual weights for 1962?

Mr. MATHEWS. For the total cargo, yes, sir.

Mr. HARDY. And did you subtract that from the total cargo and thereby arrive at the weight of the crabs and clams, or did you get that weight from the cafeteria manager?

Mr. MATHEWS. No, sir, we got the weight from the cafeteria.

Mr. HARDY. Well, now, they didn't agree, did they—the weight that the cafeteria manager gave you plus the weight of the missile parts aboard that plane didn't add up to the total cargo, did it?

Mr. MATHEWS. Well, we do not have, sir, all of the shipping documents.

Mr. HARDY. How do you know you don't?

Mr. MATHEWS. Sir?

Mr. HARDY. How do you know you don't.

Mr. MATHEWS. Because we have been advised by the contractor that they haven't provided us with all of the shipping documents.

Mr. HARDY. Let's talk about 1963, please, for a moment.

Mr. MATHEWS. All right.

Mr. HARDY. Do you have a tabulation of the weights of the non-seafood cargo?

Mr. MATHEWS. Yes, sir. The tabulation that I have, the shipping documents in my possession at the moment—

Mr. REDDAN. What shipping documents are they that show the weights?

Mr. MATHEWS. These are documents prepared by the contractor at its Baltimore plant covering the missile parts.

Mr. HARDY. It is equivalent to a bill of lading?

Mr. MATHEWS. Yes, sir.

Mr. HARDY. All right, now, what does that add up to?

Mr. MATHEWS. It adds up to 3,601 pounds.

Mr. HARDY. That is what went on that plane on that day—and how much was the weight of the seafood?

Mr. MATHEWS. It has been estimated by the contractor at 3,900 pounds.

Mr. HARDY. That gives you a total of 7,501 pounds. What was the total weight of the cargo?

Mr. MATHEWS. 8,291 pounds. With respect to this, sir, I would like to point out that the contractor's representative is still searching his files for what he says is the balance of the shipping documents.

Mr. HARDY. Do you know how many crabs were involved? Was it 558 dozen?

Mr. MATHEWS. I believe so, but I would like to refer to it.

Mr. HARDY. I have an invoice in front of me for 310 dozen steamed wrapped crabs, 230 dozen bobbed crabs, 20 pounds of back fin, and 18 dozen frozen jumbo soft crabs. I presume this is the right one.

Mr. MATHEWS. Tilghman Packing?

Mr. HARDY. From Tilghman Packing Co.

Now, this does not show any weights, but we were advised by the Tilghman Packing Co. that this shipment, iced, would represent a gross weight of approximately 8,500 pounds.

Mr. MATHEWS. I cannot comment on that.

Mr. HARDY. You might be looking unnecessarily for the 790 pounds to make up the difference in weight, which raises a question in my mind as to whether these parts you have been talking about might actually have been transported on another plane that day. I don't know.

Mr. REDDAN. Is this the normal way in which you check costs in your audit, to go to the contractor rather than to the source of the invoice?

Mr. HARDY. That I think would be reasonable, to expect the contractor to supply you with that information. However, it seems to me in the absence of being able to provide you with a bill of lading or anything that would really authenticate the weights, if you really wanted to get an auditing figure, a figure that an auditor would respect, you would have to verify it in some other way. I don't know how important it was, and it might not have been so important, but in this particular case it looks like to me the figures were not very good.

Thank you very much, gentlemen.

Mr. ANDERSON. May I make one comment on the delay of the closing of the 1962 overhead?

Mr. HARDY. Certainly.

Mr. ANDERSON. We held up the closing of the 1962 purposely because of a problem that had to have legal consideration up here at Headquarters System Command, which amounts to something approximating a half million dollars that would result in costs that are associated with NASA contracts that would fall into the overhead of Air Force contracts.

Mr. HARDY. In other words, except for that, you have already closed it.

Mr. ANDERSON. Well, we haven't closed it; we are working and researching, but we haven't had our discussions with the contractor.

Mr. HARDY. But this is the only item that really you are held up on, so I take it actually, so far as you are concerned, you have arrived at a determination of what ought to be done with the crab feast. That is what your own testimony indicates, Mr. Anderson. You are all ready to button it up except for this one legal item. That being the case, you have already decided what you are going to do with the crab feast, which is all right, but I think we might as well understand what we are talking about.

Mr. ANDERSON. What I was trying to point out is that we have done nothing—

Mr. HARDY. You were trying to show you are really not so doggoned far behind that you ought to be criticized for not closing the 1962 account, but when you did, you sort of put your foot in this other situation.

Mr. ANDERSON. I realize this, with that interpretation.

Mr. HARDY. Thank you very much, gentlemen.

I wonder now if we might have Mr. J. P. Galimberti, Mr. Marvin Silberberg, Mr. Stanley Tomaszewski, and Mr. Alfred A. Vitale.

TESTIMONY OF JOHN P. GALIMBERTI, CONTROLLER, BOSTON PROCUREMENT DISTRICT, U.S. ARMY, BOSTON, MASS.; ALFRED A. VITALE, SUPERVISORY AUDITOR; STANLEY F. TOMASZEWSKI, AUDITOR, U.S. ARMY AUDIT AGENCY, BOSTON DISTRICT; ASSIGNED TO RAYTHEON CO., WALTHAM, MASS.; AND MARVIN SILBERBERG, NATIONAL AERONAUTICS AND SPACE ADMINISTRATION, CAMBRIDGE, MASS.

Mr. HARDY. Gentlemen, will each of you identify yourselves, give your name and address to the reporter, and give us an indication of what your specific job is now.

Mr. GALIMBERTI. John P. Galimberti, controller, Boston Procurement District, U.S. Army, Boston, Mass. Home address, 7 Nantucket Road, Wellesley Hills, Mass. As controller of the Boston Procurement District, I have the overall fiscal responsibilities of advising the contracting officer of all fiscal activities including finance and accounting, cost and price analysis, financial responsibility, and am charged with the supervision of the triservices responsibilities placed on the Boston Procurement District by the Army.

Mr. HARDY. Thank you.

Mr. TOMASZEWSKI. Stanley F. Tomaszewski, auditor with the Boston District U.S. Army Audit Agency, located at Raytheon Co. residency, 141 Spring Street, Lexington, Mass.

Mr. SILBERBERG. Marvin Silberberg. I work for NASA, located at 30 Memorial Drive, Cambridge, Mass. and formerly worked for the U.S. Army Audit Agency. My former position was district supervisor, Boston District, Raytheon Residency.

Mr. HARDY. Thank you, Mr. Silberberg.

Mr. VITALE. Alfred A. Vitale. I am a supervisory auditor with the U.S. Army Audit Agency and have been assigned to the Raytheon residency for the last 3 years. The Raytheon residency I am attached to is located in Waltham, Mass., and my overall responsibility is: (1) Assistant to the managing auditor of the residency, and (2) to provide direction in the overall performance of audits and issuance of reports.

Mr. HARDY. Thank you, gentlemen.

Mr. REDDAN. Gentlemen, the committee would like to direct your attention to one phase of the audit reports of your group, particularly the income derived from the vending machines in the Raytheon plant. Can you tell the committee—and I address the question to any one of you four who is most knowledgeable on the subject—what disposition is made of the vending machine proceeds? What profits accrue annually from the vending machine operations, and what is done with those funds?

Mr. SILBERBERG. Well, actually, the money that comes into the company is kept in a separate fund which is called the Raytheon Canteen Fund, I believe—we have it written down here—

Mr. REDDAN. Excuse me. What is the basis for that disposition of funds?

Mr. SILBERBERG. It is a separate bank account—

Mr. REDDAN. But why is it put in the bank account?

Mr. SILBERBERG. It is excluded from the company's books so far as its balance sheet and income statement.

Mr. REDDAN. But why?

Mr. SILBERBERG. Specifically, this is just something the company chose to do. I don't know why.

Mr. VITALE. This represents receipts in the form of a sales commission from operating vendors. Raytheon isn't in the vending business, so-called, and they merely identify these amounts separately and place them in a separate bank account under the separate name, and do not run these receipts and disbursements through their books of account, as such.

Mr. REDDAN. I see, do they make—

Mr. SILBERBERG. Responsible company officials have told me the reason the funds are kept separate is because of the fact they feel the money does not belong to the company.

Mr. REDDAN. Do they maintain control of the funds, the company?

Mr. SILBERBERG. Yes; they do.

Mr. REDDAN. Do they disburse the funds?

Mr. SILBERBERG. Yes, sir.

Mr. REDDAN. They don't ask anybody's permission on the disbursement of the funds?

Mr. SILBERBERG. The funds are disbursed by responsible company management.

Mr. REDDAN. So that would indicate that they are company funds.

Mr. SILBERBERG. It would appear to indicate as much.

Mr. REDDAN. Well, do you have any other explanation?

Mr. SILBERBERG. Other than the fact that the funds are kept separate from their own records, this would be a legal determination I have no knowledge of.

Mr. HARDY. The fellow who spends the money usually considers it belongs to him—except when my wife spends money.

Mr. GALIMBERTI. The problem on the disposition of funds has come up in previous audits. The question was raised as to what disposition was to be made of these funds, or had been made, and under what agreement it had been made.

There was an understanding between the unions, the various unions of Raytheon, dealing with Raytheon as a company, and Raytheon, that these proceeds will be donated in the name of the employees to the United Fund of Greater Boston.

Mr. REDDAN. Excuse me. Is this an agreement reduced to writing?

Mr. GALIMBERTI. It is not a formal part of the contract, but when this came up in the 1961 negotiations, a letter signed by responsible union officials was made available through the company for the negotiators to consider, and for the legal personnel of our district to interpret as to whether it was a proper legal agreement between the parties.

Mr. HARDY. Do the employees under that sort of arrangement decide how much of these funds they can deduct on their income tax return?

Mr. GALIMBERTI. I don't believe they do, sir.

Mr. REDDAN. Does Raytheon?

Mr. GALIMBERTI. I don't believe they do, either, because it is not entered into their books of account, sir.

Mr. HARDY. Somebody is missing a tax break.

Mr. GALIMBERTI. That could possibly be so.

Mr. REDDAN. Do you know this to be a fact, or is this a supposition?

Mr. GALIMBERTI. This is a memorandum account.

Mr. REDDAN. I mean with respect to tax deduction.

Mr. GALIMBERTI. We didn't go behind asking each employee whether they took part of it, but it would seem the way it was disbursed that they probably could not, because on top of this they were also asked to contribute in their own name.

Mr. REDDAN. Well, now, with respect to the company, you say they probably did not get a tax advantage from this. Are you stating that as of your own knowledge, or is that, again, just a supposition?

Mr. SILBERBERG. Well, I would say this much, that the income is not brought on the company's books, and I would also state that the donation would not be on the company's books.

Now, for tax purposes on their Federal income tax return, what they did I specifically do not know, but I would imagine—and I am just making a supposition—that they—

Mr. REDDAN. Let's just stick to what you do know.

Mr. SILBERBERG. All right.

Mr. REDDAN. Has this agreement been reduced to writing, did you say?

Mr. GALIMBERTI. There was an exchange of correspondence between the union and the director of labor relations of Raytheon in December of 1962 which confirmed this understanding.

Mr. REDDAN. Did you see the letter?

Mr. GALIMBERTI. Yes, sir.

Mr. REDDAN. And what did it say?

Mr. GALIMBERTI. It says it is being sent at Raytheon's request to state the union's position with respect to profits realized from vending machines located in Raytheon plants in Massachusetts:

The union and the company negotiated a specific and irrevocable agreement several years ago with respect to such profits. It was agreed that the profits would be turned over by the company to the United Fund each year. In the event the company were to fail to comply with this agreement, the union would feel it necessary to initiate the customary grievance proceedings to make certain that the company would live up to the agreement in all respects.

Mr. REDDAN. Did you ask for a copy of the agreement?

Mr. GALIMBERTI. There was no other written agreement besides this letter. There were verbal understandings, we understand.

Mr. HARDY. But it makes reference to some irrevocable agreement. That is not in writing?

Mr. GALIMBERTI. I understand it is not, sir.

Mr. HARDY. I don't know how you can have an irrevocable agreement that is not in writing. Do you know?

Mr. GALIMBERTI. Well, the unions negotiate in peculiar manners, and I don't know how they operate in this particular situation.

Mr. REDDAN. What does this agreement call for, sir?

Mr. GALIMBERTI. That the income from vending machines in plants in Massachusetts be donated to the United Funds each year.

Mr. REDDAN. Has this irrevocable agreement ever been changed?

Mr. GALIMBERTI. It is in the process of being formalized into a formal trust agreement, an irrevocable trust.

Mr. REDDAN. Calling for the disposition of the entire profits from the vending machines to the United Givers Fund?

Mr. GALIMBERTI. I believe the basic condition will stay the same. I have not as yet seen the official trust papers.

Mr. REDDAN. Is there a limitation of \$75,000 on the amount?

Mr. GALIMBERTI. There is not supposed to be such limitation, sir.

Mr. REDDAN. Then do they give the full amount of the profits every year to the United Fund?

Mr. GALIMBERTI. No, sir, they have not each year been giving the full amount to the United Givers Fund.

Mr. HARDY. What happened to the rest of it?

Mr. SILBERBERG. There is—I forget exactly the figures that came in, but in 1962 they took in \$107,000. The company was given \$107,000—both in vending machine receipts and telephone receipts.

Mr. REDDAN. What year was this?

Mr. SILBERBERG. 1962.

Mr. REDDAN. How about in 1961?

Mr. SILBERBERG. For 1961, I don't have the exact figure with me, but they took in approximately \$75,000, within three or four hundred dollars.

Mr. REDDAN. In 1961?

Mr. SILBERBERG. In 1961. That is in vending machine income and telephone receipts. There is a combination of the two in here.

Mr. HARDY. How much has been accumulated in that fund?

Mr. SILBERBERG. As of July 17, sir, the \$71,824 in the fund which includes the 1964 vending machine and telephone receipts, and the balance from prior years that hadn't been donated to the United Fund.

Mr. HARDY. Well, now, that was after the 1963 donation?

Mr. SILBERBERG. Yes, sir. I have approximated that it was approximately \$40,000 that was left in the fund as of the end of the year that wasn't donated in the following year. In other words, the donation takes place in the subsequent year to the United Fund.

Mr. HARDY. I have some figures here. I don't know exactly what they mean. It says company contribution—what does that mean?

Mr. REDDAN. You have with you your audit report for the year ending December 31, 1961?

Mr. TOMASZEWSKI. Yes, sir.

Mr. REDDAN. Now, I have what purports to be an excerpt from that audit report dealing with overhead, page 15, the item, "Income from vending machines."

Mr. SILBERBERG. Unfortunately, sir, we don't have this page. Could you identify it by the exhibit, sir?

Mr. REDDAN. I will show you the copy that I have, and see if you can identify it—

Mr. TOMASZEWSKI. Yes, sir; it is page 7 of 14.

Mr. REDDAN. Did you see the item at the bottom of the page, "Income from vending machines"?

Mr. SILBERBERG. Yes, sir. This amount represents the income received by the contract on—

Mr. REDDAN. Wait a minute, you don't have the same—it starts off, "The contractor reiterates"—

Mr. SILBERBERG. That is their rebuttal, sir.

Mr. GALIMBERTI. That is the contractor's rebuttal.

Mr. REDDAN. I want to know if this ever came to your attention.

Mr. SILBERBERG. Yes, sir; it is included in our report.

Mr. REDDAN. Would you read that, sir?

Mr. SILBERBERG (reading):

The contractor reiterates the fact that the funds received have never accrued to the contractor and adds the statement that the funds, on the basis of a long-standing agreement with the bargaining unit of the major portion of the Raytheon employees, have been donated on their behalf to the United Fund of Greater Boston and specifically to the communities in which its employees reside. It further points out that in recent weeks the bargaining unit has agreed with the contractor on a modification of the arrangement to the effect that in future years only the first \$75,000 will so be donated, the balance to be used by the company to pay for such things as improvement and maintenance of cafeterias, and for other expenses incurred for similar direct benefits to employees.

The position of the U.S. Army auditor remains unchanged and the full amount of income received in 1961 is recommended as a deduction of the corporate-parent company expense pool.

Mr. REDDAN. Now I go back to my question to you, Mr. Galimberti. Doesn't this indicate that the irrevocable arrangement has been changed?

Mr. GALIMBERTI. Well, from that date to this, it still has not been changed except for at the present time when they are actually writing a new irrevocable piece of paper in the form of a trust agreement.

Mr. REDDAN. Well, they don't contribute all the proceeds from the vending machines to the United Fund. That is my understanding of what you testified to originally.

Mr. GALIMBERTI. They have not used it for any other purposes as yet, sir, to our knowledge.

Mr. REDDAN. That is not the point. I want your testimony to be correct, and if you want to change it, now is the time to do it.

I asked you what they did with the income from the vending machines, and my understanding was that you said that they had an irrevocable agreement to turn all those funds over to the United Fund. Now, I am asking you, is that correct?

Mr. GALIMBERTI. As of 1962, during the negotiations for 1961, this was the piece of paper that supported the reinstatement of that position, that allowed this as being not a credit to overhead by the negotiator at that time.

Mr. HARDY. As of that date, they still hadn't contributed all of these funds to the United Fund, had they?

Mr. GALIMBERTI. They had a \$308 balance at that time, sir.

Mr. HARDY. That was all?

Mr. GALIMBERTI. That was all. It wasn't until the 1963 report that the extra balance came to light.

Mr. HARDY. Where did that come from?

Mr. GALIMBERTI. The carryover each year, because this is given at various times of the year and not at the end of a given year.

Mr. REDDAN. You knew at the time that the audit report was formulated, the 1961 audit report, that this change had been made, did you not?

Mr. GALIMBERTI. We knew they were contemplating making one, sir, but one had not been officially written and still isn't written today, sir, to our knowledge.

Mr. REDDAN. What does the contractor tell you? He points out in recent weeks the bargaining unit has agreed with the contractor on a modification of the arrangement to the effect that in the future years only the first \$75,000 will be so donated. Now, you knew that as of the time the 1961 audit report was prepared, didn't you—or did you?

Mr. GALIMBERTI. We knew it was the statement of the contractor, but we hadn't gotten that verified or seen anything in writing to substantiate that change.

Mr. REDDAN. You haven't seen the original agreement. You believed the contractor on that?

Mr. GALIMBERTI. No; we had a letter from the union to the contractor on the first irrevocable agreement. We believe the chain of communications seems to be proper at that time.

Mr. REDDAN. You never saw the agreement but you believed there was such agreement?

Mr. GALIMBERTI. We have a letter which reflects this.

Mr. REDDAN. Now, did you send to the General Accounting Office a communication under date of June 15 of this year with respect to this same matter?

Mr. GALIMBERTI. On June 15, I gave a representative of the General Accounting Office a memorandum; yes, sir, in our office.

Mr. REDDAN. All right, what was the subject matter of your memorandum?

Mr. GALIMBERTI. Income from vending machines, Raytheon Co., sir.

Mr. REDDAN. Did you say anything there about the limitation of \$75,000?

Mr. GALIMBERTI. I don't believe there is anything in my memorandum that refers to \$75,000.

Mr. REDDAN. Well, you have it before you. Is there anything in there?

Mr. GALIMBERTI. No, sir; there is not.

Mr. REDDAN. It would appear from the memorandum that all the funds were transferred to the United Fund of Greater Boston, wouldn't it?

Mr. GALIMBERTI. Yes, sir; but this is talking about 1961, sir.

Mr. HARDY. You are still talking about 1961 in 1964?

Mr. GALIMBERTI. No; 1961 was completed, sir, but the records that were being discussed were the 1961 records, because it was the only time it had been brought to light and considered in the negotiations between the contractor—

Mr. HARDY. In 1961, actually all the funds were transferred except \$308?

Mr. GALIMBERTI. That is right, sir.

Mr. SILBERBERG. We calculated, sir, there was a balance of approximately \$2,000 that also remained over, but Mr. Galimberti didn't have this knowledge at the time of the negotiation.

Mr. HARDY. Where did that come from?

Mr. SILBERBERG. From prior years.

Mr. HARDY. Prior to 1961?

Mr. SILBERBERG. That is right.

Mr. HARDY. Then following 1961, the buildup was much larger; is that right?

Mr. SILBERBERG. Yes, sir.

Mr. REDDAN. Now, this is placed in the canteen fund, I believe you said.

Mr. SILBERBERG. Yes.

Mr. REDDAN. And how do you handle this item in your audit, the checks drawn to the United Fund? Do you allow that—just how do you handle it?

Mr. SILBERBERG. In 1961—you are talking now about the allowability—talking about the income, sir?

Mr. REDDAN. I am talking about the allowability of the contribution.

Mr. SILBERBERG. In 1961, we questioned—sir, I didn't understand the question.

Mr. REDDAN. This is a contribution, is it not, by Raytheon, and I am trying to find out how, under the ASPR's, this is an allowable item.

Mr. SILBERBERG. This is not allowed, sir. The contractor doesn't claim this amount as its own donation, and it is a nonallowable item of cost. But in the same respect, it is not even claimed by the contractor as an item of cost.

Mr. REDDAN. They are his funds, are they not? He donates them, this is a donation?

Mr. SILBERBERG. Legally, I don't know whether they are his funds or not.

Mr. REDDAN. If he didn't donate these funds, what would they be used for? They would be credited to overhead and reduce the overall cost?

Mr. SILBERBERG. I don't know what he would do with them.

Mr. REDDAN. Wouldn't that be the normal practice to require?

Mr. SILBERBERG. We could require him to do so, but couldn't force him.

Mr. REDDAN. You would wish he had?

Mr. HARDY. In this memorandum you wrote to GAO, dated June 15, in item 2, there is the statement that "legal opinion supported the validity of this agreement," et cetera. Now, are we still talking about 1961?

Mr. GALIMBERTI. That is right, sir.

Mr. HARDY. And consequently the negotiators restored the income in the overhead negotiation.

Now, where did you get that legal opinion?

Mr. GALIMBERTI. From the chief of our legal office in Boston, sir. I was not the negotiator at that time. The negotiator was a Mr. Harding who worked under my supervision.

Mr. HARDY. I don't believe he is a relative.

Mr. GALIMBERTI. That is "ing," Harding. I have a statement as to what he did and how he handled this situation, sir.

Mr. HARDY. I am still having a little trouble with this question of allowability of donations insofar as the ASPR's are concerned and the determination as to whose funds these really were. ASPR 15-205.8 says contributions and donations are unallowable. Did you have a legal opinion to the effect that this was permissible, or did that legal opinion relate to something else?

Mr. GALIMBERTI. I believe the legal opinion, from the way I can read it in the file and the way it has been interpreted to me, related to the agreement between the union and the management that this was something that was not within the control of the company and could not be credited to overhead as we, the negotiators and the auditors, desired it be done.

Mr. HARDY. Yet the company had custody of the funds and disbursed them. You had better find out who that high-powered lawyer is who made that ruling.

Mr. REDDAN. Do you have a copy of that ruling, sir?

Mr. GALIMBERTI. There was no written ruling at the time.

Mr. REDDAN. Is there one now?

Mr. GALIMBERTI. No, sir, there is not. There is only the statement of the chief negotiator, Mr. Harding, as to how he handled this, and he had a verbal conversation after showing the letter received from the union representative to the director of labor relations of Raytheon Co.

Mr. REDDAN. Who would we go to get a copy of this legal opinion? Suppose you wanted to find out whether or not this legal opinion had ever been rendered. How would you go about getting it?

Mr. GALIMBERTI. Well, the lawyer is no longer working for us, sir. We tried to get the data from his files, and in going through his files—

Mr. REDDAN. What is his name?

