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Mr. Chairman and Members of the Subcommittee:

We are appearing here today to discuss a report submitted to the Congress by the General Accounting Office on January 26, 1970, entitled "The Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts." We have also been asked to comment on Title 1 of H.R. 17880.

The GAO report had its origin in ^{Section 718 of} ~~an amendment~~ to the Defense Production Act of July 1, 1968, ^{as amended.}

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REPORT ON THE FEASIBILITY OF APPLYING UNIFORM COST-ACCOUNTING STANDARDS TO NEGOTIATED DEFENSE CONTRACTS

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CHAPTER 1

INTRODUCTION

The General Accounting Office has made a study of the feasibility of applying uniform cost-accounting standards to negotiated prime contract and subcontract defense procurements of \$100,000 and over. This study was undertaken pursuant to statutory direction contained in section 718 of the Defense Production Act of 1950, as amended (82 Stat. 229 July 1, 1968).

WHY THE CONGRESS PASSED THE LAW Directed The Study

The Congress in enacting section 718 was apparently influenced heavily by the growing proportion of defense procurements entered into on a negotiated basis--then approximately 86 percent of the total--and by testimony that differing cost-accounting practices followed in defense contracts and among different contractors could result in lack of adequate cost information and could impair comparability as among differing bidders and different contracts with the same contractor.

It was pointed out that, in a negotiated bid situation, the estimate of a contractor's cost plays an important role in the establishment of the price and that the cost of any specific order can only be measured by the application of cost-accounting principles.

House Report 1455, May 23, 1968, on the bill which originally contained proposed legislation on this subject, indicated that it was considered to be necessary mainly because of (1) substantially increased costs of procurement, (2) difficulties in having contractors carry out defense

work under contracts providing adequate safeguards to ensure against excessive profits, and (3) Government agencies' having to accept other contract terms substantially less favorable to the Government than would be necessary without enactment of the proposed legislation.

Among the views stated in the Senate debate were:

- The essential function of cost accounting is to allocate direct and overhead costs to individual orders. Thus the cost-accounting principles followed have a large impact on the determination of contractor costs. For example, cost items such as depreciation, research and development, inventory, self-insurance, small tools, and lease financing can be treated two or three different ways.
- Once a method of treatment for each of these and other items is decided upon, the contractor then may allocate costs in a variety of ways. The methods used (1) to apply general overhead to a specific product, (2) to allocate overtime or premium time between Government and commercial work or between one Government contract and another, (3) to handle interest on investment or financing, and (4) to charge for work done by affiliated companies, all have an important bearing on cost determination.
- In the absence of "uniform principles," the entire burden is placed upon procurement officials to evaluate the contractor's accounting practices without the guidance of authoritative support for the use of alternatives in specific circumstances and thus

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results in more work for auditors and procurement officials, delays in important technical work, and excessive procurement costs.

--There is growing awareness within the accounting profession itself that more uniformity is needed. Testimony from professional accountants was offered to the effect that one of the weaknesses of "generally accepted accounting principles" which now constitutes a basic guide in negotiated procurements in ascertaining costs is that, although the alternatives are well known, the criteria for the use of each alternative have never been established or "generally accepted."

EXTENT OF GOVERNMENT PROCUREMENT

~~According to published statistics,~~ total Government procurement for the fiscal year 1969 amounted to \$53 billion, of which \$45.9 billion, or 86.6 percent, represented negotiated procurements--procurements not formally advertised. Total Department of Defense procurement for the fiscal year 1969 amounted to \$40.8 billion, of which \$36.3 billion, or 89.0 percent, was negotiated.

The underlying significance of cost-accounting standards in the total contract negotiation activities of the Government is indicated by the large volume of negotiated contracts which has substantially increased in the past 5 years, as indicated below.



	<u>Total</u> <u>pro-</u> <u>urement</u>	<u>Nego-</u> <u>tiated</u> <u>pro-</u> <u>urement</u>	<u>Percent</u> <u>nego-</u> <u>tiated</u>
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(billions)

**Trend in Government-wide pro-
curement:**

1965	\$36.8	\$30.2	82.1
1966	47.4	39.9	84.2
1967	53.2	45.5	85.5
1968	52.6	46.1	87.6
1969	53.0	45.9	86.6

**Department of Defense
(note a):**

1965	27.4	22.6	82.5
1966	37.2	32.0	86.0
1967	43.4	37.6	86.6
1968	42.8	37.9	88.6
1969	40.8	36.3	89.0

**Civilian executive agencies
(note b):**

1965	9.4	7.6	80.9
1966	10.2	7.9	77.5
1967	9.8	7.9	80.6
1968	9.8	8.2	83.7
1969	12.2	9.6	78.7

^aSource: Annual reports of Military Prime Contract Awards and Subcontract Payments or Commitments (Department of Defense).