Mr. GALIMBERTI. Ralph E. Chapdelaine.

Mr. REDDAN. And where was he last heard from?

Mr. GALIMBERTI. He was a lawyer for us in Boston up to the beginning of this year, sir, in January.

Mr. REDDAN. Do you know whether he is still there?

Mr. GALIMBERTI. I haven't heard from him since he left our organization.

Mr. REDDAN. Did he live in Boston?

Mr. GALIMBERTI. I believe he lived in Framingham, Mass.

Mr. HARDY. Well, I don't know whether we are getting anywhere with that, anyway, because all you have is a statement from Mr. Harding that he talked to Mr. Chapdelaine and Mr. Chapdelaine said it was all right, and that is the way you make determinations that involve a lot of money.

Go ahead.

Mr. REDDAN. What is the balance in this canteen fund at the present time?

Mr. VITALE. As of July 17, \$71,825.

Mr. REDDAN. What is it going to be used for?

Mr. VITALE. I assume, based on past practices, they would make the donation some time later on in 1964 for the year 1964.

Mr. HARDY. There has been no donation made in the year 1964?

Mr. SILBERBERG. There has been, sir.

Mr. VITALE. They did make the 1963 donation actually in 1964. The check was drawn on April 1, 1964, for the year 1963.

Mr. REDDAN. What sort of balance did they have in their account after they drew the check for 1963?

Mr. VITALE. We just didn't break it off at that point, sir, at April 1.

Mr. REDDAN. Can you break it off right now for us?

Mr. SILBERBERG. That would be impossible, sir, with the records we have. This is available to us.

Mr. REDDAN. Can you give us any idea what the balance was?

Mr. SILBERBERG. As of what date?

Mr. REDDAN. As of the date they wrote the check.

Mr. SILBERBERG. I would guess it would be approximately in the neighborhood of anywhere in the range from \$30,000 to \$40,000.

Mr. REDDAN. Now, before they get their 1964, send in their 1964 donation, they will have received their profits from the vending machines for 1964?

Mr. SILBERBERG. They are currently receiving them during the course of the year in 1964.

Mr. REDDAN. And they have been running better than \$75,000 a year, haven't they?

Mr. SILBERBERG. In 1963, the total amount was——

Mr. VITALE. Just under \$90,000.

Mr. SILBERBERG (continuing). \$89,668. In 1962, the amount was \$107,252, and in 1961, the amount was \$75,308.

Mr. VITALE. These were the complete takeins for the respective years.

Mr. REDDAN. And under the agreement, as I understand it, they are going to pay out \$75,000 of that take each year, so that the canteen fund will continue with an ever-increasing balance.

Mr. SILBERBERG. In 1964, sir, they contributed \$84,000 to the United Fund.

Mr. REDDAN. When?

Mr. SILBERBERG. In 1964.

Mr. VITALE. That is a part of our audit report on page 30, for 1963.

Mr. REDDAN. And what did they contribute in 1963?

Mr. SILBERBERG. That was for 1963. In 1963, for 1962, they contributed, again, \$75,000.

Mr. REDDAN. Have you had any indication as to what they are going to use the balance for?

Mr. SILBERBERG. From responsible management people, in discussion with these people, they claim the balance will be used both for United Fund donations in the future along with possibly some of the recommendations that GAO made in discussion with the contractor, such as improving facilities and employer-employee morale activities.

Mr. HARDY. Did GAO recommend that?

Mr. SILBERBERG. I imagine so, in discussion with the contractor.

Mr. REDDAN. Going back to this document we referred to before which is—

Mr. HARDY. I wasn't aware of GAO going into that kind of activity. I am glad to find that out.

Mr. REDDAN. This is a part of your audit for 1961, and it says here the contractor told you that the first \$75,000 will be donated and the balance used by the company to pay for such things as improvement and maintenance of cafeteria and for other expenses incurred for similar direct benefits to the employees.

Mr. SILBERBERG. To the best of my knowledge, they haven't spent any of the balance that has accrued to the fund other than the donations to the United Fund of Greater Boston.

Mr. REDDAN. That is the part I am coming to next. How do you handle the balance between the \$75,000 and the total amount of the vending machine profits? How do you treat that balance under the ASPR's? Is that considered as an irrevocable signing over the profits to an employees' welfare association?

Mr. SILBERBERG. No, sir. In 1963, we questioned the balance over and above the amount that was taken in in 1962 and 1963.

Mr. REDDAN. But how does the contractor consider it? Does he consider this under the appropriate ASPR which permits the irrevocable transfer of funds from food profits?

Mr. VITALE. How does the contractor react to this? He didn't take any action on this, this is our own doing. He has not come out officially and rebutted our handling of this credit for 1963, yet. We don't know what his official position will be.

We took action to credit overhead for the excess between the amount taken in and the amount given to charity, and picked up the difference as a credit to overhead. We do not consider that as a set-aside under an irrevocable fund.

Mr. REDDAN. You don't then consider that as a set-aside for an employee welfare organization?

Mr. VITALE. Through our credit, we feel we are picking this up as a benefit to the Government as a reduction of overhead cost.

Mr. REDDAN. I am not quarreling with you, I am just asking. You don't consider that as a turnover of funds by the company to a welfare organization?

Mr. VITALE. The balance, no, I don't.

Mr. REDDAN. The canteen fund, then, is not considered—

Mr. VITALE. It is just a name designated on it, from my personal understanding, a name identifying it so these funds will not become a part of the general business fund. That is the way we understand the thing.

Mr. REDDAN. That is all.

Mr. HARDY. Thank you very much, gentlemen.

Let the committee stand adjourned, to reconvene at 2 o'clock. We will meet this afternoon in room 313-A.

(Whereupon, at 12:12 p.m., the subcommittee adjourned, to reconvene at 2 p.m., the same day.)

AFTERNOON SESSION

Mr. HARDY. Let the committee come to order.

Mr. Cherry, Mr. Kennedy, Mr. Muse, and Mr. Gilrein, will you gentlemen come up, please?

TESTIMONY OF JOSEPH F. CHERRY, CHIEF AUDITOR; GERALD G. KENNEDY, SUPERVISORY AUDITOR, U.S. NAVY AUDIT OFFICE; LEONARD T. MUSE, CHIEF, NAVY BRANCH FOR NEGOTIATION OF TRISERVICE OVERHEAD RATES; WILLIAM G. GILREIN, CONTRACT NEGOTIATOR, BUREAU OF NAVAL WEAPONS, ASSIGNED TO PRATT & WHITNEY AIRCRAFT DIVISION OF UNITED AIRCRAFT CORP., EAST HARTFORD, CONN.

Mr. HARDY. Will you give the committee your names, addresses, and your present duties?

Mr. KENNEDY. Gerald G. Kennedy, 116 Springfield Street, Springfield, Mass. I am a supervisory auditor at the Pratt & Whitney plant in East Hartford, Conn.

Mr. CHERRY. Joseph Cherry, 18 Bramley Road, West Hartford. I am the chief auditor at the Navy Audit Office, Pratt & Whitney Aircraft, East Hartford.

Mr. MUSE. Leonard T. Muse, 3912 Prospect Street, Kensington, Md. I am head of the branch in the Navy for the negotiations of triservice overhead rates.

Mr. GILREIN. William G. Gilrein, 415 Silver Spring Avenue, Silver Spring, contract negotiator, Bureau of Naval Weapons, Pratt & Whitney engines.

Mr. REDDAN. Mr. Kennedy, how long have you held the position you are now in?

Mr. KENNEDY. For 16 years, but on my present duty for about 2 years.

Mr. REDDAN. In what capacity with Pratt & Whitney before this?

Mr. KENNEDY. I was an auditor there.

Mr. REDDAN. A Navy auditor?

Mr. KENNEDY. Yes.

Mr. REDDAN. And how about you, Mr. Cherry, how long have you been at Pratt & Whitney?

Mr. CHERRY. I have been at Pratt & Whitney 4 years, sir.

Mr. REDDAN. In the same capacity during that period of time?

Mr. CHERRY. I have been a chief auditor, and part of the time also an assistant director responsible for other divisions of United Aircraft.

Mr. REDDAN. Mr. Muse, is there any relationship between your activity and that of Mr. Gilrein's?

Mr. MUSE. No, sir. I am in negotiation of overhead rates affecting triservice on cost-type contracts. Mr. Gilrein is a Bureau negotiator for fixed-price type.

Mr. REDDAN. Now, with respect to the Pratt & Whitney items which could be charged to overhead, these morale items, would you, Mr. Gilrein, have anything to do with those?

Mr. GILREIN. Yes, I would; to the extent that they are included in engine prices.

Mr. REDDAN. How about you, Mr. Muse?

Mr. MUSE. Mine are for the purpose of reimbursement under cost-type contracts, yes, sir.

Mr. REDDAN. Do either of you gentlemen, or both of you, review or pass upon the audits which are prepared by Mr. Kennedy and Mr. Cherry?

Mr. MUSE. In all cases, sir—both.

Mr. HARDY. Then you make the final decision on their recommendation?

Mr. MUSE. Yes, sir. They submit what we call an advisory audit report, and it is up to myself and the other two services to make the final determination of what are acceptable costs.

Mr. HARDY. Then you are not acting as auditor but as contract administrator?

Mr. MUSE. I am a contracting officer in the Navy for this purpose; yes, sir.

Mr. HARDY. You do not keep a contracting officer in the Pratt & Whitney plant now?

Mr. MUSE. Not for my purpose, sir. Mr. Gilrein can answer for the fixed-price work.

Mr. HARDY. Well, for any purpose. You don't perform at the plant itself?

Mr. GILREIN. I get up there occasionally, but to the best of my knowledge, no one in the Pratt & Whitney plant connected with the Navy has any authority in negotiating prices for either spare parts or engines. They may have some delegation of authority which permits them—

Mr. HARDY. Are both you gentlemen here with the Bureau of Weapons in Washington?

Mr. GILREIN. That is right.

Mr. MUSE. I am with the Office of Naval Material; Mr. Gilrein is with the Bureau of Weapons.

Mr. HARDY. This is this new arrangement we have now under which you are on the production side rather than the user side—under this new organization. This is not what Naval Material was a few years ago.

Mr. MUSE. No, sir. The authority has changed, but for my purpose, no.

Mr. HARDY. It has been the same?

Mr. MUSE. Yes, sir.

Mr. HARDY. The Office of Naval Material passed on these matters that came over from BuWep?

Mr. MUSE. Not in my branch. The Office of Naval Material still passes off on fixed-price approvals, but not in my branch, sir. Again, mine is strictly for the reimbursement of overhead as related to cost-type contracts, not fixed-price production.

Mr. HARDY. Of course, we are talking about fixed-price contracts—this reimbursement of overhead would not be involved in a competitive bid contract. You might have to negotiate it out, if you were negotiating a fixed-price contract, but that would be done in the beginning, wouldn't it?

Mr. MUSE. Well, sir, I don't want to offer too much outside of my bailiwick here, but the procedures—and I have been in fixed price for a good many years—the procedures for establishing fixed price versus overhead for cost-type allowances, we still go through pretty much the same procedure.

Mr. HARDY. But you do it at the beginning of a contract, don't you?

Mr. MUSE. Oh, no, sir; they have the incentive type that you have to do after the fact.

Mr. HARDY. That is not exactly a fixed price, because here you are operating under an incentive approach.

Mr. MUSE. Yes, sir.

Mr. REDDAN. Mr. Kennedy or Mr. Cherry, I would like to direct your attention to an item which was testified to yesterday, which deals with a party which was held, an annual banquet for employees having 25 years of service with the company, and the costs for the 1963 party were itemized for the committee at a total cost of \$18,343.

Have you started to audit the overhead for that year?

Mr. CHERRY. Yes, sir; we have issued our report on the 1963 overhead for fixed-price purposes.

Mr. REDDAN. And how did you treat with this particular item, sir?

Mr. CHERRY. Sir, we questioned \$3,700 of this item.

Mr. HARDY. How did you happen to pick that much out—was there something special about it, was it because it involved alcoholic beverages?

Mr. CHERRY. Yes; it involved alcoholic beverages, flowers, and I believe some cigarettes that were questioned in that one invoice.

Mr. REDDAN. Now, the liquor for that party, 303 bottles at \$2,899—that was one of the items you questioned?

Mr. CHERRY. Yes, sir.

Mr. REDDAN. In its entirety?

Mr. CHERRY. Yes, sir.

Mr. REDDAN. And the beer?

Mr. CHERRY. I believe that also; yes, sir.

Mr. REDDAN. And you say flowers, and cigars?

Mr. CHERRY. Yes, sir; I believe that also was questioned.

Mr. REDDAN. Now, how about the entertainment? There is an item there for music and entertainment, \$2,160?

Mr. CHERRY. No, sir; we didn't question that.

Mr. REDDAN. Is entertainment an admissible item under the ASPR's?

Mr. CHERRY. I believe this was for the orchestra.

Mr. REDDAN. It says "music and entertainment."

Mr. CHERRY. I am not familiar with what it was exactly, but in reviewing the invoice the auditor did not question that amount. He considered that as part of the affair. It was a dinner-dance, sir. We did not question the dinner or the dance; we merely questioned the alcoholic beverages and some other fringe items.

Mr. REDDAN. Now, a similar party was held in 1962, was it not, sir?

Mr. CHERRY. Yes, sir.

Mr. REDDAN. What was the total cost of that party and how did you handle that in the audit?

Mr. CHERRY. The total cost was \$16,665. We did not question anything that year, sir.

Mr. REDDAN. Were the items making up the cost of that party any different from those in 1963?

Mr. CHERRY. No, sir; I presume they weren't, but we did not select that month that it occurred that year, and therefore we did not have the detailed knowledge of the affair.

Mr. HARDY. How many months do you select?

Mr. CHERRY. Well, sir, we take various months of different accounts, there are some accounts we take 12 months that we have a high percentage of exceptions in, and historically will do 12 months; others we do 1 or 2, and there are a few that we do 4. There are over 500 accounts, sir, and each year we lay out all the accounts by account, by month, and then a selection is made as to which month will be selected for audit.

Mr. HARDY. How do you manage not to pick the month that has the big party?

Mr. CHERRY. Well, sir, these accounts are rather large. And an amount of this size is not obvious when you are looking at all of these accounts by month. We do look for unusual months where we see unusual expenditures in total.

Mr. HARDY. So your sampling procedure, then, doesn't necessarily prove out to be a reliable procedure?

Mr. CHERRY. It will not be a hundred percent accurate, sir. I think it is fairly good, but we can never say that we catch every affair; no, sir.

Mr. HARDY. Having selected a month that had a particular party in it for 1963, did you project that to other periods in the year, or just call for disallowance in that 1 month?

Mr. CHERRY. Sir, what we usually do—

Mr. HARDY. I want to know what you did this time.

Mr. CHERRY. This time we just questioned the \$3,700, sir.

Mr. HARDY. Now, that just happened to be what these items added up to?

Mr. CHERRY. Yes, sir; we didn't project this amount, because it did not—

Mr. HARDY. If there were other parties similar to it during the year, you wouldn't have caught them.

Mr. CHERRY. That is possible, sir.

Mr. HARDY. Well, you couldn't have caught them if there were other parties, if you just took the one month; isn't that right?

Mr. CHERRY. Yes, but we analyzed what we came up with for that one month and tried to make the determination whether this is the

type of charge that would be common throughout the 12 months. To the extent we feel it is, we will project that amount.

Mr. HARDY. I don't know how you can say whether this is the kind of thing that would recur or not. Now, apparently you didn't make a similar deduction in the previous year.

Mr. CHERRY. That is right, sir.

Mr. HARDY. So did it occur to you that maybe you had slipped up before, and did you go back and pick up the kind of deductions that you had taken the year before and add them to this?

Mr. CHERRY. The prior year, 1961, is that what you mean, sir?

Mr. HARDY. That is right.

Mr. CHERRY. Yes, sir; we had picked it up the prior year, and it had been projected in that year.

Mr. HARDY. I thought you said a moment ago that you hadn't run into this before.

Mr. CHERRY. In 1962, sir, we did not pick it, and did not have the cost questioned. In a prior year we did select it—

Mr. HARDY. How about in 1962. You didn't make any disallowance because of it, then?

Mr. CHERRY. In 1962, no, sir, we didn't.

Mr. HARDY. But in the previous year you had found it, but did you make a disallowance in 1961?

Mr. CHERRY. Yes, sir.

Mr. HARDY. If you made a similar disallowance in 1961, what did that amount to; do you recall?

Mr. CHERRY. Yes, sir; \$1,780.

Mr. HARDY. But you didn't think that was of enough significance that you ought to look for the same thing in 1962?

Mr. CHERRY. No, sir; we did not purposely make that decision, but in laying out the audit program we did not specifically remember this one item and look for it, no, sir.

Mr. HARDY. Do you take only 1 month for Pratt & Whitney?

Mr. CHERRY. For some accounts—

Mr. HARDY. I am talking about this account. You took only 1 month to determine what you were going to disallow.

Mr. CHERRY. For this particular thing, yes, sir.

Mr. HARDY. When you know very well you couldn't be anywhere near right taking just 1 month and disallowing only what you saw in that 1 month's operation to be questioned?

Mr. CHERRY. We do project an amount, sir.

Mr. HARDY. Well, where do you project anything off of this one?

Mr. CHERRY. This was only a once-a-year deal, sir, and we didn't.

Mr. HARDY. How do you know it was only a once-a-year affair?

Mr. CHERRY. Sir, we know that particular affair is only held once a year.

Mr. HARDY. But in 1962 you didn't make any disallowance for it. Why didn't you do it then, when you had it in 1961?

Mr. CHERRY. Yes, sir; we had it, but in doing all these accounts, we try to take various months, and further some of these don't appear in the same accounts.

Mr. HARDY. You want to be sure you don't come up with a disallowance you will have to argue about. You knew in 1962 they had this same thing in 1961 and you had a disallowance in connection with

it, but you didn't go look for it in 1962, nor did you make any extension to cover it in 1962; isn't that right?

Mr. CHERRY. No, sir; we didn't deliberately ignore this. We didn't take it into consideration, I will grant that, but we did not ignore it.

Mr. HARDY. You knew the party was held every year, didn't you?

Mr. CHERRY. When we are laying out our program, we had 37 pages of exceptions amounting to about \$9 million. We didn't know every exception and where it would occur again in the following year. We try to do the whole year and get out a report every single year.

Mr. HARDY. The whole question in my mind now is why do you stick to 1 month? You only used 1 month, and you made your disallowances on the basis of what you found in that 1 month, and if you can show me any evidence of projecting them into the other 11 months of the year, I want you to do it.

Mr. CHERRY. We didn't in 1962, sir. We did in 1961.

Mr. HARDY. You didn't in 1962, but you did in 1961. Now, why did you deviate in 1962?

Mr. CHERRY. In laying out our program, sir, we just didn't go after this particular item.

Mr. HARDY. What did you do in prior years—well, let's leave that alone.

Mr. Muse, why didn't you catch this? You are the fellow who finally passed on this. Or how about Mr. Gilrein—did you check it?

Mr. GILREIN. I wouldn't have any means of checking it.

Mr. HARDY. Oh, you wouldn't? You had the disallowance in 1961. In 1962 you didn't have it, you get it back in 1963 for the same party.

Mr. GILREIN. Well, it is not identified to me in terms of a specific event.

Mr. HARDY. If it is not identified for you, how can you intelligently approve or disapprove of what they do?

Mr. GILREIN. Under classifications such as entertainment, meals, and so forth.

Mr. HARDY. You haven't any idea what they are for, and yet you pass on them, either approve them or disapprove them, pass them up to Mr. Muse and he puts his OK on what you have done. If that isn't a fast way to operate. If I am mistaken on it, please straighten me out, but it seems to be a perfunctory performance by you gentlemen, and I don't know what you are there for.

Now, clear me up if I am wrong. I don't mean to be unduly critical, but it seems to me there is an awful lot in this thing here that shows a need of complete overhaul. I am serious about this. If any of you can help clear this up and put it in a better light, I would really very much like to have it.

Mr. GILREIN. Well, I don't know, offhand, how many accounts Pratt & Whitney has, and how many items or entries go into those accounts over a period of years, but it is absolutely impossible for me to establish the intimate contacts that would permit me to ferret out an item like this. The only way I could catch it and disallow it is through the medium of the advisory audit report.

Mr. HARDY. Well, as I view this one experience, immediately I wonder why in the world if you looked at 1 month and this is what you found, and you know that this is a practice that goes on year after year, why you didn't look back any further to see whether or not it

had occurred last year, in that year, you took just 1 month and made the disallowance on that basis. You come up to 1963, and you make your disallowances on what you found in that 1 month, just as though you hadn't found anything the other months in the previous years, and you gentlemen sit here in Washington and approve this. You negotiate on the basis of what these gentlemen give you.

Mr. MUSE. That is right.

Mr. HARDY. And you don't catch these other items, and they don't tell you.

This is wrong in my book. I don't know how much money is lost for Uncle Sam like that. I don't know what you have before you in the way of documentation when you make your decisions but I know what we have before us, and I don't know why it didn't stimulate the same questions in your mind that it stimulated in mine. I don't want to be unduly critical, but frankly the more I see of this, the more I think that you are really way, way out in left field and somebody ought to get you back on the reservation.

Mr. Pike.

Mr. PIKE. Mr. Cherry, I notice among the costs of this party which you did not question an item for flying three Florida employees of the corporation from Florida up to Hartford for this party and back. Is this, in your opinion, a legitimate expense to charge to the Government under the heading "health and welfare"?

Mr. CHERRY. Offhand, sir, I would agree it would appear to be an extraordinary expense, and it would seem doubtful.

Mr. PIKE. On the question of what you objected to in this advisory audit report, you said to the chairman that one of the reasons that you didn't feel it necessary to go into the other months was that you knew that this was a unique party held only once a year, but the only items you questioned on it were the liquor items, the cigars, and the flowers.

Now, there is nothing to indicate, that I know of, that there are not other parties not for employees of 25 years or more, at which liquor might be consumed, or flowers or cigars might be provided. Isn't it just as likely that they are going to use liquor, flowers, and cigars in the State of Connecticut all the other 11 months of the year?

Mr. CHERRY. Yes, sir, but we do audit various accounts, and, as I say, some of these, the sundry accounts, for instance, we audit 12 months. These accounts usually, wherever we can find travel vouchers, we audit very carefully. There are thousands of these vouchers, and when we find travel vouchers we do remove any item we see along this line. We do project this amount and disallow it. We have disallowed approximately \$200,000 in this type of expense.

Mr. PIKE. In this account for Pratt & Whitney for the year 1963?

Mr. CHERRY. For all accounts, sir.

Mr. PIKE. You disallowed, out of all accounts, the sum of about \$200,000 for similar items—out of how large a request?

Mr. CHERRY. How large a what?

Mr. PIKE. You disallowed \$200,000. How much did they ask for?

Mr. CHERRY. They do not ask for anything of this nature specifically, sir. These are within the overhead accounts.

Mr. PIKE. Well, what was their request in the overhead accounts?

Mr. CHERRY. Sir, we wouldn't—they are not specified in the overhead accounts. This covers travel going to an overhead account and when we examine the travel vouchers we find that someone may be entertaining someone at a meeting or a reception, or they went to some club, or technical meeting, and bought so many dinners. This type of thing that comes in on expense accounts can be in any overhead account, sir. We try to audit as many of these——

Mr. PIKE. Well, now, from what account or accounts did you disallow \$200,000?

Mr. CHERRY. Many, many accounts, sir, right throughout the whole overhead pools.

Mr. PIKE. Throughout the whole overhead request?

Mr. CHERRY. That is right, sir.

Mr. PIKE. Of Pratt & Whitney?

Mr. CHERRY. Right.

Mr. PIKE. For the year 1963?

Mr. CHERRY. Yes, sir.

Mr. PIKE. What was the total of the overhead request of Pratt & Whitney for the year 1963?

Mr. CHERRY. The total overhead, sir, is around \$250 million.

Mr. PIKE. So out of \$250 million, you disallowed \$200,000?

Mr. CHERRY. Yes, sir.

Mr. PIKE. The principal item in this party was dinners, 891 dinners at \$8.25 each, totaling \$7,351, and that is exclusive of liquor, entertainment, music, and so forth.

Did you check into whether the company had 891 employees with 25 years of service?

Mr. CHERRY. No, sir.

Mr. PIKE. Was the party supposed to be limited to such employees, or was it for all employees and simply honoring those having 25 years of service?

Mr. CHERRY. It is my understanding it is only for those people with 25 years' service.

Mr. PIKE. Do you feel that the item called "dinners," totaling \$7,351, is different in some manner from those entertainment costs which ASPR 15-205.11 says are unallowable, such as meals?

Mr. CHERRY. Yes, sir.

Mr. PIKE. You find that a dinner is allowable, but an item called a meal is not allowable?

Mr. CHERRY. I made no distinction between a dinner and a meal, sir, but I do, under ASPR 205.11, where it does say "except as noted in .10 above for employee morale," I did interpret this as being for employee morale; yes, sir.

Mr. PIKE. This particular dinner then was not a meal but it was a health and welfare activity such as a house publication, health or first aid clinic, recreational activity, or employee counseling service?

Mr. CHERRY. In the employee morale, sir, which is the heading of that paragraph, that is what I interpret it to be.

Mr. PIKE. If you can interpret a dinner to be an employee morale item and not a meal, is there any limit to what you can interpret to be an employee morale item?

Mr. CHERRY. Well, I am sure there is a limit, sir, insofar as they have to be reasonable, they have to be——

Mr. PIKE. Don't you really think that you are being a little bit unreasonable when you say a dinner is not a meal, but it is an employee morale item?

Mr. CHERRY. I believe it is a meal, sir, that was given to the employees for morale purposes. I do not believe that ASPR 205.11 excludes meals for morale purposes where it is for the benefit of the employees, and it is normal and customary to that plant, and is reasonable in amount.

Mr. PIKE. What do you base that belief on, when section 205.11 specifically says a meal is not allowable?

Mr. CHERRY. Based on the fact, sir, that it says "except note paragraph 10, above."

Mr. PIKE. The word "morale" has been used to allow these parties, cocktail parties, dinner parties, liquor, everything for morale. I call to your attention the fact that this word "morale" is found only in the title of this section, and the language of the section doesn't have it anywhere. It says—

reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, recreational activities, and employee counseling services—

and that is all, for the improvement, et cetera, of employer-employee relations, employee morale, and employee performance are allowable. I don't see how you can possibly say that this is allowable when the ASPR says that a meal is not allowable.

Mr. Chairman, I promise you that I am not going to raise this question any more. It runs through all of these things.

Mr. HARDY. That is perfectly all right; you are doing fine.

Mr. PIKE. A dinner is not a meal; a crab feast is not a meal; a cocktail party and dinner is not a meal—they are all recreational activities. I think the ASPR's have been interpreted to the point of extinction, and I think they have got to be tightened up and cleaned up a great deal.

Mr. HARDY. Thank you, Mr. Pike.

I would like to return to these figures we had here a minute ago. As I understand it, out of a total overhead of \$250 million in 1 year, only \$200,000 was disallowed?

Mr. CHERRY. No, sir; that is just of this specific type of item—meals, liquor, entertainment-type affairs. There was actually around anywhere from \$6 to \$9 million that was disallowed, sir, in the negotiation.

Mr. HARDY. \$6 to \$9 million out of the \$250 million?

Mr. CHERRY. Yes, sir.

Mr. HARDY. And the \$200,000 represents the disallowance in this particular group of items?

Mr. CHERRY. These particular items, sir—meals, entertainment.

Mr. HARDY. Now, what was the total amount included in the overhead for these items from which the \$200,000 was eliminated?

Mr. CHERRY. I don't quite understand, sir.

Mr. HARDY. I am trying to get something comparable. You can't compare apples and oranges here. When we talk of \$200,000 that was disallowed, what was the amount from which it was disallowed?

Mr. CHERRY. Sir, this amount was disallowed out of the various accounts that comprised that \$250 million. A great deal of it is usually

found in travel accounts. Another large portion is found in the sundry accounts. Those two accounts we do a hundred percent.

Now, there could be others, sir, that we did only 1 month, but there may have been somebody traveling, and we may not have caught it.

Mr. HARDY. Yes, but you see you still haven't given us anything to compare this \$200,000 with. What was the total of the items in this morale or entertainment area that we have been talking about from which you got a deduction of \$200,000?

Mr. CHERRY. Sir, we have no accounts that specifically set out these costs as such that I could tell you the total amount of health, welfare, and recreation.

Mr. HARDY. But you have separated out what you disallowed as belonging to these items, but you haven't got the total of the amounts charged to overhead in these same categories?

Mr. CHERRY. No, sir.

Mr. HARDY. Well, it doesn't help us much to try to compare the \$200,000 with the \$250 million. There you get a fraction of 1 percent, and a small fraction.

Mr. CHERRY. That is right, sir.

Mr. HARDY. Now, in 1963 you recommended disallowance of \$1,359 for "Meals, other." I don't know what that means. You take 54 percent of that, and you come up with \$734. Just what did that represent, that disallowance?

Mr. CHERRY. "Meals, other," are usually, sir, where somebody in the company has been out and bought a meal for somebody else and put it on their expense account; or if it is within the plant, it was a charge made by the caterer to Pratt & Whitney and came in through the overheads.

Mr. HARDY. Would that be such items as these so-called conferences? I haven't seen those specifically in Pratt & Whitney's breakdown, I don't believe.

Mr. CHERRY. No, sir, if they had a conference within plant where they had luncheon with a number of people, or there were dinners provided at the cafeteria which is run by an outside organization, the contractor would sign these meal tickets which are all collected and are billed to Pratt & Whitney by this concessionaire once a month as meals. We pick up the entire amount and just set it out as "Meals, other."

Mr. HARDY. Don't they have any private dining rooms at Pratt & Whitney?

Mr. CHERRY. Yes, sir.

Mr. HARDY. These are items that come out of the private dining rooms?

Mr. CHERRY. Yes, sir. Each guest in a private dining room gets a menu. He circles what he wants to order, and then somebody in the company will sign it and put "Guest." These tickets are collected by the concessionaire, and once a month he bills Pratt & Whitney. We get these tickets with the bill, and we question this entire amount that is billed to Pratt & Whitney for any guests, regardless of whether it was a meeting.

Mr. HARDY. In that particular month—which month did you take in 1963?

Mr. KENNEDY. What account is involved in connection with the \$1,359?

Mr. HARDY. Well, I don't know. I am talking now about this "Meals, other."

Mr. KENNEDY. If that is in the advisory report, isn't there, in the left-hand column, an identification of an account number?

Mr. HARDY. Item 92, account No. 8346.

Mr. CHERRY. Sir, I don't have that information readily available.

Mr. HARDY. I am trying to see how you did this. You have a questioned amount of \$1,359, and this is "Meals, other." Now, does that represent what you questioned from this 1 month's audit?

Mr. CHERRY. I can't say exactly, but it is very possible that might be 1 month projected to 12. If it was 1 month and it was that type of expense, it would be projected.

Mr. HARDY. Well, it would seem to me we ought to know about these things. I can't for the life of me see how Mr. Gilrein or Mr. Muse can do a thing by looking at these things; all they can do is apply a flat percentage on here, and apparently that is what they did, and then sold it to Pratt & Whitney, I would guess. Is that what you do when you negotiate this stuff out after you get the figures from the auditors?

Mr. GILREIN. If we regarded that particular item, we would disallow it.

Mr. HARDY. But you didn't know, yourself, whether the auditor has included a disallowance for just 1 month or for the whole year.

Mr. MUSE. May I interject here, myself, for my part in this, having gone through this for a good many years?

I think what we are saying here, this type of expense is considered unallowable under part 2, section 15, against getting into .11. When we receive an advisory audit report from any auditor in the field, this type—meals for guests, for example—might be audited for that 1 month. On that basis, he projects this on an annual basis.

Mr. HARDY. That is what I am trying to find out—if he did this.

Mr. MUSE. When it comes into me, I have a summary total, and offhand I don't know what year we are concerned about, but such items are in one account that is presented to me for my negotiation, and that totals up in some cases, I remember last year, 1962, some \$85,000, and in there are included such items as you mention here.

Mr. HARDY. Well, the thing that I was trying to determine, and I still haven't determined it and apparently I am not going to be able to, I am trying to determine whether these figures that are put down here represent what was found for that 1 month that was examined, or whether it is a projection. Nobody knows, not even—I think—Mr. Cherry.

Mr. MUSE. Well, I think Mr. Cherry can answer in this way. In a sampling that they put through—a sampling, again in this case of meals for guests, for 1 month is projected, multiplied by 12. That is the amount that I consider at negotiation.

I believe this is what you are telling me when the report comes in.

Mr. CHERRY. That is right.

Mr. HARDY. I don't think Mr. Cherry knows whether they projected them or not. He undoubtedly knows what his normal practice would be, but apparently can't testify with respect to these particular items.

If we had run across any uniformity of operation here, I wouldn't be quite as concerned, but apparently everybody judges for himself what he is going to do.

Go ahead, Mr. Reddan.

Mr. REDDAN. Mr. Cherry, I have just one question I want to ask you about a communication you sent to the General Accounting Office under date of July 2, 1964. Do you have a copy of that with you, sir?

Mr. CHERRY. I believe so, sir.

Mr. REDDAN. Would you turn to page 4 of that, sir—pardon me, enclosure 2, page 1.

Mr. CHERRY. Yes, sir.

Mr. REDDAN. Item 2 on that refers to a question that was asked you about whether or not the party costs were questioned, the 1962 party costs, is that right, sir?

Mr. CHERRY. Yes, sir.

Mr. REDDAN. It seems to me that what you are saying there does not conform entirely to what you said here today, and I would like to get that straight. Would you read that paragraph No. 2, please, sir?

Mr. CHERRY (reading):

Also mentioned is the fact that the Navy Audit Office did not question any costs pertaining to the 1962 banquet. The 1962 costs were in fact questioned, albeit indirectly. To understand my position, it is necessary to review the method employed by the Navy Audit Office in auditing approximately 500 overhead accounts with aggregate costs of over \$250 million a year * * *.

Mr. REDDAN. Right there, sir, what do you mean, you question this indirectly?

Mr. CHERRY. Sir, in auditing this 1 month, as I recall, we had something like \$500 that eventually resulted in being projected to \$3,306.

Mr. REDDAN. What were the items you were questioning?

Mr. CHERRY. It was mostly items of "Meals, other," liquor, or items of that type, sir.

Mr. REDDAN. What sort of meals were these that you were questioning, sir?

Mr. CHERRY. They were anything, sir, we found on travel vouchers or any accounts for people having meals outside—it could be for guests, or it could be for parts of their meals we considered disallowable.

Mr. REDDAN. These were normal expenses of this type which would recur month after month?

Mr. CHERRY. That is right, sir.

Mr. REDDAN. You examined 1 month and questioned \$329.11 worth in that month?

Mr. CHERRY. Yes, sir.

Mr. REDDAN. And then you projected that figure over a 12-month period?

Mr. CHERRY. That is correct, sir.

Mr. REDDAN. And came up with a total of \$3,306?

Mr. CHERRY. That is right, yes, sir.

Mr. REDDAN. How does that bear any relation to the party that the General Accounting Office was asking you about? That projection doesn't include the party.

Mr. CHERRY. No, sir, we just questioned it in total. As I say, we projected out that amount to cover that type of expense. The type of

expense we questioned in the party is only the liquor. We weren't questioning the party itself.

Mr. REDDAN. Have you since looked at the 1962 costs of that party for liquor?

Mr. CHERRY. No, sir.

Mr. REDDAN. Do you have them before you there?

Mr. CHERRY. No, sir, I haven't got the 1962 invoice.

Mr. REDDAN. Well, in 1962—and I have the vouchers here in front of me—there were 274 bottles of liquor at a cost of \$2,174, 168 bottles of beer at a cost of \$84, and other beverages, and so forth, paralleling the 1962 item, so you can see your disallowance was eaten up almost entirely—if you are going to project it—eaten up almost entirely by one party.

I am just asking you now about the accuracy of your statement here where you are suggesting to the GAO that you even questioned these things indirectly. I don't see how your projection can be considered a questioning of the 1962 party.

Mr. CHERRY. Well, sir, in this one instance, the party itself, I grant you, would outweigh the amount we projected. However, in 1961 we did have a number of items that we did project, and \$1,780 for this exact same party was questioned in the amount of \$16,819. It wasn't a mathematical certainty, but it certainly did the exact opposite, sir, as you found in 1962.

Mr. HARDY. And how was that one settled? Was that one agreed to?

Mr. CHERRY. It was disallowed, sir; yes, sir. The negotiators disallowed it.

Mr. HARDY. You mean the negotiators made it stick?

Mr. CHERRY. Yes, sir.

Mr. HARDY. Then I would have to assume there was some element of validity and that maybe you have been overly generous in the earlier years.

Mr. PIKE. Mr. Chairman.

Mr. HARDY. Mr. Pike.

Mr. PIKE. I note in the record of the 1962 party there were once again three employees who were flown up from Florida to attend this party. Do you have any recollection of whether they flew some employees up from Florida for the 1961 party which you did audit?

Mr. CHERRY. I do not have a recollection, sir, offhand.

Mr. PIKE. You say that as to these parties for morale purposes, your advisory audit report does not question the meals, but does question the liquor. You justify the meals on the ground that these are for employee morale purposes. It is your opinion that a meal without liquor is better for morale than a meal with liquor?

Mr. CHERRY. Well, sir, it comes into a debatable area. To be conservative, we attempt to question anything of this nature to—to advise the auditors hitting such items through thousands of vouchers to bring up and record some on their worksheets. Then we pick them up, question them in our report, which goes to the negotiator.

Now, if the company feels that we have picked up something that is truly morale, they have the right then to give their argument to the negotiator.

Mr. PIKE. Well, from the outside observer's seat, I would like to say to you that I think you have got it just backward. I think that the

party with the liquor is much more likely to have some effect on the employees' morale—at least on a temporary basis—than the party without the liquor. I would also say to you that your auditor colleagues in California tend to adhere to my view, because they seem to take the position that without the liquor it is just a meal, and a meal is clearly barred by the ASPR.

There were, according to the GAO report—and I guess this question would properly be advanced to Mr. Cherry—in the Pratt & Whitney Aircraft Division, East Hartford, Conn.—is that under your jurisdiction?

Mr. CHERRY. Yes, sir.

Mr. PIKE (continuing). Charges in both 1962 and 1963 for an outing by company firemen and employee volunteer firemen, and also an outing by company foremen. During 1962, these two outings cost \$25,000, and during 1963 they cost \$24,000.

Did these two outings occur during the month which you chose to use for your audit?

Mr. CHERRY. Yes, sir; we did the year on these accounts. Our figures are a little different, to begin with. The firemen for 1962, was it?

Mr. PIKE. 1962.

Mr. CHERRY. In 1962, they had \$8,107.

Mr. PIKE. How much did the foremen have?

Mr. CHERRY. \$11,168.

Mr. PIKE. Is that what the total cost of the parties was or what you allowed them?

Mr. CHERRY. No, sir; that is the total cost of the party.

Mr. PIKE. Well, you do differ with the GAO on that. How about for 1963?

Mr. CHERRY. \$7,997 for the firemen, and for the foremen \$9,154.

Mr. PIKE. Once again we are talking about parties in 1962 for the fireman and the foremen of approximately \$20,000 and approximately \$20,000 in 1963, also, in round figures—\$18,000 in 1963.

Mr. CHERRY. Yes, sir.

Mr. PIKE. Did these parties come in the month which you audited?

Mr. CHERRY. In one of them, sir, we did the complete year.

Mr. PIKE. Which account was that?

Mr. CHERRY. Account No. 9375, sir.

Mr. PIKE. What is that called, what is its title?

Mr. CHERRY. "Manufacturing, sundry."

Mr. PIKE. "Manufacturing, Sundry." That is as good a place to put a party for foremen, I guess, as any other place.

What account did the other one come under?

Mr. CHERRY. In one year it was under 8346, in 1962.

Mr. PIKE. The numbers actually don't mean much to me. How do they label these parties?

Mr. CHERRY. "Personnel Supplies and Expenses," sir.

Mr. PIKE. "Personnel Supplies and Expenses?"

Mr. CHERRY. Right, sir.

Mr. PIKE. And having found a party under "Personnel Supplies and Expenses" in 1 month, didn't you audit the whole year in that account?

Mr. CHERRY. No, sir.

Mr. PIKE. Thank you.

Mr. HARDY. You wouldn't use that same kind of personnel supplies in the other months?

Mr. CHERRY. No, sir; that account we didn't do the complete year.

Mr. PIKE. How large a party did you find in those 2 years in that account?

Mr. CHERRY. How large a party, sir?

Mr. PIKE. Yes; in that "Personnel Supplies and Expenses."

Mr. HARDY. He didn't look at that but 1 month.

Mr. PIKE. I know, but how large did you find in that 1 month?

Mr. CHERRY. My total exceptions in that account?

Mr. PIKE. No; this party for company foremen or firemen. Which party was located in "Personnel Supplies and Expenses"?

Mr. CHERRY. That was in 1962, sir, the one that was \$11,168.

Mr. PIKE. All right, in 1 month in 1962 you found an \$11,000 party listed under "Personnel Supplies and Expenses," and you didn't bother to look at the other 11 months. Is that correct?

Mr. CHERRY. That is correct, sir.

Mr. PIKE. That is all.

Mr. HARDY. Did you get invited to any of those parties?

Mr. CHERRY. Yes, sir.

Mr. HARDY. And how many did you go to in the same year?

Mr. CHERRY. Well, sir, over the 4 years, I have gone to one foremen's and I believe two Christmas parties.

Mr. HARDY. Did you disallow those parties that you went to?

Mr. CHERRY. Yes, sir.

Mr. HARDY. Entirely?

Mr. CHERRY. Entirely—well, let me say that the Christmas ones are disallowed entirely. On the foremen's, we disallowed the liquor.

Mr. PIKE. Did they stop inviting you after that?

Mr. CHERRY. No, sir.

Mr. HARDY. You didn't get them to send any invitation down to Mr. Muse?

Mr. CHERRY. No, sir.

Mr. MUSE. I get them quite often; yes, sir.

Mr. HARDY. Do you disallow them, too?

Mr. MUSE. I don't attend them, so I don't have any trouble disallowing them.

Mr. HARDY. Well, I find it a little strange, sure enough, that you don't examine these things. I think if I were looking at an account of personnel supplies and found an \$11,000 party in it in 1 month, I might be curious about the other 11 months.

Mr. CHERRY. We would like to do a lot more audit, but we have to render a report every year—we are on a yearly negotiation, and in fact we have three of them—and within that time we have to hit just the accounts that we feel we can get the most exceptions out of.

Mr. HARDY. Now, has that party been an annual event?

Mr. CHERRY. Yes, sir.

Mr. HARDY. And you disallowed it every year, or did you find it in the other years?

Mr. CHERRY. No, sir; I didn't disallow the party.

Mr. HARDY. You disallowed the whisky.

Mr. CHERRY. Yes, sir.

Mr. HARDY. Have you been disallowing the whisky in that party in other years?

Mr. CHERRY. In certain years; yes, sir.

Mr. HARDY. If you found the party.

Mr. CHERRY. Yes, sir.

Mr. HARDY. You have to pick up that month accidentally in order to disallow the whisky.

Mr. CHERRY. Except some of them—in sundry we do 12 months.

Mr. HARDY. I would like to get a good estimate of how much money you all have missed that ought to have been disallowed. Boy, this is not good.

Is there anything further?

Mr. PIKE. No, sir.

Mr. HARDY. Thank you, gentlemen, you are excused.

Next, Mr. Neiswender, Mr. Zinn, and Mr. Firko.

TESTIMONY OF JOHN L. NEISWENDER, AIR FORCE RESIDENT AUDITOR; HAROLD M. ZINN, DEPUTY AIR FORCE PLANT REPRESENTATIVE; FRANK J. FIRKO, CHIEF, CONTRACT DIVISION, ASSIGNED TO DOUGLAS AIRCRAFT CO., INC., SANTA MONICA, CALIF.

Mr. HARDY. Gentlemen, will you give the reporter your names, your addresses, and your current occupation?

Mr. NEISWENDER. My name is John L. Neiswender, 1220 Shelly Street, Manhattan Beach, Calif. I am the Air Force resident auditor at Douglas Aircraft Co., in Santa Monica, Calif.

Mr. ZINN. My name is Harold M. Zinn. I am the deputy Air Force plant representative, Douglas Aircraft Co., Santa Monica, Calif. I reside at 3559 Woodcliff Road, Sherman Oaks, Calif.

Mr. FIRKO. My name is Frank J. Firko. I am chief of the contract division at Douglas Aircraft. I reside at 271 Hill Street, Santa Monica, Calif.

Mr. HARDY. Thank you, gentlemen.

Mr. REDDAN. Mr. Neiswender, how long have you been resident auditor at Douglas?

Mr. NEISWENDER. Since April of 1961, which is slightly over 3 years.

Mr. REDDAN. And prior to that?

Mr. NEISWENDER. Prior to that, I was resident auditor at Northrop Corp., for 6 years. I have had 22 years with the Air Force auditor.

Mr. REDDAN. Mr. Zinn, how long have you been the deputy Air Force plant representative?

Mr. ZINN. I have been deputy Air Force plant representative since June of 1960. Prior to that, I was chief of the contract division at the same AFPR.

Mr. REDDAN. And you, Mr. Firko?

Mr. FIRKO. I have been chief of the contract division since September of 1963. Prior to that, I had been stationed at Republic Aviation in Farmingdale, Long Island, and also at Martin, in Baltimore.

Mr. REDDAN. Gentlemen, there is just one particular item the committee would like to direct your attention to, and that is the welfare organization at Douglas. As I understand the setup, the welfare division has recently been changed, and a new nonprofit organization

set up for the Douglas Employees Auxiliary Service. Are you familiar with that?

Mr. ZINN. Yes, sir.

Mr. REDDAN. In what way does the new organization differ in its operations—that is, the scope of its operations—from the old employee organization?

Mr. ZINN. Prior to this period of time, Douglas had a welfare division which was in the form of a separate division of the Douglas Aircraft Co. At this time, by establishing a welfare foundation, Douglas did establish a nonprofit organization to take over the specific functions of the welfare group as a separate entity, of course, as a charitable organization.

Mr. REDDAN. Now, the assets, as I understand it, of the welfare division were then donated to this new charitable foundation, is that right?

Mr. ZINN. That is correct.

Mr. REDDAN. Do you know the basis for the valuation of the assets at the time of transfer?

Mr. ZINN. Appraised value, according to the rules for establishment of a charitable foundation.

Mr. REDDAN. Do you know what the book value was of the welfare division assets just prior to the transfer?

Mr. ZINN. I am informed that the fixed assets had a value of approximately \$409,000, according to its books. Its fair appraised value, in accordance with the laws of California, as I understand, established the value at approximately \$489,000 if my memory serves me.