^bSource: Annual reports of Procurement by Civilian Executive Agencies, Size of Business and Types of Procurement (General Services Administration, Office of Administration).

PRESENT GUIDES TO COST ACCOUNTING

Section XV of the Armed Services Procurement Regulation (ASPR) contains general cost principles and procedures for the determination and allowance of costs in the

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POTENTIAL BENEFITS From Best Standards

In contract negotiations, an understanding of the contractor's cost-accounting practices is of vital importance to negotiators on both sides of the table. By providing a common framework for the buildup of the prospective and actual cost of a product or service in the light of the environment in which the costs are accumulated, cost-accounting standards could

- supply the guidance, support, and coordination required for better understood cost estimates and subsequent reports of actual costs;
- facilitate the preparation and reporting of cost information by contractors and its audit and evaluation by the Government; and,
- provide guidance in helping to ensure that items of costs on a given contract are reported on a consistent basis; are comparable with costs originally proposed or projected and are comparable with costs cited in other reports such as financing requests, change orders, claims for reimbursement, price redeterminations or adjustments, and termination claims.

Standards could require that

- the basis upon which forecasts of costs are predicated be disclosed;

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--that final reported costs incurred be supported by, or be readily reconcilable with, the contractor's accounting records; and

--that costs identifiable with other products or services or with other contracts be excluded from total contract performance costs.

Standards could also:

--improve the communicative process between the Government, the Congress, industry, and the public generally.

--serve to identify for contractors the type of authoritative support for costs incurred that would be required to be accumulated by them for all contract administration purposes, including audit.

--establish criteria for the use of alternative methods of cost accounting or could narrow the use of alternatives where criteria for their use cannot be established.

Properly administered cost-accounting standards, together with a written disclosure by the contractor of his cost-accounting practices, could do much to promote a common understanding as to the methods of cost determination to be used consistently. This would minimize subsequent controversy in the administration and settlement of the contract.

In our report we have recognized certain limitations on what cost-accounting standards can achieve. I will not, however, take time to discuss them here, except to say that to require consistent uniform

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cost-accounting practices for all contractors, whatever the circumstances, goes to such an extreme as to be unreasonable and unenforceable. Yet, consistency in the cost-accounting practices for all contractors in similar contracting situations appears to be a desirable and attainable objective.

CONCLUSIONS AND RECOMMENDATIONS

We have concluded that it is feasible to establish and apply cost-accounting standards to provide a greater degree of uniformity and consistency in cost accounting as a basis for negotiating and administering procurement contracts.

In our report we stated that cost-accounting standards should not be limited to defense cost-type contracts, ^{but} ~~They~~ should apply to all negotiated procurement contracts and subcontracts, both cost-type and fixed-price. Further, they should be made applicable Government-wide. We recognize that making their application Government-wide presents some practical problems so long as enabling legislation is provided through amendment to the Defense Production Act of 1950. We have no objection to confining it to defense production at this time; however, we would hope that the Congress will see fit to broaden their application when the cost-accounting standards are ultimately promulgated.

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Views Expressed by Federal Agencies, the Accounting Professions, and Industry Associations

An earlier draft of the GAO report was submitted for suggestions and views of interested Federal agencies, the major professional accounting associations, and a large number of industrial organizations. We ~~attempted to take~~^{took} into account to the extent feasible the views expressed in ~~the~~^{our} final report to the Congress.

All Federal agencies agree on the feasibility of establishing cost standards.

With one exception the professional accounting organizations agree on the feasibility of establishing such standards, although reservations and questions were extensive with respect to the form of such standards, and the manner in which they would be prepared and implemented.

~~Third,~~ The industrial organizations generally are opposed to the establishment of such standards and question the feasibility of applying them. Their concerns and reservations were extensively set forth in hearings before the Senate Banking and Currency Committee, corresponding for the most part to comments received by the General Accounting Office on the draft report which had been supplied to these organizations for an expression of their views.