Mr. REDDAN. At how much?

Mr. ZINN. Approximately \$489,000, if memory serves me.

Mr. REDDAN. Well, now, the fixed asset—that is, the net book value—of White Oak Park is what, sir?

Mr. ZINN. I am sorry.

Mr. REDDAN. On the books of the welfare division, what was the book value of White Oaks Park?

Mr. ZINN. The book value was, if my memory serves me again, approximately—

Mr. HARDY. Do you have any records with you that would shed any more definite light on these figures?

Mr. FIRKO. Yes, sir; the auditor has some records.

Mr. Chairman, if I may point out, Mr. Zinn is slightly hard of hearing and may possibly appear to miss a question.

Mr. HARDY. I did not understand.

Mr. ZINN. That is all right. I can refresh my recollection from the figures, if you so require.

Mr. HARDY. Let us have the accurate figures, if you have them in the papers you have with you.

Mr. REDDAN. Mr. Neiswender, you can reply to the question, sir, if you have the information.

Mr. NEISWENDER. Yes, the figures that appear in the draft of the General Accounting Office report on pages 22 and 23, on the appendixes 3 and 4, came from records available in our office. The White Oaks Park, which is a recreational area for the California Division of Douglas, was carried on Douglas Aircraft Corp.'s books at \$140,800. Now, that included the cost of the land and the improvements.

Mr. REDDAN. And that was donated to the new foundation?

Mr. NEISWENDER. That is correct.

Mr. REDDAN. And at what figure was that then carried on the books of the foundation?

Mr. NEISWENDER. Well, it appears on the foundation's books at \$2,258,600. This is directly from the GAO report.

Mr. REDDAN. An increase of over \$2,100,000?

Mr. NEISWENDER. Correct.

Mr. REDDAN. Now, do you know how the principal part of the welfare division's assets, cash assets, were accumulated; what the source of that accumulation was?

Mr. NEISWENDER. Yes, sir. For a 10-year period, the Douglas cafeterias—and when I speak of cafeterias, I am talking about Long Beach, Torrance, and Santa Monica, Calif., because they are all a part of welfare—had a net loss of \$161,000. The stores that are operated at the three locations show gross profit of \$1,232,000.

Mr. REDDAN. Over a period of how long, sir?

Mr. NEISWENDER. Ten years. These figures are all 10 years ended November 30, 1963.

The services activity, which includes the money from vending machines, netted \$1,125,000 over the same 10-year period.

Roughly, that is a total of \$2,197,000 before taxes. The welfare division was a profit-making organization.

Mr. HARDY. Was there any setoff for taxes against the welfare division?

Mr. NEISWENDER. The financial statement of the welfare division shows a provision for taxes.

Mr. Chairman, I would like to point out at this time, so you might better understand what we are talking about, that the welfare division is a separate operating activity of the Douglas Aircraft Co., Inc., and neither receipts nor losses have been charged to Government contracts.

Mr. REDDAN. But the receipts or the losses of the welfare division were included in Douglas' overall income tax returns to the Federal Government, were they not?

Mr. NEISWENDER. That is correct.

Mr. PIKE. Do you know whether when Douglas turned over the White Oaks Park, which the welfare division had had listed at \$140,800 in value, to the foundation at an appraised value of \$2,258,600—did Douglas claim a charitable deduction of \$2,258,600?

Mr. NEISWENDER. I can't answer that question, for two reasons. The first one, at the present time, I do not know. The second reason is that I have not seen the income tax return for November 30, 1964, because it hasn't occurred.

Mr. PIKE. Regardless of any income tax benefits which Douglas may accrue from this, is not the net result of this transaction at Douglas going to be the following: the vending machine profits which heretofore went to the company and formed a part of their income and were used to offset their food sales losses, are these not now going to go to a tax-exempt corporation in such a manner that Uncle Sam will have no vending machine profits to set off against their losses, and Douglas is going to be coming back to the Government to make up their losses on food sales?

Mr. NEISWENDER. Congressman Pike, I have a financial statement for the period from February 1, 1964, to May 31, 1964, in which there is a net gain from the former welfare activities, which are now identified as employees auxiliary services—

Mr. PIKE. Net gain to whom?

Mr. NEISWENDER. It is a credit to overhead at three locations.

Mr. PIKE. Douglas will continue to get the benefit of the vending machine profits?

Mr. NEISWENDER. There has been no change. The auxiliary services will continue to administer the cafeterias, to generate the expense and take care of various club activities, and that will be offset by income.

Mr. PIKE. Good. Then I am wrong, sir.

Mr. NEISWENDER. I don't believe that I gave the figure.

Mr. PIKE. I don't believe I asked you, but I am sure you want to give it at this point, and I would be delighted to have it in the record.

Mr. NEISWENDER. \$6,149 net gain, which is included as a reduction of overhead.

I would like to make one observation, if I could. Douglas has operated profitably in 8 out of the last 10 years. From there, you can draw any conclusion.

Mr. PIKE. Well, I don't know what that observation adds. Frankly, if I could get some of the deductions that some of these people have gotten, and some of the allowances that some of these people have gotten, I could form a corporation and operate very profitably, too. What do you make of the fact that Douglas has operated profitably in connection with these overhead expenses?

Mr. NEISWENDER. Well, assuming that there was no major change in the level of employment, then it would be reasonable to suppose that we will have a credit accruing to us in overhead.

Mr. PIKE. Well, it depends entirely on how they operate. We have had all kinds of corporations in here, some of which have been operating profitably, and some of which have not, but there has been no uniformity whatsoever in the way they have treated these overhead expenses.

I could operate profitably, for example, if my meals didn't cost me anything. I gather that the Douglas Corp. does charge for their food, and therefore they make money on their sales of food instead of losing money.

Mr. NEISWENDER. That is correct.

Mr. ZINN. And in addition to that, if you please, Douglas does not submit claims for dining rooms, executive dining rooms, for reimbursement.

Mr. PIKE. I would have to say that, from what I have seen of this, I think the Douglas Co. comes out looking pretty good in the overall picture. The only thing I am concerned about is this transfer from the welfare division to the foundation of an asset which has been accumulated through Government contracts, which is now taken and put into a tax-exempt foundation. It may well have constituted a charitable deduction, I presume—

Mr. ZINN. No, sir; and I would like to explain this, if I may. The White Oaks Park was not obtained through the employee benefits. It was a Douglas capital asset. As a Douglas capital asset, its transfer, for whatever amount, would not be the income or profit or gain

to the Government in any event to the same extent that if a Douglas building purchased with its own funds were then sold by Douglas for a capital gain, the Government could not participate in that capital gain—and when I say the “Government,” I mean to the extent of our activities.

Mr. PIKE. That is not my point. My question to you—and you are a CPA, I am not—

Mr. ZINN. I am not a CPA.

Mr. PIKE. You are telling me if Douglas does contribute something it owns to a charity they can claim a deduction for it?

Mr. ZINN. Insofar as the income tax provisions, I am not prepared and am not an expert in that area. I am saying in our own area of concern.

Mr. PIKE. Well, we are concerned with something a little larger than this. You mentioned to us that Douglas has been operating at a profit in 8 of the last 10 years and would therefore have some interest in a charitable deduction of \$2 million, if they could get one.

Counsel has just handed me a statement of their 1963 taxable income and analysis of earned surplus and undivided profits for the fiscal year ended November 30, 1963. They are in a 50-percent tax bracket, and they show as a deduction the contribution of property at its fair market value to the Douglas Aircraft Welfare Foundation. This doesn't surprise me—I think it is within the law, but it interests me.

Mr. HARDY. I think if I can properly read these scratch sheets—and I want to get this verified here—with respect to the inclusion of any expense for meals for morale and entertainment—not entertainment, but morale building activities, the extent of Douglas' submission for those expenses for reimbursement in their overhead is very small, is that right?

Mr. NEISWENDER. I am sorry, Mr. Chairman. I heard the last part of the question but not the first.

Mr. HARDY. The extent to which Douglas has requested reimbursement in their overhead is very small, is that correct, for morale building activities?

Mr. NEISWENDER. To the best of my knowledge it is all identified under welfare. There could be minor charges for some odd service furnished for drawing cards, or something like that, announcing a picnic that might not have been transferred over. The general practice is to charge the auxiliary services for all of its costs.

Mr. HARDY. According to the sheet I have in front of me, Douglas Aircraft during this 12-month period had a \$6,000 expenditure for picnics; food service loss, \$189,000; \$323,000 in athletic and club activities, for a total of \$518,000. But they got \$384,000 back from the vending machines. Employee contributions were \$127,000, which only left \$7,000 as probable cost to the Government which, as Mr. Pike said a while ago, is really modest as compared to some of the others that we have observed.

Is this approximately accurate as you understand the situation there?

Mr. NEISWENDER. Yes, sir.

Mr. HARDY. Actually, this was derived—according to this GAO spread sheet, from \$7,000 net food service losses, of which 76 percent was Government business and this brings it down to a computation

of \$5,000. Does that sound about like what you have been experiencing, or maybe I should ask Mr. Firko about that.

Mr. FIRKO. Yes, sir; the report is substantially correct.

Mr. HARDY. Thank you very much, gentlemen.

Mr. McCORMICK. Mr. Webster, and Mr. Hyland, will you come up, please?

Gentlemen, will you give the reporter your names, your addresses, and your current duties, please?

TESTIMONY OF WILLIAM L. HYLAND, ADMINISTRATIVE CONTRACTING OFFICER AND CHIEF, CONTRACT BRANCH, AIR FORCE JOHNSON CITY CONTRACTING MANAGEMENT OFFICE; JOHN A. McCORMICK, CONTRACT AUDIT COORDINATOR AND RESIDENT AUDITOR; WILLIAM L. WEBSTER, ADMINISTRATIVE CONTRACTING OFFICER, JOHNSON CITY CONTRACTING MANAGEMENT OFFICE, DEPARTMENT OF THE AIR FORCE; ASSIGNED TO INTERNATIONAL BUSINESS MACHINES CORP., OWEGO, N.Y.

Mr. HYLAND. I am William L. Hyland, administrative contracting officer, Chief of the Contract Branch of the Air Force Johnson City contracting management office.

Mr. McCORMICK. John A. McCormick, 2200 Watson Boulevard, Endicott, N.Y., contract audit coordinator for IBM and resident auditor for IBM, Owego.

Mr. WEBSTER. William L. Webster, administrative contracting officer of the Johnson City CMO, assigned to duty station at Owego, N.Y.

Mr. HARDY. Thank you, gentlemen.

Mr. REDDAN. Gentlemen, the committee has one matter it wishes to inquire about at IBM, and that is the employee activities which involve the operation of country clubs for recreation and morale activity—located at Sands Point, Poughkeepsie, and Owego—is that right?

Mr. McCORMICK. That is right.

Mr. REDDAN. Can you tell the committee, please, the cost of operating these clubs, and how you handle it in your audit report; what part you allow, what part of the cost of operation is charged to the Government, and what is the justification for the allowance under the ASPR?

Mr. McCORMICK. The cost of operating the clubs is shown on appendix III, 222—

Mr. REDDAN. Appendix III of what?

Mr. McCORMICK. The preliminary General Accounting Office report.

Mr. REDDAN. The GAO report, you say?

Mr. McCORMICK. That is right.

Mr. REDDAN. I am trying to find the preliminary report. Do you have the final report in front of you there?

Mr. McCORMICK. No, I don't.

Mr. REDDAN. What page, sir?

Mr. McCORMICK. Appendix III.

I am resident auditor at IBM, Owego, and have assumed the duties at Kingston in order to close the office up, because the Government

business has gone down. I have confirmed these figures, because I am contract audit coordinator with the New York branch office which audits New York, and with the Washington branch office which audits Bethesda, Md., and the figures are substantially correct.

Mr. PIKE. Mr. Chairman, before we go any further, I would like to state publicly—and I will clean up the record, but I would like to state publicly that I am not sure after looking at these documents that Douglas did claim a charitable deduction on this transfer to the welfare foundation. I can't tell from the documents in front of me whether they did or not.

Mr. HARDY. I wouldn't know that there would be any impropriety—so far as I know, it wouldn't even if they did.

Mr. PIKE. I don't think it would be illegal if they did, but I stated rather flatly that they had, and I think I am in error based on what we have before us.

Mr. REDDAN. This schedule to which you refer shows athletic club activities in the amount of \$563,000. Is that the schedule you have there?

Mr. McCORMICK. Yes.

Mr. REDDAN. Now, can you tell the committee what part of that sum is made up of the cost of operation of the golf clubs that I have just referred to?

Mr. McCORMICK. I can't give it to you that way. What we do is take what is known as the Recreation Association, which includes the golf clubs, and we allocate at Owego—the golf club records are kept at the data processing division in Endicott, N.Y. Endicott, the Glendale Laboratory, and Owego are within 20 miles of each other, and all employees within that area have the use of the golf club which is at Johnson City. The cost is maintained on the books at Endicott, allocated to Owego on the basis of population between the Owego plant and the total number of employees in the area. It is carried in overhead and allocated to Government contracts.

Mr. REDDAN. Could you tell the committee what percent of the cost of operation is charged to Government contracts?

Mr. McCORMICK. At Owego, roughly 90 percent of the cost to Government operations.

Mr. REDDAN. How much?

Mr. McCORMICK. The GAO has 90 percent. Our figures are a little higher, 95.7 for 1963.

Mr. REDDAN. Now, that is—

Mr. McCORMICK. 95.7 percent of the \$182,000 for the Owego plant, roughly 24 percent in 1963 for Kingston, but Kingston has no golf club. Poughkeepsie is mentioned in the GAO report, but that is a commercial division. There is less than 1 percent Government work in it.

Mr. REDDAN. Kingston has Poughkeepsie?

Mr. McCORMICK. Poughkeepsie is not included with Kingston, because in the opinion of the corporation and those up there the distance is too great for those people to avail themselves on a regular basis of the use of the Poughkeepsie golf course.

Mr. REDDAN. How great is the distance, sir?

Mr. McCORMICK. I understand it is better than 30 miles. The course is south of Poughkeepsie.

Mr. REDDAN. Do you actually make any computation of the number of people from Poughkeepsie that use the course?

Mr. McCORMICK. I have not been up there, only since September when I was taken over to close the office because the volume of work has decreased. It will be less than \$7 million in 1964.

Mr. REDDAN. Do you know the number of people on the books at Kingston?

Mr. McCORMICK. Yes; there are about 5,200 at Kingston.

Mr. REDDAN. But the company tells you those employees do not use the Poughkeepsie course?

Mr. McCORMICK. That is right.

Mr. REDDAN. In your audit, sir, how do you handle, for instance, the 90-percent allocation to Government contracts at Owego?

Mr. McCORMICK. At Owego we use the cycle audit approach—

Mr. REDDAN. The what?

Mr. McCORMICK. The cycle audit approach, which is using statistical tables. We evaluate the labor, material, and overhead, and in this overall approach cover some of the charges to the recreation association. Then the recreation association maintains its own books, monthly sends us a journal entry transferring the amount, giving us the population and the amount spent. We do not do much of an audit of the recreation association because it is audited twice a year by the internal audit staff, and annually reviewed by Price, Waterhouse & Co., whose reports are available to us.

Mr. REDDAN. Is the country club the principal activity in the realm of employee morale and recreation?

Mr. McCORMICK. Yes, it is.

Mr. REDDAN. What percentage of the expenditures for employee morale and recreation are represented by the country club costs of operation?

Mr. McCORMICK. At Owego, \$157,000 was represented by country club operation, and \$44,000 is represented by the operation of what is known as the IBM Club, so out of \$201,000, 75 percent roughly is represented by the operation of the country club.

Mr. REDDAN. Are any of these costs defrayed by employee contributions?

Mr. McCORMICK. Yes, sir.

Mr. REDDAN. What part?

Mr. McCORMICK. There is a schedule of payments by the employees in the schedule, operating the recreation association, and the figures I have are those of the Owego Country Club.

Mr. REDDAN. Are any of these costs defrayed by employee contributions?

Mr. McCORMICK. Yes, sir.

Mr. REDDAN. What part?

Mr. McCORMICK. There is a schedule of payments by the employees in the schedule, operating recreation association, and the figures I have are those of the Owego IBM Club. The employees, along with their dues and membership and admission to events, contributed \$34,111 out of an expenditure of \$39,000.

Mr. HARDY. How much are the dues?

Mr. McCORMICK. The dues are—regular employee member, \$1 a year, associate member, \$1 a year; an intermediate member is 50 cents a year. A junior member is 50 cents a year, and a child is 25 cents.

Mr. HARDY. There are not many of them who couldn't take advantage of that if they wanted to.

Mr. McCORMICK. No. There are charges for the use of the various activities. Golf, I believe, is \$2 greens fee. Archery is 10 cents a game, or whatever you call it in archery. Billiards is 15 cents for a half hour. Bowling is 40 cents a game. Golf is 75 cents on weekdays and \$1 on Sunday for greens fees. Shuffleboard is 10 cents. Swimming is a quarter. Table tennis is 10 cents. Court tennis is, for 1 hour, 30 cents.

Mr. HARDY. I don't believe that anybody who could buy a tennis racquet would be unable to afford the price of a game.

Mr. McCORMICK. That is right.

Mr. HARDY. So the company picks up the bill for the rest of the actual cost, and Uncle Sam pays his percentage based on the percentage of business, is that right?

Mr. McCORMICK. That is right.

Mr. HARDY. Now, what other recreational activities are available to the employees during the course of a year, in the way of parties, and so forth, or picnics?

Mr. McCORMICK. There is a family picnic. There are square and round dances from which the income was, for instance, \$557, disbursements \$1,000. There was a Watson memorial dinner—

Mr. HARDY. Just what is that?

Mr. McCORMICK. That is a dinner where the various teams—the winners in golf during a season, baseball teams, tennis champions, and those who win tournaments—are awarded trophies.

Mr. HARDY. Just once a year?

Mr. McCORMICK. One a year.

Mr. HARDY. Is that the same as a trophy dinner, and do they have these at each plant?

Mr. McCORMICK. Yes, sir.

Mr. HARDY. I thought I saw something here somewhere about a Watson dinner and then a trophy dinner. Are they the same thing?

Mr. McCORMICK. The Watson dinner is a trophy dinner.

Mr. HARDY. What is the installation?

Mr. McCORMICK. Installation dinner. The officers who are elected to office in this recreation club are given a dinner at the time of installation.

Mr. HARDY. How many people usually attend that?

Mr. McCORMICK. I don't know, sir.

Mr. HARDY. How many people normally attend a Christmas party, and who is eligible to attend?

Mr. McCORMICK. Only the employees of the company, their wives and their children, and I understand that at the last Christmas party there were about 2,000. It is an affair that runs on Saturday, and they go in and out during the day.

Mr. HARDY. Did you examine the elements of cost that went into these parties?

Mr. McCORMICK. Only on a sampling basis as they go through the records. We did not come up with the cost of food or anything like that.

Mr. HARDY. In order to try to determine the uniformity with which you several people operating in this area approach the subject, did

you examine the itemization of these parties to determine how much was spent for whisky and cigars?

Mr. McCORMICK. There was not a cent spent for whisky, because the IBM Corp. will not allow alcohol to be served at any dinner with which the name of IBM is identified.

Mr. HARDY. So none of these parties had any expenditures for alcoholic beverages?

Mr. McCORMICK. No, sir.

Mr. HARDY. And none of the items which were questioned in these other parties would have applied to the IBM parties, is that right?

Mr. McCORMICK. It doesn't apply to the corporation as a whole for any event.

Mr. REDDAN. Have you disallowed any of these items which were charged?

Mr. McCORMICK. No, sir.

Mr. REDDAN. You have never found any—

Mr. McCORMICK. No, the policy has been going on since 1934, and I resolved that it conformed to ASPR for reasonableness as being what a prudent businessman would do in the circumstances in that it applies equally to all their employees, whether commercial or not.

Mr. REDDAN. Your decision as to reasonableness, in your judgment as to that do you consider whether these costs are reasonable in the light of what other companies might be doing along this line for their employees?

Mr. McCORMICK. I do not know what other companies are doing, sir.

Mr. REDDAN. Have you ever examined the operations of the General Electric Co. in the operation of their country club?

Mr. McCORMICK. They have no country club in that area.

Mr. REDDAN. What would you call it if they have swimming, golf, tennis—

Mr. HARDY. He said in that area.

Mr. REDDAN. Oh, I am sorry. They do have a country club.

Is there any attempt on the part of the auditors who are concerned with these problems to get together and discuss the problems which they have in the various areas of the country and determine how other companies handle similar activities?

Mr. McCORMICK. Not that I know of.

Mr. REDDAN. So that the people who would handle the General Electric operations, there would be no communication between them and you?

Mr. McCORMICK. No, sir.

Mr. REDDAN. Although GE might furnish the same kind of accommodations for their employees at little or no cost to the Government, that is not a matter of interest to you?

Mr. McCORMICK. It would be, but I don't know how it would bear on the policy of International Business Machines who have this uniformly throughout the corporation.

Mr. REDDAN. Maybe if you knew how the other companies did it you could suggest a way of them doing it so it wouldn't cost the Government anything.

Mr. HYLAND. Mr. Reddan, may I make a point here?

Mr. REDDAN. Surely.

Mr. HYLAND. The operation of these clubs has been going in practically their present format, as we know them today, since 1934, with no Government business in the area. The IBM Owego Space Guidance Center came into existence in 1957. It seems the criteria here as to what a prudent businessman would do in the performance of his own business in the area of expense—IBM fully qualifies in that area, because those clubs were there long before they ever did any Government business in that area, and they would continue to operate them, I might add.

Mr. HARDY. Thank you very much, gentlemen.

I believe we have a bill on the floor in a few minutes so we will adjourn at this time and reconvene in this room at 10 o'clock tomorrow morning.

(Whereupon, at 3:55 p.m., the subcommittee adjourned, to reconvene at 10 a.m., Thursday, July 23, 1964.)

COST OF MORALE AND RECREATION BENEFITS FOR DEFENSE CONTRACTOR EMPLOYEES

THURSDAY, JULY 23, 1964

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
SUBCOMMITTEE FOR SPECIAL INVESTIGATIONS,
Washington, D.C.

The subcommittee met at 10 a.m., in room 313A, Cannon House Office Building, Porter Hardy, Jr. (chairman of the subcommittee) presiding.

Members present: Hon. Porter Hardy, Jr., Hon. Otis G. Pike, and Hon. Charles S. Gubser.

Staff members present: John T. M. Reddan, special counsel; Walton Woods, staff investigator; and Phyllis M. Seymour, secretary.

Mr. HARDY. Let the committee come to order.

The Chair is delighted to welcome back the gentleman from California, Mr. Gubser.

I think we will start off this morning with Mr. Fuller and Mr. McMeen, if you gentlemen will come up. Please give the reporter your names, addresses, and present occupations.

TESTIMONY OF KENNETH W. FULLER, AIR FORCE RESIDENT AUDITOR; AND LAIRD McMEEN, CHIEF, CONTRACT ADMINISTRATION DIVISION AND PRINCIPAL CONTRACTING OFFICER, AIR FORCE PLANT 66, FORT WORTH, TEX., ASSIGNED TO GENERAL DYNAMICS CORP.

Mr. FULLER. Kenneth W. Fuller, 6734 Fortune Road, Fort Worth, Tex. I am resident auditor at General Dynamics, Fort Worth.

Mr. McMEEN. I am Laird McMeen. I reside at 1206 Cozby, South, Fort Worth, Tex. I am chief of contract administration division, principal contracting officer, Air Force Plant 66, General Dynamics Corp.

Mr. REDDAN. Mr. Fuller, how long have you been chief resident auditor?

Mr. FULLER. Approximately 1 year.

Mr. REDDAN. What was your position prior to that?

Mr. FULLER. I was the assistant resident auditor.

Mr. HARDY. How long were you assistant resident auditor?

Mr. FULLER. About 1 year, sir.

Mr. HARDY. So you have been in this particular audit operation for 2 years with General Dynamics?

Mr. FULLER. That is correct.

Mr. HARDY. Did you inherit a lot of loose ends or how is your situation? Are you pretty current or are you as far behind as some of the rest of them?

Mr. FULLER. Well, we are fairly well up, sir. We have a tentative draft on our 1962 overhead, and we are expecting to get through with 1963 by November of 1964. That is our schedule.

Mr. HARDY. When you refer to the draft of 1962, what do you mean by a tentative draft? Is this the basis on which you would hold discussions or negotiations with the company?

Mr. FULLER. Well, have completed all our audit work, except that there has been no review on the 1962 by myself—1962 overhead draft.

Mr. HARDY. Is that calendar year 1962?

Mr. FULLER. Yes, sir.

Mr. HARDY. So your contracting officer, your contract administrators haven't received the data on which they could begin negotiations with the company for 1962 yet?

Mr. FULLER. Well, sir, most of that has been reviewed by the contracting officer. We are on an audit determination basis for division overhead expenses.

Mr. HARDY. You say you have a tentative draft of the report for calendar year 1962. It won't be long before we will be at the end of calendar year 1964. Will the 1962 report be buttoned up before the end of this calendar year?

Mr. FULLER. I hope to have it buttoned up within a matter of weeks after I get back to the office.

Mr. HARDY. You are talking about the audit report or about the final determination with respect to the allowable items in overheads?

Mr. FULLER. It is an overhead advisory report. The items of overhead have already been determined, sir.

Mr. HARDY. I don't know what your overhead advisory report means.

Mr. FULLER. Well, it is the items which the contractor and the contracting officer have made a determination as to the items that were allowable.

Mr. HARDY. That has already been done?

Mr. FULLER. Yes, sir.

Mr. HARDY. The contracting officer and the contractor have reached agreement on these items?

Mr. FULLER. Yes, sir.

Mr. HARDY. Well, that is a little better than I thought.

Go ahead.

Mr. REDDAN. How many auditors do you have under you?

Mr. FULLER. Twenty auditors including myself, and three clerks.

Mr. REDDAN. To what extent do you audit the accounts of General Dynamics?

Mr. FULLER. Well, in our overhead section, we have five men—a supervisor, team supervisor, and four staff auditors. This area is covered rather extensively. We use a continuous audit approach.

Mr. REDDAN. You check every month?

Mr. FULLER. Yes, sir; we check every month. We have people over in the contractor's accounting department practically every day, and these audits are made on accounts, by accounts.

Mr. REDDAN. Mr. McMeen, how long have you been the contracting officer, sir?

Mr. McMEEN. I have been a contracting officer for approximately 5½ years at the present site, sir.

Mr. REDDAN. Mr. Fuller, I would like to draw your attention to just one item with which I know your audit has been concerned in the past, and that is the cost of the operation of the executive dining room at General Dynamics. Is there more than one dining room that has that name, or is it just one dining room?

Mr. FULLER. Well, they have a cafeteria operation that is really broken into three phases—the executive dining room, the main dining room, and what they refer to as the “hot line.” That is the food service in the plant.

Mr. REDDAN. Who uses each one of those?

Mr. FULLER. The executive personnel, primarily department heads, use the executive dining room. All other salaried personnel, primarily salaried personnel use the main dining room, and the blue-collar workers use the hot line.

Mr. REDDAN. Now, do you have records there from which you could tell the committee whether or not the executive dining room has been operating at a profit or a loss?

Mr. FULLER. The executive dining room has been operating at a loss. The loss for 1963 was \$41,223.

Mr. REDDAN. How have the costs of the meals been defrayed for the executive dining room? Are the meals catered in the executive dining room?

Mr. FULLER. Yes, sir; they are.

Mr. REDDAN. And how was the cost of the meals covered?

Mr. FULLER. They have a standard price that they use in the executive dining room of \$1.33.

Mr. REDDAN. When did that standard price go into effect?

Mr. FULLER. It went into effect in 1963.

Mr. REDDAN. Prior to that time what was it, sir?

Mr. FULLER. It was \$1.25.

Mr. REDDAN. How much of that \$1.25 did the purchaser pay—that is, the executive who used that dining room—how much did he pay?

Mr. FULLER. The executive reimbursed a dollar of that, and 25 cents was subsidized.

Mr. REDDAN. By the company?

Mr. FULLER. By the company.

Mr. REDDAN. Did that go into a reimbursable account?

Mr. FULLER. It was a nonreimbursable account.

Mr. REDDAN. So that that 25 cents at that time was not passed on to the Government?

Mr. FULLER. That is correct.

Mr. REDDAN. Now, was there a cost which this \$1.25 did not defray?

Mr. FULLER. Well, there was a cost of an executive dining room manager whose salary, I believe, was \$415 a month, which the company paid, also. This went into a nonreimbursable account.

Mr. REDDAN. Was there any of the cost of the executive dining room that went into a reimbursable account?

Mr. FULLER. Would you repeat that?

Mr. REDDAN. Was there any part of the cost of the executive dining room that went into a reimbursable account?

Mr. FULLER. Not before January 1, 1963.

Mr. REDDAN. Not before that time?

Mr. FULLER. That is right.

Mr. HARDY. Did that \$1.25 pay the entire cost except for the manager's salary?

Mr. FULLER. It paid the standard price, sir.

Mr. HARDY. But did the standard price meet the entire cost of operating the dining room?

Mr. FULLER. It is not our belief that that \$1.25 was enough to cover the cost of the meals.

Mr. HARDY. What happened to the rest of it?

Mr. FULLER. Well, the balance of this went against the main dining room, the cost of which was paid by those employees that ate in the main dining room, plus possibly those that ate on the hot line.

Mr. HARDY. You don't know what that amounted to?

Mr. FULLER. No, sir; it was all coming out of common inventories and out of the same pots of food. There was no breakout on this cost by the caterer.

Mr. HARDY. Let me see if I understand this accounting procedure. The executive dining room and the employees' dining room all came out of the same food account?

Mr. FULLER. That is correct.

Mr. HARDY. They also used the same personnel accounts, employee accounts, maids, cooks, or what have you?

Mr. FULLER. Well, all these—this caterer kept one set of books. In his set of books, the food inventories were used, the issues to the dining room, the executive dining room and the hot line all came out of these common accounts.

Mr. HARDY. So the caterer served both the main dining room and the executive dining room?

Mr. FULLER. Yes, sir.

Mr. HARDY. Now, then, the only additional cost accruing to the executive dining room was the manager?

Mr. FULLER. That is correct, the dining room manager.

Mr. HARDY. The only thing he managed was the executive dining room?

Mr. FULLER. Yes, sir.

Mr. HARDY. Now, how was it determined that \$1.25 was the proper amount to charge for the executive meals?

Mr. FULLER. The caterer, back in 1951 was where this dollar and a quarter was established, at that time must have come up with some kind of a formula to determine the price of the meal served.

Mr. HARDY. Then the \$1.25 was not supposed to cover the manager, but was just supposed to cover the food, maintenance of equipment, and so forth, and depreciation on equipment—is that included?

Mr. FULLER. The Dynamics plant is Government owned. There is no depreciation on the plant facilities.

Mr. HARDY. Did the caterer provide all the facilities for preparing the meals?

Mr. FULLER. Yes, sir; he did. There is equipment in the plant, in the cafeteria—

Mr. HARDY. Does it belong to him or to the Government?

Mr. FULLER. It belongs to the Government.

Mr. HARDY. It belongs to the Government?

Mr. FULLER. Yes, sir.

Mr. HARDY. So there is no charge made for the depreciation of the equipment?

Mr. FULLER. That is correct.

Mr. HARDY. So that you have a fictitious cost of the food, anyway. If you are separating out the food as being chargeable to the employees or the people that use it, from an accounting standpoint you would have a false statement?

Mr. FULLER. Well, if you used incremental costing, which is used in that cafeteria, then you are looking only to those incremental costs. You are not looking at depreciation, or costs that would have been there regardless of whether the cafeteria was there or not.

Mr. HARDY. Well, I understand the problem that you have there insofar as the plant and equipment might be chargeable to the product that is being produced, but if your food service is supposed to be paid for by the people that are using it, it would have to include the cost of the equipment or amortization on it?

Mr. FULLER. Yes, sir, to get a correct cost, it would.

Mr. HARDY. But they didn't do that?

Mr. FULLER. That is correct.

Mr. HARDY. Now to get back to the cost of operating the executive dining rooms, you say you do understand there was a formula used to distinguish between the value of the meals served in the executive dining rooms and those served in the main general dining room which accounted for the \$1.25 to start with?

Mr. FULLER. That is correct, sir.

Mr. HARDY. Is the main dining room self-supporting?

Mr. FULLER. Under the conditions that we were describing a moment ago, the incremental costing procedure, it has been self-supporting.

Mr. HARDY. Other than the items such as amortization of equipment?

Mr. FULLER. That is correct.

Mr. HARDY. And the use of space?

Mr. FULLER. Yes, sir.

Mr. HARDY. Those are not involved in the accounting costs.

Now, was there a profit made?

Mr. FULLER. Pardon me?

Mr. HARDY. Was there a profit made on the total food service?

Mr. FULLER. Yes, sir, there was. There has been some approximately \$22,000 profit over the last 7 years.

Mr. HARDY. Was that a profit on the combined operation of both the executive dining room and the main employees' dining room?

Mr. FULLER. No, sir, that is only for the main employees dining room.

Mr. HARDY. Well, I thought the food all came out of the same pot; didn't you say that?

Mr. FULLER. Yes, sir, it did, but the price of the executive dining room, or the cost of the executive dining room, the portion that was not paid—the dollar per plate cost that was paid by General Dynamics, this went into a nonreimbursable account. It was separated.

Mr. HARDY. That was the quarter per plate that went into the non-reimbursable account?

Mr. FULLER. Yes, sir, that was prior to January 1, 1963. The excess cost went into a nonreimbursable account.

Mr. HARDY. But I don't understand how you say that the \$22,000 represented a profit on the employees dining room, eliminating the executive dining room, because certainly if the food was all charged out of the same thing—do you mean the executive dining room had a loss in addition to the dollar that they charged?

Mr. FULLER. There was a loss on the executive dining room. For example, if you had a thousand employees eating there at \$1.25 apiece, and there was, say, \$1,100, approximately, if there was reimbursement to the manager, the caterer, of only \$900, this \$200 went into a nonreimbursable account which was not paid for by the Government.

Mr. HARDY. What charges were carried against the executive dining room that weren't charged to the main dining rooms?

Mr. FULLER. The manager of the executive dining room was not charged, and all the food cost of the executive dining room—this \$1.25 was supposed to cover all the food costs that went into the executive dining room.

Mr. HARDY. I thought you said they didn't keep the food costs separate.

Mr. FULLER. No, sir, they didn't, but the issues that were made to the executive dining room and the labor cost, and so forth, this \$1.25 was supposed to cover this. This was a standard price, sir.

Mr. HARDY. Then they did charge to the executive dining room the food that was issued to it?

Mr. FULLER. No, sir, they didn't charge the food. It was a determination that this food that they issued cost this amount of money.

Mr. HARDY. And they did set that up as a cost to the executive dining room?

Mr. FULLER. Yes, sir.

Mr. HARDY. And reduced the cost of the food in the main dining room by that amount?

Mr. FULLER. That is correct.

Mr. HARDY. How did they arrive at that if they didn't keep track of the food issued?

Mr. FULLER. This was a formula established prior to 1951.

Mr. HARDY. So it was a formula without regard to accuracies?

Mr. FULLER. That is correct.

Mr. HARDY. There were meals served in the executive dining room that were not available to the patrons in the main dining room?

Mr. FULLER. There were certain types of food that they would serve from time to time that would not be available in the main dining room. It may be, for example, steaks they might have several times a week. Those same steaks would not be available in the main dining room at that particular point in time.

Mr. HARDY. Well, how did they handle the charges for that? If they still used the formula, the steaks weren't actually charged to the executive dining room but were in the pot going to the rank and file of folks who didn't get a chance to eat any of it.

Mr. FULLER. That is the same formula that they had used back in the past, this same \$1.25 that was established in 1951.

Mr. HARDY. So the executive dining room was eating high off the hog and charging it to the main dining room.

Mr. FULLER. That is our contention, sir. We have a report on that.

Mr. HARDY. What did they do with the losses in the executive dining room? What were the losses of the executive dining room in 1962? Is that the one we are talking about?

Mr. FULLER. In 1963, sir, the loss was \$41,223.

Mr. HARDY. And did I understand that there was a profit of \$22,000 on the employees' dining room?

Mr. FULLER. No, sir.

Mr. HARDY. Where did I get that?

Mr. FULLER. I said for the last 7 years, that was the profit.

Mr. HARDY. Oh, that is 7 years?

Mr. FULLER. Yes, sir.

Mr. HARDY. Oh, my gracious.

Mr. FULLER. For the 1 year, 1963, it was \$7,126.

Mr. HARDY. \$7,000. Was that \$7,000 used to offset in part the loss on the executive dining room?

Mr. FULLER. Yes, sir; it went into a common account, General Dynamics common account.

Mr. HARDY. That left a \$34,000 loss on total food service which was in addition, was it, to the manager?

Mr. FULLER. No, this involved the whole thing, sir, this \$41,223 loss in the executive dining room.

Mr. HARDY. Who paid the \$34,000?

Mr. FULLER. Pardon me?

Mr. HARDY. Who paid the \$34,000 which presumably included reimbursable overhead?

Mr. FULLER. It was, up until the time that we suspended that cost, sir.

Mr. HARDY. Well, in previous years, this additional cost had been paid, included in reimbursable overhead.

Mr. FULLER. The executive dining room had not been included in reimbursable overhead. The main cafeteria profit or loss had been.

Mr. HARDY. Take a look at 1962, then. We are talking about 1963, but what happened to it in 1962? What was the loss on the executive dining room in 1962?

Mr. FULLER. Let me get my report and I will give you that information. In 1962, the net expense was \$33,100.

Mr. HARDY. And who paid that?

Mr. FULLER. The contractor, sir.

Mr. HARDY. The contractor paid that and did not include it in the reimbursable?

Mr. FULLER. Yes, sir.

Mr. HARDY. Where does this 33 cents come into play?

Mr. FULLER. The \$1.33?

Mr. HARDY. Well, the dollar is what is contributed by the people that eat the food. The 33 cents is charged to what—charged to the company?

Mr. FULLER. Well, the \$1.33—there is a dollar that is paid by the employee, the 33 is made up of a 25-cent subsidy and an 8-cent estimated per plate cost for this caterer or manager in the executive dining room, which makes a total of \$1.33.

Mr. HARDY. Who pays the 8 cents and who pays the 25 cents?

Mr. FULLER. Well, that is part of the cost that goes into this common account, now this 33 cents. The contractor pays the dollar.

Mr. HARDY. Well, does this \$41,000 loss consist in major part of the 33 cents?

Mr. FULLER. Yes, sir; it is the subsidy, the 33 cents, and nonpaying guests.

Mr. HARDY. Nonpaying guests? Now you have brought another element in there. Who do they include? Do they include folks like the military who come out to look over the situation?

Mr. FULLER. Yes, sir; and vendor representatives that come there at General Dynamics.

Mr. HARDY. General Dynamics officials and military officials who have business out there—do they include you folks in that?

Mr. FULLER. Well, I have eaten over there when there are guests, when I have visitors from out of town, sir. I am not a regular eater there.

Mr. HARDY. You mean you eat over there and pay your dollar?

Mr. FULLER. Yes, sir; I do.

Mr. HARDY. But you can take along guests without paying for them, or do you have to pay a dollar for them, too?

Mr. FULLER. All the guests that I have had paid their way, sir.

Mr. HARDY. They paid their dollar?

Mr. FULLER. Yes, sir.

Mr. HARDY. You know, my guests aren't usually that considerate.

Mr. McMEEN. Mr. Hardy, I would like to point out that the plant representative office has a policy there of informing all visitors that they have the obligation of paying for meals in the event they are extended the courtesy of using the executive dining room.

Mr. HARDY. So that Uncle Sam won't be charged 33 cents for their meals? Why don't they pay \$1.33, if you are going to charge a dollar. If they are going to be big hearted, and you are going to let them pay the dollar, why don't you let them pay the 33 cents? It is not the policy to do that. Go ahead.

Mr. REDDAN. Mr. Fuller, you say the policy was changed or recommendation for change was made by the company in 1963?

Mr. FULLER. Yes, sir.

Mr. REDDAN. Would you tell us what that change involves and what your position is with respect to that?

Mr. FULLER. In March 1963, the contractor made a proposal that this cost that had formerly been borne by the contractor be allowed under ASPR 15-205.15 as reasonable losses.

Mr. REDDAN. Did you take a position with respect to that proposal?

Mr. FULLER. Yes, sir; I did.

Mr. REDDAN. Is it covered in the communication which you prepared under date of August 20, 1963?

Mr. FULLER. The first report that we made on this proposal was our requested comments, and I believe that was May 16, 1963, in which the contractor's proposal was submitted to us, and a JAG decision on this same proposal was submitted to us for our comments.

Mr. REDDAN. This is a JAG decision on this specific proposal?

Mr. FULLER. It was a JAG opinion, not a decision—I stand corrected.

Mr. REDDAN. Did you have a citation for that opinion?

Mr. FULLER. It is a letter dated April 4, 1963, James P. England, for George R. Stevens, Staff Judge Advocate Office.

Mr. REDDAN. Addressed to whom, sir?

Mr. FULLER. Addressed to General Dynamics, AFPRO.

In May of 1963, our interpretation of the ASPR was different than the interpretation put on by the JAG Office. We believed that this reasonable food loss that had been spoken of was not ordinary food loss and should not be allowed.

Mr. REDDAN. This is food loss referred to in the ASPR?

Mr. FULLER. Yes, sir; that was our interpretation of the ASPR.

Mr. REDDAN. When was this new agreement to become effective?

Mr. FULLER. Well, the contractor wanted it to become effective as of January 1, 1963.

Mr. REDDAN. Have you had occasion to pass on that portion which is now charged to overhead?

Mr. FULLER. Yes, sir; we have taken exception to that cost.

Mr. REDDAN. Has that now been settled?

Mr. FULLER. No, sir; it has not. The exception route that we take is that we requested the contractor to suspend that from cost reimbursement which he has agreed to do, and we have presented certain facts to the contracting officer, and the contractor was due to come in on July 22, this month, to discuss these matters and bring his facts to bear.

Mr. REDDAN. What was the thrust of the JAG opinion which you referred to?

Mr. FULLER. The JAG opinion—reading from the opinion—says:

We have reviewed the information contained in the basic letter and attachment thereto.

And he is speaking of the contractor's letter with the attachments.

It is our opinion that in accordance with ASPR 15-205.14, reasonable losses for the executive dining room should be considered as allowable provided those losses are considered in connection with the overall food service operation at the contractor's plant.

Mr. REDDAN. As I understand it, it is your position that these are not reasonable losses but planned losses?

Mr. FULLER. That is right, they are self-induced losses—I believe that is the term that we use.

Mr. PIKE. I would like to say this is a sort of breath of fresh air to me. The concept that you have is exactly what I have, that a dining room should be operated with an attempt to break even, and if they incur losses while attempting to break even, they will be treated as a reasonable loss; but if they incur losses when they are charging \$1.50 for a meal they know cost \$5, this is not reasonable but is a willfully incurred loss with no thought in mind except that Uncle is going to make up the difference.

I think your interpretation is fine, and I think it is to be commended.

Mr. FULLER. Thank you, sir.

Mr. HARDY. Have you any questions, Mr. Gubser?

Mr. GUBSER. I have no questions.

Mr. HARDY. I would point out again that this shows the variation with which our own Government employees approach this, based in turn on their interpretation of the ASPR and perhaps based in part

on some of their lawyers' interpretations. One of the major problems is that there is no general uniformity and no general understanding of what the ASPR means.

Mr. PIKE. Yesterday we had an example of one outfit that charged nothing for a \$3 meal and got half of it back from the Government, and another that charged \$1.50 for a \$5 meal and got half of it back from the Government. It seems to me that the approach taken by these gentlemen at General Dynamics is the proper approach. I think they should stick with it, and maybe we can spread the doctrine down the line a bit.

Mr. HARDY. I think it would be helpful if we could. I think this was the particular point that we wanted to clear up insofar as General Dynamics was concerned.

Mr. Reddan, were there any parties, picnics, or items of that kind in this particular audit, or maybe I should ask the witness.

You have heard some of the testimony we have had here in connection with some rather expensive picnics. Does General Dynamics have an annual picnic program?

Mr. FULLER. They have a recreation program, sir, similar to others, in which they derive income from vending machines. This is under a license agreement from the General Dynamics to the recreation association, and all the moneys derived from the vending machines are spent on employees welfare and morale.

General Dynamics excludes any of those type items from their overhead accounts, voluntarily, and these are in nonreimbursable overhead, these type expenditures, in General Dynamics overhead accounts.

Mr. HARDY. Do you audit that account?

Mr. FULLER. Yes, sir, we do.

Mr. HARDY. Now, since they are excluded, let me ask you, do they expend all of the vending machine receipts for that purpose?

Mr. FULLER. There have been some surpluses, sir. I understand that there was a surplus of some \$150,000 built up through fiscal year 1962, but since then I understand that they have purchased some land, and this surplus has gone down considerably.

Mr. HARDY. According to the GAO report, they have estimated the cost to the Government for this particular 1962-63 period, which they examined, at \$34,000.

The GAO summary tabulation shows that the entire vending machine receipts were expended. Maybe that was for the purchase of property, but who does that property belong to?

Mr. FULLER. It belongs to the General Dynamics, Fort Worth, recreation association.

Mr. HARDY. A nonprofit association?

Mr. FULLER. Yes, sir.

Mr. HARDY. In the case of liquidation, who would it belong to?

Mr. FULLER. I understand—when I say "I understand", I recently read the articles, bylaws of the association, and there is a stipulation in there that the directors of the association and officers of the association may contribute this to some charitable cause, or maybe to the city of Fort Worth.

Mr. HARDY. The other question which was in my mind in connection with any surplus accumulated and not expended for proper purposes, why wouldn't that be used to offset in part the food losses?

Mr. FULLER. Well, I would like to give my personal view here, sir. This surplus that the employees have, that, as I say, was built up for purchase of this property, and I think it would be inequitable if the employees association were to offset this against overhead for the executive dining room.

Mr. HARDY. Aren't you sort of straining at a gnat and swallowing a camel there? What do they do in the case of the employees dining room? They take the money from the employees and make a profit on it and have to pay for the losses on the executive dining room.

Mr. FULLER. They do, sir.

Mr. HARDY. Shouldn't sauce for the goose be sauce for the gander? I don't know why they should subsidize an executive dining room from profits from the employees dining room—at least it seems to me the theory should be applied across the board if it is valid at all.

Mr. McMEEN. Sir, I would like to answer that. Inasmuch as these costs have been questioned and have not been resolved, I plan to examine this in every detail and every aspect.

Mr. HARDY. That is fine insofar as 1963 is concerned, but, as a matter of fact, there has been some subsidizing of the food costs in the executive dining room during the past by the employees dining room, hasn't there? All you have done is set up an arbitrary figure.

Mr. McMEEN. To the extent the costs may be incorrect, you are right, sir.