The remainder of my statement is addressed principally to a discussion of the ^{Principal} concerns expressed, although I will comment briefly on the specific organizational arrangements proposed in H.R. 17880 and the proposed procedure for implementation of the recommendations of the General Accounting Office.

Your attention is also directed to two attachments which set forth in greater detail comments on two matters which may be of assistance to you in your consideration of the legislation.

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Defense Contract Audit Agency Cost Accounting Standards
exists

1. That certain audit and investigative activities of Government agencies provide ample disclosure of contractors' cost-accounting practices, thus providing assurance of both their acceptability and consistent use. Cited in support of this contention are the activities of the Defense Contract Audit Agency, the General Accounting Office, the Internal Revenue Service, the Renegotiation Board, and the Securities and Exchange Commission. Also cited were the audits by public accountants of defense contractor companies in connection with their certification of financial reports.

* * * * *

DCAA has responsibility for reviewing contract cost proposals and reported costs involved in the reimbursement and settlement of contracts where incurred costs are factors. GAO reviews only a limited number of contracts and elements of contract cost on a selective basis. These two activities are the only "safeguards" among all those mentioned in the testimony of the trade associations. However, availability of records for audit does not constitute what we consider as disclosure or insure the consistent use of appropriate accounting practices. Our report shows that whether selective contracts are audited or whether every contract is audited, the lack of an authoritative body of cost-accounting standards provides contractors with the latitude for a selection from alternative methods of accounting in arriving at contract costs without any requirement for using agreed-upon criteria in making their selections.

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The regulations of the Internal Revenue Service, the Renegotiation Board, and the Securities and Exchange Commission were not designed for use in costing of individual contracts. They are concerned primarily with total costs and revenues for a reporting period and not with separation by products, services, or contracts. In addition, the regulations of the Renegotiation Board, which by statute are tied to the Internal Revenue Code, are more liberal than ASPR. For example: what is considered a reasonable and proper cost for purposes of taxation and renegotiation may not be a reasonable and proper cost for purposes of contract costing.

~~As we have stated elsewhere,~~ The public accountants' principal concern is with matters related to the presentation of reports or financial condition and results of operations and are seldom concerned with the specifics of estimates and subsequent reports of negotiated contract costs. In connection with financial reporting, consistency is an important facet of generally accepted accounting principles. However, this concept of consistency is not extended to internal cost-accounting practices of a contractor and it is free to present contract cost data on any basis it chooses whether it be in connection with a cost proposal, a claim for reimbursement, a termination settlement, or any other purpose for which contract cost data is furnished to the Government. In fact, in discussing the concept of consistency, Accounting Research Study No. 7, Inventory of Generally Accepted Accounting

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Principles for Business Enterprises, published by the American Institute
of CPA's, states:

"As protection against possible misunderstanding of the scope
of this concept, it should be understood that it does not
imply uniformity or even comparability among independent
units. In fact, it does not mean consistency among existing
accounting practices of affiliated units or even in the
internal practices regularly followed by one corporation . . ."

(Underscoring supplied.)



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2. That there is not available a sufficient amount of data concerning the cost of establishing and implementing authoritative cost-accounting standards for use in connection with negotiated defense contracts.

Further, that the application of such standards would cause both costs of Government procurement and contractors' operations to increase.

Also, that both small contractors and certain business organizations which are predominantly oriented to commercial work would suffer cost penalties or even withdraw from participating in defense work.

* * * * *

From the outset of the GAO study, the cost of implementation ^{ing Standards} was recognized as an important factor to be considered. We were not supplied with any reliable estimates of cost because of the difficulties of envisioning just what would be required until a body of cost-accounting standards is actually formulated. Costs will vary from contractor to contractor, depending on the extent to which existing cost-accounting and management-information systems can produce cost data in accordance with cost-accounting standards for purposes of negotiated contracts. Some of these costs will be borne by the Government, either directly or indirectly, others will be borne in part by the contractors. We believe that "there are enough advantages even without firm figures on costs involved or potential savings to warrant proceeding" as stated by Mr. Leonard Savoie, Executive Vice-President of the American Institute

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of CPA's. Our study also confirms the following statement by Mr. I. Wayne Keller, Chairman, Committee on Accounting Practices, National Association of Accountants: "After the initial change the cost of continuing cost accounting under the standards as promulgated would be little or no different from the costs that those companies are expending now in recording costs under their present systems. There would be some minor cost of adapting to the new standards."