Mr. HARDY. So it has been going on over a period of time, but that is another matter that I think we will want to explore. Essentially, so far as General Dynamics is concerned, I think we have covered it.

Thank you very much, gentlemen.

Next we will ask Mr. Fogelman and Mr. Cristin to come up.

Will you give the reporter your names and addresses and your present occupation?

**TESTIMONY OF MILTON A. FOGELMAN, CONTRACTING OFFICER;
AND RAOUL CRISTIN, RESIDENT AUDITOR, DEPARTMENT OF THE
AIR FORCE; ASSIGNED TO AEROSPACE CORP., EL SEGUNDO, CALIF.**

Mr. CRISTIN. My name is Raoul Cristin. I live at 48 Fifth Street, Hermosa Beach, Calif. My position is resident auditor of Aerospace Corp.

Mr. FOGELMAN. My name is Milton Fogelman. I live at 18348 Coastline Drive, Malibu, Calif. I am assistant for procurement to the chief of the contracts management office of the space systems division. I am contracting officer assigned to Aerospace.

Mr. HARDY. Thank you, gentlemen.

Go ahead.

Mr. REDDAN. Mr. Cristin, how long have you been resident auditor?

Mr. CRISTIN. Since September of 1962.

Mr. REDDAN. And prior to that time?

Mr. CRISTIN. I was assigned to the Hughes Aircraft Co. at Culver City, Calif.—the Auditor General's Office.

Mr. REDDAN. And how long were you in that position?

Mr. CRISTIN. Oh, approximately a year and a half, sir.

Mr. REDDAN. Are you a CPA, sir?

Mr. CRISTIN. Yes; I am.

Mr. REDDAN. Mr. Fogelman, how long have you been contracting officer at Aerospace?

Mr. FOGELMAN. I have been contracting officer since the inception of Aerospace. However, I was not the principal contracting officer until June of 1962.

Mr. REDDAN. Mr. Cristin, I would like to call your attention to your advisory report for January 1 through December 31, 1961, and particularly page 2 of exhibit B. Do you have that before you, sir?

Mr. CRISTIN. Yes, sir.

Mr. REDDAN. Item 9 on that—let me ask you first, exhibit B is what, sir?

Mr. CRISTIN. Exhibit B is an attachment to the audit report dated 15 January 1963.

Mr. REDDAN. And does this list the items which you questioned?

Mr. CRISTIN. Yes, sir.

Mr. REDDAN. And one of the items which you questioned is item 9 on page 2, which is entitled "Executive/commander dining rooms." Are they separate dining rooms?

Mr. CRISTIN. Yes, sir.

Mr. REDDAN. Is there more than one executive dining room?

Mr. CRISTIN. No, sir; this is one dining room at the R. & D. center, and another dining room at the Arbor Vitae complex.

Mr. REDDAN. And that one is the commanders' dining room?

Mr. CRISTIN. Yes, sir.

Mr. REDDAN. Who eats in the executive dining room, sir. What is the cutoff point?

Mr. CRISTIN. I am not sure exactly where the cutoff is, but to my knowledge the top executives, the company officers eat there.

Mr. REDDAN. Is there any charge for meals in that dining room?

Mr. CRISTIN. Yes, sir; there is.

Mr. REDDAN. Is there a profit or a loss on the operation?

Mr. CRISTIN. There is a loss on the operation, sir.

Mr. REDDAN. What percent of cost is recovered by the price charged?

Mr. CRISTIN. I don't have that percent right with me.

Mr. HARDY. What is the total operating cost of the dining rooms and how much is recovered?

Mr. CRISTIN. I don't have those figures, sir. I have the net loss for the period. The net loss for both dining rooms combined for that period was \$16,453—I beg pardon—for the executive dining room the losses were \$10,389, sir.

Mr. HARDY. That is the executive dining room?

Mr. CRISTIN. Yes, sir.

Mr. HARDY. Both or just one?

Mr. CRISTIN. For both of them, sir.

Mr. REDDAN. Now, who eats in the commanders' dining room?

Mr. CRISTIN. I don't know of personal knowledge, sir, but I understand it is for the senior commanders of the Space Systems Division.

Mr. REDDAN. Is there any charge in that dining room?

Mr. CRISTIN. Yes, sir; I believe there is.

Mr. REDDAN. Do you know whether there is?

Mr. CRISTIN. There are cash sales recorded, sir, on the books.

Mr. REDDAN. Well, does everybody who eats there pay for their meal?

Mr. CRISTIN. As far as I know, sir, they do.

Mr. HARDY. What is the total cost of operating that dining room, and what is the total intake? If you don't have it, let me read this statement, because I think this clears it up, and it doesn't seem to me to jibe entirely with your testimony, but maybe it does. It says:

Executive/commander dining rooms. This represents the operating losses and guests' meals of the executive dining room at R. & D. complex and the commanders' dining room at the Arbor Vitae complex. It has been stated that the operating loss of the executive dining room was largely attributable to the gourmet type of meals at less than cost and to food wastage. Since no accurate accounting charge is made for meals furnished guests, the cost of guests' meals included in the operating cost is indeterminable. Costs are questioned for allocability and reasonableness under ASPR 15-201:2.

The amount is \$10,389.

If there is no accurate accounting, I just wonder what is the basis for your statement that they do make a charge for all the meals.

Mr. CRISTIN. Sir, the information we have indicates that the corporate officers, the regular members that go to this executive dining room, do pay for the meals that they have.

Mr. HARDY. Is it a fact that military officers of a certain rank can eat in one or both of these dining rooms without charge?

Mr. CRISTIN. Not to my knowledge, sir. The regular members of the dining rooms pay the charge for their meals.

Mr. HARDY. Regular members of the dining rooms?

Mr. CRISTIN. Yes, sir.

Mr. HARDY. Who are the regular members?

Mr. CRISTIN. Well, the officers of the company are the regular members of the executive dining room, and it is my understanding that the senior commanders are the regular members of the commanders dining room.

Mr. HARDY. Who are the senior commanders?

Mr. CRISTIN. I understand it is——

Mr. HARDY. I don't understand that term as applied to Aerospace.

Mr. CRISTIN. I have a statement here that was made to GAO which defines this category.

Mr. HARDY. Don't you know who they are?

Mr. CRISTIN. Not of personal knowledge.

Mr. HARDY. You aren't interested in that?

Mr. CRISTIN. I have never been to the dining room. It says "full and senior colonels and above could utilize the dining rooms with their guests."

Mr. HARDY. I still don't understand who is included in this. Are they only the people employed by Aerospace?

Mr. CRISTIN. The full colonels and above were the ones that were authorized to eat at the commanders dining room at the Arbor Vitae facility, which is separate from the executive dining room at the R. & D. Center.

Mr. HARDY. Well, now, would they be regular, assigned personnel, or who are they?

Mr. CRISTIN. They were the regularly assigned personnel to my knowledge, sir.

Mr. HARDY. Do you know that, or are you just guessing?

Mr. CRISTIN. I am guessing, sir, frankly.

Mr. HARDY. That is what I thought.

Mr. FOGELMAN. Sir, might I take a moment?

Mr. HARDY. Certainly, if you can shed light on it, please feel free to do it.

Mr. FOGELMAN. Sir, I am confident it is a miscommunication here. Aerospace was begun in 1960.

Mr. HARDY. I very well remember.

Mr. FOGELMAN. Yes, sir. They took over certain responsibilities which had been established in certain areas that had been occupied—

Mr. HARDY. And I remember that very well, also.

Mr. FOGELMAN. The dining room, and I think this is the critical point, the commanders dining room was closed in August of 1961 and has been operated since that time under unappropriated funds. The officers club operates all of the food facilities at Arbor Vitae, and has ever since August of 1961.

I have the personal responsibility for having accepted these costs, and I accepted them, sir, on the basis that the most rapid action that was possible was to phase Aerospace out of these kinds of functions which would be subject to criticism. It took some time—it took some time to get authority to use the equipment which had been under a facilities contract, and under our regulations we are not permitted to let that be used by an officers club. However, I believe, I believed at that time and I remain convinced that the most rapid action was taken to phase Aerospace out of this activity, and at the end of August 1961 the commanders dining room no longer was the responsibility, and in fact none of the food services at Arbor Vitae were a responsibility of Aerospace.

During the period that they did operate the dining rooms, this was part of the executive dining room plant, part of their overall food services, and, as such, there was a contractual clause which had been incorporated into the initial Aerospace contract which said that reasonable losses from their overall food operation would be allowable. This was contractually agreed to.

The area was not good, the area should not have been operated that way. However, Aerospace operated in every way toward the phasing out of this, and for that reason I accepted them as being reasonable in the sense that they were kept to the absolute minimum.

Mr. HARDY. How do you know that?

Mr. FOGELMAN. I said several things. Which is your question, sir?

Mr. HARDY. You wound up by saying they were kept to the absolute minimum, and I was wondering how you know it was kept to the absolute minimum.

Mr. FOGELMAN. To my knowledge—and I don't have personal knowledge because I have not eaten there—to my knowledge, all persons who ate at the commanders dining room paid for the food. It may be that protocol funds paid for some of it. I don't really know the detail of it. If the commander had a guest, it may very well be that he did not lay out the money, but I have been assured by corporate management that there were no free meals in the commanders dining room.

Mr. HARDY. Now, you are talking about a change that was made in 1961?

Mr. FOGELMAN. Yes, sir.

Mr. HARDY. Well, in your accounting for the first 6 months of 1962, January 1 through June 30, I don't know what this belongs to, but

there is an item of food and refreshment which says—and this was an amount that was disallowed, I think, or at least questioned—food and refreshments, costs include dinners for guests, banquets, coffee, doughnuts, petits fours, board of trustees luncheon, department dinners, and so forth, and the amount questioned was \$50,044. So it had it all straight at the beginning of that year but still got \$50,000 questioned for these items. Maybe that is something different.

Mr. FOGELMAN. I was addressing myself, sir, only to the commanders dining room in the other discussion. This item you speak of is under the heading of conference costs, and these were examined in detail.

Mr. HARDY. They weren't incurred in the commanders or executive dining rooms?

Mr. FOGELMAN. No, sir.

Mr. HARDY. Mr. Pike.

Mr. PIKE. When did you first become aware of these excessive losses in the commanders and executives dining room?

Mr. FOGELMAN. If I can put this in context, I was the procuring contracting officer, and I was aware of it at the time of formation of Aerospace. I was aware that the previous operation had had losses.

Mr. PIKE. Well, they had about \$27,000 worth of losses in 1961 from the commanders and the executive dining rooms, and these special dining rooms. What did they pay for a meal in these dining rooms? You say they paid for a meal. How much did they pay for a meal?

Mr. FOGELMAN. Well, I have seen menus which indicate that it is \$2.30 for a small steak, I believe 30 cents for jello—

Mr. HARDY. That is high priced.

Mr. FOGELMAN. Yes, sir. There is not a small opinion that the prices are unreasonably high.

Mr. HARDY. You know, that surprises me.

Mr. PIKE. You saw those prices as of 1961 when they were incurring these losses?

Mr. FOGELMAN. Yes, sir; we have some of the menus here if you would care to see them.

Mr. PIKE. This, to me, is a rather sad commentary on whoever was operating the dining facilities at the Aerospace Corp. Who was operating the dining room facilities?

Mr. FOGELMAN. There is an industrial caterer by the name of Harding Williams, a national concern.

Mr. PIKE. He was operating them and charging Aerospace executives those prices?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. And still incurring losses of \$27,000 in just those four executive dining rooms?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. You have the highest food service losses charges per employee in this operation that we had in any of the ones we investigated throughout the country.

Mr. FOGELMAN. Sir, may I address myself to that?

Mr. PIKE. Right.

Mr. FOGELMAN. When we received the General Accounting Office assistance in examining this and we found the amount was \$145,000 as stated by the General Accounting Office, we went back to try to recon-

struct this. The numbers are correct—we have no quarrel with the fact that these numbers are all from the audit report. However, we would submit that some of these are not food service operations.

Now, the opening statement of the General Accounting report indicates that these are losses, and in the losses, as Mr. Pike mentioned earlier in the hearings, there needs to be something sold, something bought, and the net difference between them is a loss.

Now, in those areas of the food losses, per se, there was indeed \$16,453 lost in waitress dining rooms which are available to all employees and colocated personnel. There was, in addition to that, \$10,389 which was indeed a loss on food operations in the executive dining room. There was a loss of \$18,647 in the coffee service.

However, there are two other items, \$59,000, and \$40,401—which I would invite to your attention is not of that category.

Mr. PIKE. Well, all right, let's talk about those, because those are the big ones. The \$59,000 says cost of parties held at executives' homes, dinner for guests, banquets, luncheons and department dinners.

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. And \$59,000 was attributed to that; \$40,000 was for catering service for the cost of more than five employees engaged in providing service for executive meals, coffee services to officers in conferences, and service for special dinners, and you allowed all of that \$99,000?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. It isn't food service cost, but it is certainly an expense to the Government for parties and banquets and luncheons and department dinners.

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. How do you justify that?

Mr. FOGELMAN. The \$59,290 was the amount that was submitted for reimbursement from an account that originally was something over \$63,000. As a result of discussions that I had with the assistant treasurer of the corporation, the amount of approximately \$4,000 was withdrawn from the total of that account No. 169. The \$59,290 was audited by Mr. Cristin in comprehensive detail, to the extent I think of some \$20,000 worth of it down to the exact dollars, the names of the people, everything that was involved.

We went over that in a meeting that lasted some 5 or 6 working days, with the contractor, and in there we found one more item which amounted to \$151.90, which I did not feel was appropriate to be included. The balance of these were, indeed, meetings. They were meetings of departments, such as the security department which working different shifts is unable to get together for policy meetings; it was technical meetings. We have such information that penetration aids programs had these meetings in order to better perform their function.

Mr. PIKE. They couldn't have these meetings without meals and parties?

Mr. FOGELMAN. Well, I suppose they could have, sir. I submit they could have. However, if we put this—

Mr. PIKE. You see, you are saying this is not a food service expense.

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. You operate under ASPR's, and under ASPR section 15, it has to do with reasonable losses for food service expense. You say this is not in that category, this is not a food service expense.

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. Then you have got to get it under section 15-205.10, which makes it welfare or morale or something like that, don't you?

Mr. FOGELMAN. No, sir.

Mr. PIKE. If it isn't a food service, under what ASPR do you justify paying for these meals?

Mr. FOGELMAN. ASPR 15-205.43 specifically speaks of conference expenses as being allowable.

Mr. PIKE. You mean these were conferences held within the plant, or were they held outside of the plant?

Mr. FOGELMAN. Some were held in the plant, some of them were held in the working offices. Some of these costs consist of coffee and doughnuts that were sent in.

Mr. PIKE. Then you disagree where the GAO report says "costs of parties held at executives' homes, dinner for guests, banquets"—you say this is not so?

Mr. FOGELMAN. There was one party held at an executive home at a cost of \$151.90, which was specifically withdrawn.

Mr. PIKE. That was the only party that was held at any executive's home out of this \$59,000?

Mr. FOGELMAN. Out of the approximately \$20,000 that was audited and of which I have close intimate personal knowledge, I know of no other parties that were held at executive homes that are in this account or charged to the Government.

Mr. PIKE. Well, you certainly take fairly sharp issue with the General Accounting Office on that. How about the word "banquets." Do you know of any banquets?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. How many and at what cost?

Mr. FOGELMAN. Well, one specifically that I recall—however, that is item No. 13 of the same audit report.

Mr. PIKE. But it was allowed.

Mr. FOGELMAN. No, sir, it was allowed partially.

Mr. PIKE. Well again, then, you are disagreeing with the GAO report when they say—

During negotiation by the Air Force, \$152 of the above cost was disallowed, the remainder of the \$145,000 was accepted by the Air Force negotiator for inclusion in contract prices.

I assume that the \$152 they are talking about is the \$151.90 that you just mentioned.

Mr. FOGELMAN. Yes, sir, I would believe that is in error, sir.

Mr. PIKE. You believe the report is in error?

Mr. FOGELMAN. No, I believe the particular thing in context as it is stated may lead the subcommittee to an erroneous conclusion, because there are a great many of the items that were withdrawn by the contractor that were not disallowed.

Mr. PIKE. Well, now, let's talk about this one party you mentioned, which is item 13 in your audit report; 225 dinners at \$8.29, 924 drinks, flowers, check girl, musicians, total \$2,932. How much of it did you allow and how much did you disallow?

Mr. FOGELMAN. \$973 was not allowed.

Mr. PIKE. \$973?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. And would that be the total cost of the musicians and the 924 drinks?

Mr. FOGELMAN. Yes, sir.

Mr. PIKE. In other words, drinks are taboo but flowers are OK?

Mr. FOGELMAN. No, sir, I don't believe that would be a fair summation of my position.

Mr. PIKE. Well, you disallowed the drinks but allowed the flowers, did you not?

Mr. FOGELMAN. Yes, sir. One of the functions that the contracting officers have is to insure that there is not overengineering of blueprints and there is not gold plating of hardware nor an overstatement of the requirements for a symposium or a meeting.

I considered that this symposium or meeting could probably have been conducted as adequately without the drinks and without the musicians.

Mr. HARDY. But not without the flowers?

Mr. FOGELMAN. I felt the flowers might have added something.

Mr. PIKE. Did you think possibly that the presence of drinks and musicians might have tended to make it a little less of a symposium and a little more of a social gathering?

Mr. FOGELMAN. I believe that it had the aspect of a social gathering. It also was a meeting of the highest level of scientists and engineers with very heavy responsibilities in the missile and space program, and who had completed a symposium of a technical nature during the day.

Mr. PIKE. Well, I am very sure that you could get scientists of the very highest technical capability and still have them at a dinner at which drinks and musicians are present, and it isn't really a conference at all—it is just a fine party. I know some scientists of the greatest technical ability, and they just love to be at a party, and I don't hold this against them at all. But I do say to you that when I see a dinner set up with drinks and musicians, I would be inclined to think of it as a social gathering and not as a symposium, or as a conference.

Mr. HARDY. I want to get back to one or two specific items. Item 10 in exhibit B, on page 2 of 7, coffee maid service.

Mr. FOGELMAN. Yes, sir.

Mr. HARDY. We talked about that a little bit at the opening of the session, and I want to read this section because I don't understand some of it.

You have a recommended disallowance here by the auditor of \$18,647, and the comment is:

This represents the loss involved in selling coffee to employees and Government personnel during the first few months of 1961. Fresh coffee was brewed by maids in individual coffee rooms at both the R. & D. and Arbor Vitae complexes. Subsequently, coffee vending machine profits of \$6,017 were not offset against this cost but were given to Aerospace Employees Association.

Now, will somebody explain to me why this was permitted?

Mr. FOGELMAN. Yes, sir.

Mr. HARDY. Heretofore they had total losses, nothing but losses because of maid services, and they put in mechanical maids. They made a little money but the profits were not offset against what the human maids cost over and above any income that was received.

Mr. FOGELMAN. The coffee service by someone there to prepare the coffee and serve it and wash the cups was begun on December 16, 1960, by Aerospace. The first report that came in was on the 4th of January 1961, some 18 days later. This report which was an internal Aerospace report, said this was just not feasible, it wasn't working, it required more help than had been initially calculated, and the recommendation was made 18 days after they began the service to phase over to vending machines. The action was begun some time in January to get vending machines and get them installed. It was completed the first part of April—

Mr. HARDY. I want to know why the \$6,000 wasn't used to offset the losses.

Mr. FOGELMAN. I haven't come to that part.

Mr. HARDY. I think we could dispense with a few of the window dressings, but I don't want to cut you off.

Mr. FOGELMAN. All right, sir.

From the inception of Aerospace, vending machines of other nature than the coffee vending machines had been in place, such as cigarette machines, candy bars, and this sort of thing. The income from those vending machines had, by agreement, gone to the Aerospace Employees Association, and when the coffee vending machines were installed, they were handled as part of the vending machine commitment that the corporation had made to the employees association.

Mr. HARDY. And you were sitting there looking out for the interests of the Federal taxpayers and were perfectly willing to pass on the losses from the maid service and not even take out this little \$6,000 as a deduction against it. I just don't understand what in the Sam Hill you were doing to earn your pay.

Mr. FOGELMAN. The \$6,000 was part—

Mr. HARDY. You weren't looking out for Uncle Sam's interest at all. I am having a hard time understanding what you really do, Mr. Fogelman.

Your auditors recommended in this particular account—what is it, 1961—recommended disallowances of \$1,623,925. You are the contract administrator, you are the negotiator who worked it out with Aerospace, and you wind up with a total disallowance of \$46,949.96 out of \$1,623,000 recommended. If this isn't a high-powered performance, I never saw one.

Mr. FOGELMAN. May I address myself to that, sir?

Mr. HARDY. Please.

Mr. FOGELMAN. The auditor performs his audit against corporate policies which have been approved. The corporation prepares them, and they are submitted to the contracting officer for approval. A new company, such as Aerospace, which had been in business only 6 months at the time this period began, did not have policies. As a matter of fact, they have—

Mr. HARDY. Don't tell me they didn't have policies. We even had to get a policy decision from the board here the other day to let us see some information. Boy, they set up policies in a hurry. Don't tell me about that. Maybe you just didn't find out about them.

Mr. FOGELMAN. No, sir, the policies on the individual items had not been submitted to me for approval, and I am thinking now of such items as the handling of these kinds of costs. The auditor in the per-

formance of his tasks quite properly questioned anything for which there had not been either an advisory from the contracting officer to the auditor, or an approved policy, so that in setting this out the auditor quite properly raised the question and provided the detail for examination.

During the course of negotiating this overhead, we were successful in getting policies issued, and in getting an understanding, really, of what their procedures were going to be and what their practices were going to be, so that the total amount that was set out was a summation of those areas for which the auditor had not yet received guidance.

Mr. HARDY. Well, let me just put one other little touch on here which, as I view it, explains your position and makes it just as crazy as some of the others that we have run across, and I will invite your comment on this when I get through.

This is at the bottom of your report which has to do with this tremendous disallowance of not quite \$47,000 out of a recommended \$1,623,000. This is what you said:

It should be noted that this contractor was organized by the Air Force as a nonprofit, nonendowed corporation 6 months prior to the beginning of this period. The fee negotiated with these corporations is based upon "need" rather than "worth of the task" and disallowances in overhead must be considered in arriving at the corporation's "fee need" during the following fiscal year. In view of this, the disallowance of overhead costs did not have the effect on total cost to the Government that normally occurs with other commercial organizations. Therefore, one of the major concerns of the Air Force during this negotiation was to establish mutually acceptable policies and practices in those areas which prove to be particularly controversial.

In other words, you were saying just let them go ahead and spend anything they want, \$113,000 for auto rental, let them spend anything they want. That is about as cockeyed as any administrative officer's approach to a problem of this kind as I have ever seen, and I would appreciate any comment your care to make to justify that position, because frankly I don't know why in the world the Air Force has got you out there. I don't know why they just don't say to Aerospace, "You send the stuff in, we don't need the auditors, you send it in and we will pay it, or increase your fee to cover it."

That is your view, as I read it, or at least that is my interpretation. Now, do you feel like you want to comment on that? You don't need to.

Mr. FOGELMAN. Yes, sir, I would be pleased to comment on it. It is my belief that the Air Force has a desire to have policies implemented by Aerospace and practices implemented by Aerospace which will insure that the expenditures are good costs and need not be disallowed.

In the initial days of a contractor's formation, there is a tendency, as you acquire people from various organizations, for things to come along with these people which will not be in consonance with the corporate policies once they are issued.

I have addressed myself, sir, for the period of time I have been assigned there, toward this single goal of getting clear-cut policies that will, indeed, give guidance to the Aerospace employees in such manner that the costs will be good costs.

Mr. HARDY. Would you explain what you mean by the "fee negotiated with these corporations is based upon need rather than worth of task"?

How do you define "need"? Is it whatever they need to cover everything that they want?

Mr. FOGELMAN. In defining "need," you must recognize the needs that a commercial contractor has that a nonprofit does not have.

Mr. HARDY. What you say is they should go hog wild, spend anything they want as overhead, and either we allow it as overhead or add it to the fee next year. That is exactly what you have said to me, and if anybody in the world can justify that as a reasonable approach, I don't know who it is.

Let's take one other little item that was in these recommended disallowances. I don't know how you came up with this. This was for 1962—consulting psychologists: cost of retaining professional services of psychologists at a rate of \$240 a day for 31 days. Maybe that is fine, but is it a normal overhead item?

Mr. FOGELMAN. No, sir; it would not be of a normal nature.

Mr. HARDY. But it was allowed.

Mr. FOGELMAN. I inquired into this and found there was an organizational problem, some conflict in a department, and it was a management decision to utilize this method of resolving it.

Mr. HARDY. Well, there were one or two other items I meant to comment on, but it does seem to me that some of these that have come to our attention in this particular examination are a far cry from what any prudent businessman would consider to be appropriate, such as the cost—as small as it is—of continuing these dining rooms. Maybe they should have employed General Dynamics to give them a little lesson in running a cafeteria or food service. This is just absolutely out of any reason, and yet it is a nonprofit organization and Uncle is paying every doggoned dollar that goes into it, plus a fee. We are going to consider this whole program in some depth. I am amazed at your approach to negotiating out the items which your auditor set out.

I mentioned automobile rental a moment ago. In connection with the automobile rental item which you did allow, I presume, \$113,000 your auditor says this:

Our examination indicated that the use of rental automobiles is fast becoming a way of life with the company traveler.

But you didn't pay any attention to that; you just passed it over as something they had spent, and you had to allow it or increase their fee.

Mr. FOGELMAN. With respect to automobiles, sir, as a result of negotiation the automotive pool was reduced by some 30 vehicles. It is now a requirement on the corporate travel voucher that they give a justification and have a prior authority to rent a vehicle.

Mr. HARDY. So the \$113,000 was already spent, and you just let it go.

Mr. FOGELMAN. Yes, sir; that is pretty much it.

Mr. GUBSER. What was the purpose of hiring these psychologists?

Mr. FOGELMAN. I don't know the details, sir. I spoke to the head of the department, and he gave me his assurance that was a very valuable management tool to him to resolve a problem that was in his department.

Mr. GUBSER. At \$240 a day?

Mr. FOGELMAN. Yes, sir.

Mr. GUBSER. But you don't know what the problem was?

Mr. FOGELMAN. No, sir.

Mr. GUBSER. Or the type of problem?

Mr. FOGELMAN. It was some type of personality organization problem. I don't know in detail, sir. It may very well have been improper for me to have asked.

Mr. HARDY. Thank you very much, gentlemen.

Now we come to the conclusion of this phase of our examination into specific items. The committee is extremely pleased to have with us Deputy Assistant Secretary of Defense for Procurement, Hon. Graeme C. Bannerman.

TESTIMONY OF HON. GRAEME C. BANNERMAN, DEPUTY ASSISTANT SECRETARY FOR PROCUREMENT, DEPARTMENT OF DEFENSE; ACCOMPANIED BY KENNETH KILGORE, DEPUTY COMPTROLLER FOR AUDIT; AND COL. GEORGE THOMPSON, PROCUREMENT SPECIALIST

Mr. HARDY. Mr. Bannerman, we are delighted to have you present.

Mr. BANNERMAN. Mr. Chairman, I have with me Kenneth Kilgore, Deputy Comptroller for Audit, and Col. George Thompson from our Office, who is our pricing specialist on matters of this nature. I would like to have them with me.

Mr. HARDY. By all means, gentlemen, come on up.

I have had some conversations with Colonel Thompson, and I wasn't sure he was going to keep Commander Fitzgerald around. If you want to bring him up, please do so, as I understand we won't have the opportunity very long, as Commander Fitzgerald is going to take another assignment. We will miss him.

Mr. BANNERMAN. He is going to sea, Mr. Chairman.

Mr. HARDY. Yes, sir. He said he wasn't getting enough enlightenment in Washington, so he is going aboard ship.

I welcome your other associates here, Mr. Bannerman, as we welcome you. I appreciate your presence. I believe we already have a copy of your statement.

Mr. BANNERMAN. I would like to read the statement, if I may, Mr. Chairman.

Mr. HARDY. Fine. If you will proceed, we won't interrupt you—if I can keep Mr. Pike quiet.

Mr. BANNERMAN. Mr. Chairman, I appreciate your invitation to be present at this hearing and to present my views on the subject of the allowance to contractors of the costs and credits of employee morale, health, and welfare activities. This subject was commented on by the General Accounting Office after a recent survey which that Office conducted for your subcommittee and has been the subject of several days of public hearings.

I would like to discuss what our policy is, and, partially as a result of information obtained at these hearings, to discuss how it is working. At the outset I would like to explain that it is, and for many years has been, our general policy under cost-reimbursement contracts to allow all of our contractors' normal costs of doing business determined in accordance with generally accepted accounting principles, provided, as to any element of cost—

(1) That it is reasonable in nature and total amount. Our principal test of reasonableness in the nature of the cost is that it is a type of expense which is common in business practice and does not contravene any public policy or standard, statutory or otherwise. Our test of reasonableness in amount is that the total amount is not in excess of that which would be incurred by an ordinarily prudent person in the conduct of a competitive business, and, provided,

(2) That it is properly allocable to the Government contract. We consider it allocable if it relates either directly to the specific contract or to a broad group of work of the contractor, which group includes the Government work. We do not consider it allocable to us if it is designed to be of exclusive benefit to nongovernmental work.

These general rules are incorporated as the contractual agreement for cost allowability under cost reimbursement contracts and are used as guides in negotiating prices based on cost analysis for noncompetitive, fixed-price types of contracts.

Specifically, with respect to employee morale, health, and welfare expense we concluded, at the time our present cost principles were drafted in 1959, and in all earlier drafts back to 1949, that such expenses, properly categorized and reasonable in amount, are normal in U.S. industry and are not contrary to any public policy. Such costs are allowable for income tax purposes. Accordingly, and subject to the limitations I have stated, we have always treated such costs as "allowable" for contract cost purposes.

I would like to add, parenthetically, that "entertainment" costs, that is, amounts spent on customers or other than for employee morale activities, are unallowable. The reason entertainment costs are unallowable is because they are not considered to be properly allocable to Government work.

It is not our policy to substitute the judgment of our auditors or contracting officers for that of company managements as to the relative efficacy or value to the company of specific expenditures made for employee morale, health, and welfare purposes so long as the amount is reasonable. Rather, as I shall try to show later in this statement, our efforts in recent years have been directed toward requiring our contractors to have an increasing financial stake of their own in the results of all such judgments and, hence, toward compelling them to take such judgments under increasing financial disciplines.

This, then, is our policy.

These hearings have been examining into the adequacy of this policy to determine whether it is sufficiently specific, whether it is understood by our contracting officers and auditors, whether it is capable of being consistently applied, and, finally, whether it is, in fact, reimbursing waste.

Before discussing these questions in detail, I would like to mention a few highly relevant background factors. The first is that in examining the accounting systems, management judgments, and types of costs incurred by American industry, we characteristically find no uniformity whatsoever. This randomness is very evident from the figures supplied by the GAO on morale, health, and welfare expense but is by no means confined to such costs. Members of this subcommittee may recall earlier hearings on profits in segments of defense industry in which there were collateral inquiries into executive salaries. These

were found to be so random as to be incapable of consistent explanation. It was not uncommon to find one company which had half the sales volume, and even lower rates of profitability, than another, but which, nevertheless, paid its principal executive substantially more.

Several years ago, at a time when we were becoming increasingly concerned with the extent and cost of help-wanted advertising, by means of which our contractors sought to hire engineers, we made a study of these costs. Again we found no pattern, but we did discover some interesting relationships. For instance, we found that some companies which had substantially higher-than-average expenditures for help-wanted advertising actually had normal or lower-than-normal total recruitment expense. Other companies did no advertising for engineers but appeared to hire them by inducing them away from their competitors at higher wage rates.

I mention these earlier stories only to indicate that it is characteristic of many overhead cost elements that they rather regularly follow no pattern among different companies and they are difficult to evaluate realistically as isolated cost elements. These characteristics also apply to morale, health, and welfare costs. First, as seen from the GAO report, they follow no pattern and, second, they are part of the total package of employee costs which package also includes basic wages. Different companies form different judgments as to the segments into which this total package can best be divided and, hence, it is predictable that you would find, as GAO did, that this one segment of the package will vary among different companies from practically zero to fairly high amounts.

It is interesting to note from the GAO report that the one contractor (or division thereof) with the lowest percentage of Government work, 3 percent, has by far the highest rate of expenditure per employee per year for morale, health, and welfare expense. It is also interesting to note from the same report that the average "morale" expenditure for the seven companies with the lowest percentage of Government business is substantially higher than the average of all of the other companies which have a higher percentage of Government work. I mention these figures not for the purpose of proving anything concerning the adequacy or suitability of our policy but simply, by way of background, to make it clear that the GAO report does not attempt to demonstrate that contractors predominantly engaged in defense work are more wasteful or spend more money for employee morale, health, and welfare purposes than other companies. I think that the GAO survey was not designed for this purpose and, certainly, it is not broad enough to allow us to form any judgment on this subject.

I think that the GAO survey and these hearings will have been quite useful in providing us with additional facts on which to evaluate the adequacy of our policy guidance and the consistency with which it is being applied.

In evaluating these problems, it seems to me that the questions we should ask ourselves are:

- (1) Are Government contractors in practice being allowed substantial total amounts for employee morale, health, and welfare expense which are unreasonable?
- (2) Are specific costs being allowed which are clearly excessive or for which the reimbursement is contrary to public policy?

(3) Are amounts being reimbursed for morale or recreational expenses which, in fact, belong in some other cost category, such as entertainment expense?

(4) Are we inconsistently disallowing costs which should properly be allowed?

As to the first of these questions, I have already stated that the GAO survey does not demonstrate that the total "morale" costs of contractors with a high percentage of Government work is greater than the total for other companies. Heretofore we have not tried to establish norms or cutoff points to provide tests of reasonableness for our auditors or contracting officers. At the moment, because of the wide range of company practices in competitive industries and because of the complex interrelationships of such other factors as total wage rates, fringe benefits, special needs at isolated locations, and the like, we do not know at what levels such norms or cutoff points should be drawn. However, stimulated by this subcommittee's interest, we started an additional survey on these points several months ago. We hope that this survey will augment the facts in the GAO survey by furnishing more detail and by including a number of companies not primarily engaged in Government work. It is clear from these hearings that we need specifically to provide better guidance as to the treatment to be afforded to vending machine receipts whether or not they are "irrevocably set over to an employee welfare organization." I suspect also that to achieve a higher degree of judgment and uniformity of approach in determining "reasonableness" of this and many other cost elements, we would do well to augment our departmental training programs, focusing them on these issues. These matters will receive our very early attention.

However, at the moment, I do not think we can judge with any assurance the extent to which our total allowances for these costs may have been unreasonable.

As to the second question—"Are specific costs being allowed which are clearly excessive or for which the reimbursement is contrary to public policy?"—I conclude from the record, with some reservations, that the answer is "No." The principal thrust of the GAO survey, which is relevant to this question, has to do with employee parties and entertainment, such as retirement parties, 25-year-award parties, annual picnics, and the like—at some of which alcoholic beverages were served—gifts of turkeys on holidays, athletic or recreational activity, and partial subsidies of food services. It is obvious that different people would have different views as to the desirability of a company spending funds for any or all of these purposes. Those who would object could be expected to intensify their objection if any part of these expenses were reimbursed by the Government. Nevertheless, it is a fact that a very great many companies not engaged in Government work do choose to spend their own funds for these purposes. These expenditures are recognized as legitimate costs to the company under the tax laws. We know of no public policy reason why costs of these types must be disallowed, provided total expenditures are reasonable in amount, do not include sums spent for other than company personnel purposes, or individual wasteful expenditures. With one or two possible exceptions, I think that the individual costs mentioned in the GAO report meet our general criteria for allowability.

On the third question, our policy considers that employee morale expense relates to activities on behalf of the company's employees. Entertainment expense, which is unallowable, relates to expenditures for purposes not related to company employee morale. We believe that this distinction is clear to our auditors and contracting officers. The GAO survey gives no evidence that this is a significant problem. I may say I think perhaps the last day or two of these hearings may change my opinion on certain facets of that question.

As to the last question—"Are we disallowing costs which should be allowed?"—the GAO survey includes a few cases where this has occurred. In most instances where costs of this nature were questioned by the auditor, it appears that the contracting officer nevertheless properly allowed them. As to the balance, we can be sure that the contractor was aware of his rights on appeal. Undoubtedly, in the very few instances of this kind where the disallowance was not challenged, it was considered that the individual amounts in question were such an infinitesimal part of a total negotiation that it was not worthwhile for the contractor to raise the issue. In any event the number, amount and final result of the cases revealed by the GAO survey did not lead us to conclude that our present policy guidance is inadequate in this respect.

Summarizing our appraisal of the adequacy of our present guidance as it is working out in practice, we conclude that it is probable that we need to issue more specific guidance for determining when the total of expenditures for employee morale, health, and welfare purposes become unreasonably large particularly as it relates to the treatment of vending machine receipts. It also appears that we need to provide better and more uniform training in these subjects. Surveys currently underway should give us better insights as to the nature of the supplementary guidance which is required.

WHAT SHOULD OUR POLICY BE?

In considering this question, again we need to get the problem in perspective. At the outset we should recognize that, whereas the GAO describes a total of \$1.9 million—which is not an inconsiderable amount—as the "probable cost to the Government" for these 28 contractors at 36 plants, the total Government business contracted to these companies during fiscal year 1963 was in excess of \$7.5 billion. Hence, the \$1.9 million—a figure which I would like to challenge in concept a little later—is less than three one-hundredths of 1 percent of our 1963 purchases from these contractors. This cost item, which, like most other overhead costs, is handled in different ways by different companies and is subject to widely varying management judgments, is nevertheless only one of a very great many different overhead accounts which we must examine in pricing noncompetitive contracts. Hence, as we review our policy and practice, and guided by the normal management precept that we should put our greatest time, attention and effort where we are likely to find the greatest payoffs for the Government, we need to keep in mind the size of the prospective gain.

It might be said, as has already been proposed, that the way to get large savings in this field is simply to disallow these costs in total.

Certainly this would make for ease of cost administration. However, there are certain obvious objections to this solution. In the first place, the fact that competitive American industry has seen fit to spend varying but modest amounts of money in this way, means that many company managements have concluded that a dollar spent for morale purposes, under management control as to nature and amount, is likely to be more productive in terms of enhanced efficiency, productivity and stability of work force than a dollar spent for increased wages. We should not overlook the fact, however, that although we could disallow "morale" expense, we certainly could not disallow our share of reasonable wages and salaries. If we were to disallow "morale" expense it seems likely, if current industrial management judgments are right, that wage and salary increases among contractors principally affected might more than offset the apparent saving, but would nevertheless be such a small incremental increase to wages as to be unidentifiable. Thus, it is quite doubtful that disallowing this cost element would, in total, save the Government money.

In addition to this objection, there is the additional factor that contractors whose work is predominantly governmental would be denied a management tool which other companies have found useful. Such discrimination between predominantly Government contractors and other companies would not seem to be either a fair or a logical result.

As members of this subcommittee know, from testimony given before the full committee in each of the last 2 years by the Secretary of Defense, the Department has for some time been engaged in an extremely intensive cost reduction effort. This effort has been focused on a wide variety of different subjects including, importantly, contract pricing.

The first phase of this part of the cost reduction effort has been directed at increasing the amount of our procurement which is awarded on the basis of price competition. In 1962, when our awards based on price competition had been running at just under 33 percent of our total dollars of contract awards, we and the military departments established goals for increasing this figure in each year through fiscal year 1965. These goals were subdivided to each buying activity throughout the department so that every activity knew exactly what was expected of it. The composite goal for fiscal year 1964 was 38.4 percent. The final result for the recently completed fiscal year will exceed 38.6 percent. This represents the conversion to price competition of over \$1.4 billion from the fiscal year 1961 level, on which our price savings last year alone exceeded \$350 million. We are bending every effort to continue this increase in the volume of competitive procurement.

In connection with this accomplishment it should be pointed out that, whereas the GAO report identifies \$1.9 million as being the "probable cost to the Government" for morale, health, and welfare expense at the 36 plants listed, it ignores the fact that an undetermined portion of the Government business of these plants is in the form of competitively awarded firm fixed-price contracts. As to such contracts, which, of course, must bear their share of overhead expense, any costs of "morale" expense actually are paid entirely by the company just as any savings go entirely into company profit. To this extent, then, it is not accurate to describe all of the \$1.9 million as "probable cost to the Government."

The second, and for the purposes of this hearing probably the most significant, phase of this part of our cost reduction effort has to do with our reduction in the use of cost-plus-fixed-fee contracts. These contracts, as the subcommittee knows, frequently provide little or no incentive for good management, control of costs, or efficiency. The contractor receives the same profit whether he is frugal or wasteful, efficient or inefficient. For the purpose of inducing responsible management decisions of the type expected of a prudent manager of a competitive business they are the worst form of contract. In the years from fiscal year 1956 to mid-1961 their usage had gone steadily up from 19.8 percent of our total procurement dollars to 38 percent. This meant that nearly \$8.5 billion a year was being awarded under this basically undisciplined form of contract. There is no question that this fact had a very important effect on the economic climate and the quality of management decisions in the defense industries. There was no motivation to be frugal with respect to costs which were otherwise allowable.

It was thus decided that a key objective of the cost reduction program would be to reverse this trend. Goals were established by years and by buying activities. The overall objective was to reduce the use of CFFF contracts from the peak of 38 percent to approximately 12 percent by the end of fiscal year 1965. We have reached this goal 1 year ahead of time. This means that, during fiscal year 1964, approximately \$5.5 billion which under the 1961 pattern would have been in CFFF contracts, were converted this past fiscal year to other, more disciplined types, principally fixed price or incentive types.

The obvious purpose of this conversion is to provide our contractors with a financial stake in every decision to spend or save money. Let's consider for a moment how this works.

If a contractor had in his plant nothing but cost-plus-fixed-fee Government contracts every dollar he spent for "morale" expense—or for expense in any other allowable overhead category—would be reimbursed by the Government, if the total was reasonable. On the other hand, if his work were 100 percent on a firm-fixed-price basis, every dollar he spent would be paid entirely by the company just as all savings would be added to company profit. In between these two extremes, we have various categories of incentive contracts which have, as a common characteristic, provisions for the contractor to share, in varying ratios, in his expenses or savings. Such contracts provide that the contractor will share at a predetermined rate, say, 20 percent, of the amount which his costs underrun or overrun some preestablished target. Thus, if he overruns the target \$1 he pays 20 cents of that dollar, whereas if he underruns the target \$1 he retains as profit 20 cents of that dollar. In this example we would say that he has a 20-percent stake in the result. Under incentive contracts, the pre-agreed portion of every dollar he might spend for "morale" expense—or for any other overhead expense—would come out of his pocket, just as the same portion of all savings would be added to his profit.

As a practical matter, of course, no contractor has in his plant at any one time contracts of only one type. Contractors normally have a wide mix contracts. It might be helpful to the subcommittee to consider how this works as a motivating factor. As a simplified ex-

ample, let us assume that a particular contractor has, in his current contract backlog, the following amounts of the following contract types:

Contract type	Amount (million)
Cost plus fixed fee.....	\$20
Incentive with 10 percent share.....	20
Incentive with 20 percent share.....	20
Incentive with 50 percent share.....	20
Firm fixed price or commercial work.....	20
Total.....	100

Knowing the contractor's share in costs or savings under each of these contract types, we can determine the weighted average of his share in the total backlog, as follows:

Contract type	Percentage of con- tractor's stake	Amount of backlog	Contractor's dollar stake in backlog
	<i>Percent</i>		
Cost plus a fixed fee.....	0	\$20,000,000	0
10-percent incentive.....	10	20,000,000	\$2,000,000
20-percent incentive.....	20	20,000,000	4,000,000
50-percent incentive.....	50	20,000,000	10,000,000
Firm fixed price.....	100	20,000,000	20,000,000
Total.....		100,000,000	36,000,000

NOTE.—Weighted average of contractor's stake in total backlog, 36 percent.

Since the contractor's overhead costs must be allocated at the same rate to all of his contracts, Government or commercial, and regardless of contract type, it follows that for every dollar of overhead expenditure made by this contractor, his share is 36 cents. Hence, of every dollar he spends for employee morale expense, 36 cents comes out of his own pocket. Conversely, for every dollar he saves, 36 cents goes into his profit.

The foregoing example is a graphic illustration of why we are pressing so hard to get our contractors away from cost-plus-a-fixed-fee contracts into contracts involving higher risks and greater company participation.

I have mentioned that we have reduced our usage of cost-plus-a-fixed-fee contracts to approximately 12 percent of our total procurement. The following listing of our awards by contract types for fiscal year 1961 and for the first 11 months of fiscal year 1964 gives an additional indication of the extent and nature of this achievement:

Contract type	Percentage of total dollars awarded	
	Fiscal year 1961	Fiscal year 1964 (11 months)
Firm fixed price.....	36.2	49.8
Incentive.....	14.4	33.3
Cost plus fixed fee.....	36.6	11.8
Other (redeterminable, time and materials, etc.).....	12.8	5.1

This swing away from low-risk contracts into contracts providing the contractor a greater average stake in his own expenditure has, of course, had its impact, to varying extents, on each of the contractors covered by the GAO survey. Hence, to the extent these contractors now have, in total, a stake in their own overhead expenditures, the \$1.9 million is overstated as "probable cost to the Government."

It is clear, then, that this effort has been very successful in terms of statistical accomplishment. We believe that it has been equally successful in terms of its actual impact on the efficiency of our defense contractors. A major revolution in their managements appears to have been started. This seems bound to produce a new economic climate with great savings to the Government.

There are many evidences that these changes are, in fact, occurring. A few examples may be helpful. During the past month we received 28 reports from Government personnel who are resident in the plants of some of our very largest contractors. The following observations were taken from these reports:

During fiscal year 1964 several contractors predominantly engaged in Government work made sizable personnel reductions due to improvements in productivity and operating efficiency. Much closer management attention to hiring and release of personnel in accordance with workload variations was reported.

Major reductions were reported in overhead personnel; in one company the ratio of indirect to direct employment had dropped from 60 to 40 percent.

Several companies had sharply reduced overtime expenditures, one from an average of 12 to 4 percent, and another from 13 to 3 percent.

Most of the Government representatives reported an increased contractor resistance to contract changes which increased costs and to "gold plating."

The Government representative at one plant reported the institution by the contractor of a formal cost reduction program with 546 cost-saving ideas generated in the last 15 months. These resulted in verified savings of over \$20 million.

On one very large development program, the contractor, who has completed 17 months of a 45-month schedule is 1 percent under the original cost forecast with the development strictly on schedule.

There are many other reports of better advance planning, and substantial increases in the amount of competitive subcontracting. The foregoing examples can be multiplied many times over. Suffice it to say, they are indicative of what has been happening in the last year or two and will continue to happen increasingly as we progress in the cost reduction efforts I have been describing.

The significance of these changes to the problem the subcommittee is studying is that our contractors now have increasingly large incentives to manage all of their costs with prudence and skill. This, of course, includes the costs of employee morale, health, and welfare activities.

Where do we go from here? We are not yet sure, but it seems to us that the facts presented above suggest a way in which we in the Government can focus our attention on the areas where it is most

needed. In our current study of the actions needed in the field of morale costs, it now seems reasonable that we should concentrate our efforts primarily on those contractors who have the lowest stake in their own costs. These are not necessarily those with the heaviest percentage of Government work but, rather, are those with the heaviest percentage of low-risk contracts.

As we find ways to make better use of this device for concentrating our management efforts on those areas and contractors where we have the greatest exposure and, in any event, as we develop solutions to the specific problems this subcommittee has been examining we will, of course, keep you informed.

Thank you, Mr. Chairman.

Mr. HARDY. Thank you very much, Mr. Bannerman. I am very pleased to have your discussion of these things. There are a few points in your statement that I think we might profitably discuss, though I don't know how much time we will have before we will have to go answer a rollcall.

There are a few points you make that I, frankly, don't get over-excited about. You, I think very properly, call attention to the improvement that has been made in your overall contracting, and certainly, personally—and I am sure the committee will join me in this—I commend the increase made in the competitive fixed-price procurement, which I think is something we ought to continue to work at.

While I think we have accomplished a great deal in that, I am not at all sure, to the extent we still have to continue with CPMF contracts, that there aren't plenty of avenues for improvement in that procedure.

Now, you have discussed this business of employee morale and recreation, and pointed out that the committee will have to keep in mind that there are certain of these practices which are normal to any business and are regarded as good business, and generally I think have proved to be good business. However, I am not at all sure that I subscribe to the notion that—especially where there has been any large volume of CPMF contracts, or a larger percentage in a particular company operation, I don't subscribe to the notion that we shouldn't scrutinize these very carefully, not necessarily so much on a total basis as on a specific basis, to see what is being done and whether or not it is the kind of thing that that contractor would do if more of his business were on an incentive basis, where he would have more concern with it.

Mr. BANNERMAN. Mr. Chairman, I agree with you completely. You of course have pointed right at the reason we are trying to reduce to the utmost the use of CPMF contracts. The 12 percent which remains—not in backlogs, now, but on the basis of our recent years awards—I suspect is going to turn out to be near the norm for the future. There are certain kinds of work—basic research, exploratory and advanced research, and certain types of study work—which are not susceptible to being defined with sufficient accuracy to allow us to go to one of these more disciplined types of contracts.

On the other hand, we have established as a matter of policy that major weapons developments—where the big money is, in the field—shall not be performed on CPMF contracts. As we narrow that field of CPMF contracting down, we make it administratively possible to take the very type of approach you have described, the very close

scrutiny of a much narrower base, and I would hope with a great deal more success than we have been witnessing.

Mr. HARDY. If I might make another observation about your statement, you referred to the \$1.9 million which GAO has estimated as the possible cost to the Government for morale, recreation, and welfare expenses and you seem to minimize the significance of that. Actually, I would view this from the opposite direction. This represents only the analysis of, what was it, only 28 prime contractors. Now, I don't think that can be considered as even an approximation of the amount that really is involved, because it doesn't involve the "subs" at all. This is a selected approach. Obviously, we couldn't cover the whole waterfront, so I sort of wish that you hadn't tried to belittle that.

Mr. BANNERMAN. Mr. Chairman, I don't try to belittle that \$1.9 million—\$1.9 million to me is a lot of money, no matter what you compare it with.

Mr. HARDY. Then I wish you hadn't spoken of it in terms of percentage. I know you have a lot of big jobs to undertake, but if you didn't try to belittle this all through your talk, then I sure didn't understand it properly.

Mr. BANNERMAN. Mr. Chairman, I mentioned in terms of percentage that this \$1.9 million—

Mr. HARDY. I can figure the percentage as well as you can, but it is almost \$2 million, and in my book we have got to look at the dollar amounts.

Mr. BANNERMAN. The percentage I mentioned is the percentage of the total business of these companies. I agree it is a lot of money.

Mr. HARDY. I understand that it is a percentage of the business of these companies and it isn't a percentage of the cost-plus-fixed-fee business of these companies, either. It would be a little more realistic if you confined it to that.

Mr. BANNERMAN. I agree; the total would be less.

Mr. HARDY. So what you did, you picked out something here that is not unfactual, but it is misleading, and you know it, because if you wanted to make a proper comparison at least you could have compared it to the CPFF business they had rather than the total business.

Mr. BANNERMAN. These companies have a variety of mixtures, and quite frankly at the moment I don't know what percentage of their CPFF business is. Some are quite heavy and some are not.

Mr. HARDY. That, of course, is true. That is why your selection of the percentage figure is misleading in my book, and I think is unfortunate that you did that, you sort of let me down on that. I didn't think you would pull that kind of sneaky thing.

Mr. BANNERMAN. Mr. Chairman, I certainly did not think I did that.

Mr. HARDY. Mr. Gubser.

Mr. GUBSER. I don't know whether this is pertinent to this inquiry, but I would like to ask you, Mr. Secretary, in a competitive bidding situation, do you allow the costs of preparing bids as fully allowable costs?

Mr. BANNERMAN. You say in a competitive bidding situation?

Mr. GUBSER. Yes, sir.

Mr. BANNERMAN. In a competitive bidding situation, we don't, of course, inquire into costs at all.

Mr. GUBSER. But you require cost data.

Mr. BANNERMAN. Not in a competitive bidding situation, we do not.

Mr. GUBSER. That is right, excuse me.

Mr. BANNERMAN. We simply award to the low price.

Mr. GUBSER. The cost of preparation for proposals of incentive contracts—are those fully allowable?

Mr. BANNERMAN. Contractors' bidding costs are allowable items of cost whenever we are inquiring into it, as an overhead.

Mr. GUBSER. I wonder if in this trend away from cost-plus-fixed-fee contracts we are not forcing Government contractors to prepare proposals at considerable cost knowing full well that maybe they will only connect on 1 out of 50, and the costs on the other 49 which they don't get will eventually show up in a contract which they are successful in getting.

Mr. BANNERMAN. Mr. Gubser, the costs of bidding are overhead costs, and as such, we would require that they be distributed to the total business of the company. Now, if we make a noncompetitive, cost-plus-fixed-fee contract with that company, that contract would only pick up its allocable share of the total, so that I don't think there would be any overcharging to the noncompetitive contracts.

Mr. GUBSER. It seems to me that the cost of making proposals is becoming a tremendous cost to industry. I am wondering perhaps if we didn't limit those making proposals, to a point where competition was assured, and let different groups bid on different proposals, you wouldn't actually wind up saving some money.

Mr. BANNERMAN. This is, of course, a separate question, a very interesting one and one that many people in industry are vitally concerned with. So are many people in the Government, both in our department and in NASA. There has been a great deal of time and attention devoted in the last year or two to what steps may be taken to reduce the total impact of this bid and proposal expense. It ties up the time of a lot of good engineers, and other people, frequently uselessly. I don't know any simple answer to this. We have some proposals underway that we think will approach it. One obvious but impractical proposal is to deal only with the best qualified firm. This would mean excluding other firms for a variety of reasons. We don't intend to do that. We hope to keep it as competitive as we can, but more manageable and less wasteful.

Mr. GUBSER. Cost-plus-fixed-fee has advantages as well as disadvantages, I think you will agree.

Mr. BANNERMAN. There are two basic problems with the cost-plus-fixed-fee contract. The first is they are too easy to get into without actually defining what it is you are trying to accomplish. Hence you frequently get into improvident contracts and you don't find it out until after you have spent a lot of money. If you set up a more disciplined contract form, you are required to explore its potential for completion before you start.

Secondly, of course, cost-plus-fixed-fee doesn't give incentive for good management once we are into it.

Mr. HARDY. Mr. Pike.

Mr. PIKE. Mr. Bannerman, you show that we have gone from 36.2 percent firm fixed price contracts in 1961 to 49.8 in 1964. Of these firm fixed price contracts, how many are based on competition and how many are based on negotiation?

Mr. BANNERMAN. You will accept an approximation, I hope.

Mr. PIKE. Yes, sir.

Mr. BANNERMAN. Of that 49.8 percent, I would say that in the order of 38-plus percent was based on price competition. The balance was based on negotiation.

Mr. HARDY. I want to be sure you distinguish between negotiated competition and competitive bidding.

Mr. PIKE. That is what I am doing.

Mr. BANNERMAN. No, I am including—

Mr. HARDY. I know what you are doing. That is why I want him to be sure.

Mr. BANNERMAN. I include all those on which we obtain firm fixed price quotations from a number of people with no exclusions and award to the low bidder. Now, a lot of these were in fact not formally advertised, but were, nevertheless, firm fixed price awards.

Mr. PIKE. Firm fixed prices based on competition at which you got several bids, didn't look beyond the bids themselves, and awarded the contract.

Mr. BANNERMAN. That is correct.

Mr. PIKE. You say that was about 38 percent of your 50 percent?

Mr. BANNERMAN. That is correct, about 11 percent were not of that type. In short, the difference between 38 and 49, or 38-plus and 49-plus.

Mr. PIKE. So that of your firm fixed price, there were some 12 percent which were negotiated?

Mr. BANNERMAN. Negotiated on the basis of other than price competition, yes, sir.

Mr. HARDY. He is leading you down that blind alley.

Mr. BANNERMAN. No, I am not, Mr. Chairman. This is very direct.

Mr. PIKE. Were the ones which were subjected to price competition negotiated in any manner regarding the overhead of the contract?

Mr. BANNERMAN. No.

Mr. PIKE. Were those which were negotiated otherwise negotiated with regard to the overhead of the contract?

Mr. BANNERMAN. Yes.

Mr. PIKE. So that we still find ourselves in a position where in some two-thirds of all of the contracts, the overhead of the contractor is still an element of cost to the Government?

Mr. BANNERMAN. I am with you on the percentage. The overhead of the contractor is an element in the fixing of the contract price or target. However, once that is fixed, whether he spends it or not is his own judgment, and the results affect him and not us.

Mr. PIKE. And the overhead of the contractor is based on his past overhead records, is it not?

Mr. BANNERMAN. Well, when you are going into a negotiated fixed price contract, based on cost analysis rather than competition, you do, of course, examine his past overhead records, but you don't neces-

sarily simply project those into the price of the contract. You are seeking to accomplish efficiencies, and you price with that as a background. Pricing of future contracts is not simply the addition of past costs.

Mr. PIKE. You state on the second page of your statement what I deem to be a definition of entertainment costs, that is, you say, amounts spent on customers or other than for employee morale activities.

Do you mean to define entertainment as not applying to employees?
Mr. BANNERMAN. Yes, sir.

Mr. PIKE. You are telling us, then, that when a company spends money for its employees, it is not entertainment?

Mr. BANNERMAN. That is correct.

Mr. PIKE. Under what theory do you say they can spend money on their employees for food but not for liquor?

Mr. BANNERMAN. I don't hold that theory, Mr. Pike.

Mr. PIKE. Well, then, on page 6 of your statement, you talk about the consistency of the policy being applied here. It seems to me there hasn't been any consistency whatsoever in the policy being applied.

Mr. BANNERMAN. Mr. Pike, on this point I quite agree with you.

Mr. PIKE. All right; I can stop that right there.

Now, isn't the policy of the Government implemented through its ASPR's?

Mr. BANNERMAN. Yes.

Mr. PIKE. You have stated to us that you don't consider that liquor spent for employees, or meals spent for employees are entertainment?

Mr. BANNERMAN. No; I didn't say that, Mr. Pike.

Mr. PIKE. Didn't you?

Mr. BANNERMAN. No; I said the definition of "entertainment" that we have in ASPR is designed to deal with expenses paid for other than employee welfare and morale purposes, and that is spelled out in the regulation.

Mr. PIKE. Well, would you tell me where in the regulations, where in the ASPR's, you find the language which says that entertainment does not apply to employees?

Mr. BANNERMAN. I think I can give it to you. Under "entertainment" it says "costs of amusement diversion, and so forth, are allowable, (but see 15-205.10)," which I take to mean, and I assume others would, that costs which are allowable under 205.10 are not treated as "entertainment" costs.

Mr. PIKE. All right; let's read 205.10:

Reasonable costs of health and welfare activities such as nose publication, health or first-aid clinics, recreational activities and employee counseling services—

And that is all that they use for examples—

Mr. BANNERMAN. No, keep on—there is more in that.

Mr. PIKE. "Incurred in accordance with," those are the examples they used, "the contractor's established custom or practice in the industry or the area for improvement of working conditions * * *" I can read the whole thing if you want, but these are the only examples they use. The words, the key words are "health and welfare activities such as," and then they give some examples.

Do you find a cocktail party to be a health and welfare activity?

Mr. BANNERMAN. No; I don't, Mr. Pike.

Mr. PIKE. And yet you would find it to be allowable under this ASPR?

Mr. BANNERMAN. Mr. Pike, I wouldn't want to say in a given case whether a cocktail party is allowable or not allowable. I think you need more facts. I think it is entirely possible it may be allowable as an employee morale operation, and employee morale costs are allowable—if it is reasonable in amount.

Mr. PIKE. But this defines the employee moral activity, and this is the one to which you have referred?

Mr. BANNERMAN. That is correct.

Mr. PIKE. I would like you to tell me how you make a cocktail party, under any circumstances, into either a health or welfare activity.

Mr. BANNERMAN. "Recreational activities" for the improvement of employee morale.

Mr. PIKE. Wait a minute. Recreational activity is given as an example of a health and welfare activity. To me, this would mean providing an area for a softball team, or something of this nature. If you can make a cocktail party into a health or welfare activity, you can make anything into a health and welfare activity.

Mr. BANNERMAN. Mr. Pike, if a company were to give a party for, say, its 25-year employees, I would consider this a welfare activity for morale purposes.

Mr. PIKE. Well, obviously you would consider it that, because that is what has been done time and time again.

Mr. BANNERMAN. That is correct. The title of this cost classification is clear, but I don't disagree with you at all that this language under the title needs clarification.

Mr. PIKE. Well, I think the language has been completely violated by the use of saying a meal is not a meal, but a cocktail party is a recreational activity. A banquet is a recreational activity; it is not a meal.

Mr. BANNERMAN. I don't think that there has been any attempt to say that a meal is not a meal. I think that meals for some purposes are unallowable, meals for other purposes are allowable.

I think it is very clear that if a company requests some of its executives or others to work all night on some occasion, they could be expected to put up the cost of the meal.

Mr. PIKE. That would apply under 205.14 for food service.

Mr. BANNERMAN. Yes; but that is a meal.

Mr. PIKE. And allowed as such?

Mr. BANNERMAN. That is right.

Mr. PIKE. In order to allow a banquet, in order to allow a cocktail party, in order to allow a crab feast, you have to define it as a health and welfare activity?

Mr. BANNERMAN. Or recreational activity.

Mr. PIKE. You have to define it as a health and welfare activity of which they give recreational activities as an example?

Mr. BANNERMAN. That is correct, which means to say that you have to define "recreational activities" as health and welfare activities. I think the words, in the light of what has been brought out here, are somewhat inartistic. They need clarification, I agree.

Mr. PIKE. To me it is the other way around. The words are clear when they say meals are not allowable and they say amusement, diversion, and social activities are not allowable, they are talking about meals and talking about social activities. To me, a meal is a banquet whether it is a crab feast or a picnic unless it is covered under normal food service operations.

Now, you talked also—how much time have I got?

Mr. HARDY. You go ahead. We have a quorum call on.

Mr. PIKE. Has the second bell rung?

Mr. HARDY. It has just rung.

Mr. PIKE. You talk about normal accounting practices in the business. Under ASPR 205.14, which covers food service costs, can you conceive of a normal accounting activity in the business which charges nothing for meals which would come within such a provision?

Mr. BANNERMAN. I would like to make two comments about that section, if I may, Mr. Pike.

No. 1, I think it is very clear that we need to reexamine this exception that I mentioned in my statement. That is to say, we need to reexamine the treatment of receipts from vending machines, whether or not they are irrevocably set over. I personally hold the view—though I don't know that my view will prevail—that those things should come into the general receipts of the company.

Mr. PIKE. Leave the vending machines out of it. I am talking about the restaurants which make money for the basic employees and lose money for the executives.

Mr. BANNERMAN. I think that I participated in the original drafting of this section a great many years ago, and at that time it was certainly our intention, when we incorporated a provision that reasonable losses from food services could be charged as allowable overhead. Our intention was, as you have said—

Mr. PIKE. To break even.

Mr. BANNERMAN (continuing). To break even. You don't always come out that way. After all, these companies aren't in the restaurant business. But I agree with you on this point. We will make it clear.

Mr. PIKE. On page 8 of your statement, you raise the question, "Are specific costs being allowed which are clearly excessive or for which the reimbursement is contrary to public policy?"

I conclude from the record, with some reservations, that the answer is "No." Now, approximately half of all of these excessive costs—not half, but about one-fourth of all of these excessive costs have come from these food service losses. Wouldn't you say that based on the policy as you understand it and the intent of the ASPR, this might be a fairly substantial reservation?

Mr. BANNERMAN. I completely agree. There are two types of situations which I had in mind when I said, "with some reservations." I would like also to explain, Mr. Pike, that this draft statement of mine has been undergoing some revisions in the last 2 days, and I don't guarantee that I have kept up with all that has been said. But I do feel very clearly that food service losses should be allowed only when it is clear that the intent is to break even. I say that, and that is my opinion. ASPR does not now say that, and hence I think that, since ASPR is incorporated as a contractual provision in an awful lot of contracts right now, the fact that I say that isn't going to change

the practice overnight. Nevertheless, I feel that, and I will undertake to get that change made.

Mr. PIKE. I would simply like to say I appreciate both your answers, Mr. Bannerman, and the good nature with which they were rendered. I have studied at the feet of a master as far as learning to needle is concerned—

Mr. BANNERMAN. I agree with you.

Mr. PIKE (CONTINUING). And if I have gone overboard, I apologize.

Mr. HARDY. I don't know who the master is that Mr. Pike is referring to. I have been studying under some right good, competent people, too.

There is one thing that I would like to follow up, and that is this point Mr. Pike was raising in connection with fixed-price contracts. I think we ought to make a wider distinction between advertised fixed-price contracts and negotiated fixed-price contracts than we do make, and I must make this observation in that connection, which I am sure you will recognize, Mr. Bannerman. In a negotiated fixed-price contract you have to go through the negotiation on all this various stuff we have been talking about that is involved in cost-plus-a-fixed-fee contracts. That is a part of the cost that is negotiated in a fixed-price contract.

Mr. BANNERMAN. Mr. Chairman, I would like to make this point very clear, because in my judgment that isn't quite an accurate description of it.

Mr. HARDY. Well, it certainly has to be included in the fixed-price contract that is negotiated.

Mr. BANNERMAN. Of the 49.8 percent, I think the figure was, of our total fixed-price contracts, I forget the exact figure but let me pick one out of the air of the right order of magnitude—say 15 percent of that, and it is going up, is awarded by formal advertising. Another 23 to 24 percent of that is awarded by what is called negotiated price competition.

Mr. HARDY. Yes, but sometimes that is as phony as it can be, and I can give you an illustration.

Mr. BANNERMAN. No, Mr. Chairman, I disagree with that.

Mr. HARDY. Of course you do, you have to.

Mr. BANNERMAN. That group includes only contracts on which we have obtained competitive price quotations from a number of firms and have awarded the contract on the basis of the low bid.

Mr. HARDY. Is that without further negotiation?

Mr. BANNERMAN. It is without further negotiation based on costs. There is the remaining 11 or 12 percent Mr. Pike was referring to which is negotiated fixed price without competition, and in those we do analyze the very costs we are talking about, so you are right as to that group.

Mr. HARDY. You have one group, but I don't know which one it falls in, where you solicit proposals and get so-called competitive proposals, which are frequently a far cry from the ultimate contract. Sometimes you have a hard time finding any relationship.

Mr. BANNERMAN. I would be glad to discuss them with you, Mr. Chairman.

Mr. HARDY. I don't think we want to get into that here, but I think we need to keep in mind the fact that at least on a great many of your

negotiated contracts this very thing we are talking about here has to be a part of the cost which is under negotiation.

Mr. BANNERMAN. You are quite right as to the group of contracts negotiated on the basis of cost analysis. These costs are considered in the pricing of the contract, but if we make a fixed-price contract of that sort, which is then going to run say for 3 or 4 years in production (at the same time the contractor has many other contracts in his shop) we are now talking about what does this do to the management decision as to overhead expenses? A question arises "Should we throw this employee picnic?" Now, if they throw it, that portion of the cost of that picnic allowable to the fixed-price contract is coming out of the company.

Mr. HARDY. That is right, and there isn't any reason I know of why, since you do negotiate this in certain of your negotiated fixed-price contracts, you couldn't negotiate it in your fee to begin with, and avoid all of this auditing hassle that we are getting into here.

Mr. BANNERMAN. Well, I don't believe I would want to put it in the fee, but what you are suggesting is certainly a desirable objective. I don't think that you can expect, by a detailed, hundred-dollar-by-hundred-dollar audit, to achieve good management or good control over \$28 billion a year worth of business.

Mr. HARDY. I think that is probably correct, that you can't in a postaudit and postnegotiation come up with any reasonable conclusion. That is why I think as much as possible ought to be done before the contract is originally awarded.

Mr. BANNERMAN. I completely agree, and it ought to be done in forms of contract that make the contractor have a share in the result.

Mr. HARDY. I want to comment on one other comment in your statement—which I wish you hadn't done, because it is not characteristic of your normal performance—where you say:

It is interesting to note from the GAO report that the one contractor (or division thereof) with the lowest percentage of Government work, 3 percent, has by far the highest rate of expenditure per employee per year for morale, health, and welfare expense.

By sticking that parentheses in there, you were correct. That is IBM, and we discussed that yesterday.

Mr. BANNERMAN. I know you did.

Mr. HARDY. And we observed that they do apparently have a very fine employee morale program, but instead of stating that it is 3 percent and apparently uniform among all their divisions, it would have been a lot more accurate if you had said that Government business was 38 percent, instead of pointing out one single division.

Mr. BANNERMAN. I didn't point it out, Mr. Chairman. The GAO did.

Mr. HARDY. The GAO didn't do that. The GAO, in its statement, showed that by taking the company as a whole it was 38 percent. They have a sheet that shows that that particular division has only 3 percent Government business.

Mr. BANNERMAN. Well, that is correct, and as to this—

Mr. HARDY. But their spread sheet shows overall it is 38 percent, so I was a little surprised that in order to try to make it look ridiculous you picked a figure that I think is unfortunate.

Mr. BANNERMAN. I was not trying to make it look ridiculous. The only reason I included that in the statement was to show that the GAO report does not allow us to draw any conclusions on this point.

Mr. HARDY. Well, you could have done that, and you did—I thought very effectively—in some other areas.

Mr. BANNERMAN. I assure you I was not trying to select out a particular case.

Mr. HARDY. It is a little on the picayunish side, which is not one of your characteristics.

Since the House is in session and we have a quorum call, I want to express my appreciation for your statement. It was very well done. I wish we had time for the few more specifics I would have liked to argue with you about.

Mr. BANNERMAN. Maybe we can do it some other time.

Mr. HARDY. I think we will have to defer it, but we can, I think, close this phase of the hearing, and we will stand adjourned subject to the call of the Chair.

(Whereupon, at 12:35 p.m., the subcommittee adjourned.)