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3. That the establishment of such cost-accounting standards might result in rigid rules, so detailed as to create, in the course of their application, inflexible operating conditions and unreasonable difficulties for contractors. Certain of the most evident apprehensions are concerned with inequitable reductions in the amounts of allowable costs, with bureaucratic regulation of rigid cost-accounting systems, with the necessity of operating separate or duplicate systems, and even with Government-prescribed uniform financial accounting procedures and bookkeeping systems.

* * * * *

Our report concluded that it is not feasible to establish cost-accounting standards in such detail as would be necessary to ensure a uniform application of precisely prescribed methods of computing contract costs. It also stated that such standards should evolve from sound commercial accounting practices which now exist. We do not envision ^{the} ~~any~~ necessity for extensive modifications to present accounting systems or for new or separate systems. Certainly neither rigid cost-accounting systems or Government prescribed uniform financial accounting procedures and bookkeeping systems are contemplated in the establishment of cost-accounting standards. Furthermore, cost-accounting standards should not usurp the decision-making functions of the Department of Defense in regard to negotiated profit allowances or determinations of reasonableness and allocability in connection with items of cost attributed by a contractor to a specific contract.

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4. That Defense Department regulations and existing statutes, notably Section XV of ASPR and the Truth-in-Negotiations Act, provide all the guidelines and procedures needed for determinations of contract cost for the negotiations and administration of negotiated defense contracts. That these regulations and statutes have the support of generally accepted accounting principles and the cost-accounting practices already in use by various elements of industry. That all of the factors mentioned above are subject to an evolutionary process and can be modified when and if it is found appropriate to do so.

* * * * *

We have shown in our report that the effectiveness of Section XV of ASPR, the section intended to provide general cost-accounting guidance and procedures for defense contracting, is impaired because of reliance of generally accepted accounting principles. We have also shown that generally accepted accounting principles have limited relevance because they are concerned primarily with reports of financial condition and cost allocations between fiscal years and do not go into details such as cost allocations during the fiscal year to specific products, services, or contracts.

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Indeed the cost-accounting practices and techniques of contractors ^{now} do reflect their concepts of cost measurement, i.e., their individual selection of cost-accounting standards. However, there is no body of authoritative cost-accounting standards, accompanied by definitive criteria for their use, which insures proper, equitable, and consistent allocations of costs according to their real causes and benefiting sources regardless of product, contract type or origin. ~~Furthermore, the guidelines contained in Section XV of ASPR are mandatory only for cost-reimbursement-type contracts.~~

Under the Truth-in-Negotiations Act, although contractors are required to certify as to the currency, completeness, and accuracy of cost and pricing data there are no authoritative cost-accounting standards with definitive criteria which they are required to observe in the preparation of the cost and pricing data submitted to the Government. Further, because there is no requirement to maintain data on costs incurred in the same manner as proposed during price negotiations, it is frequently impossible to evaluate the estimates of contract performance costs with actual performance costs.

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5. That many of the cases cited in our report clearly were violations of the existing provisions of the Armed Services Procurement Regulation, Section XV and, therefore, such provisions if adequately applied are adequate to cure the cited problems; that the number of cases in the report, which were 90, were not representative; and that in many of the cases the contractor's position was sustained either by the contracting officer, the Board of Contract Appeals, or the Court of Claims.

* * * * *

Most of the 30 cases alleged to have been clear violations of ASPR Section XV are examples of ^{instances of} ~~where~~ certain costs ~~which were~~ being charged directly to contracts ^{which} were normally treated by the contractors as indirect costs. The violation of ASPR referred to is the failure of the contractor to eliminate from overhead the cost of like items charged directly. It is often difficult, if not impossible, to adjust overhead rates particularly where there are other contracts--cost-type and fixed-price type--that have been or will be negotiated without any credit for the proposed direct charge. Such an adjustment must be made to each contract. Some contractors have hundreds of cost-type and fixed-price type contracts. It is our view that what is required here, in addition to better defined criteria for distinguishing between direct and indirect costs, is a good workable requirement for disclosure and consistency.

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It should also be noted that whereas it might be evident that the problems cited were clear violations of ASPR Section XV, at that time ASPR was mandatory only for cost reimbursement contracts and was required to be used only as a guide for fixed-price contract cost proposals and termination claims. The first 30 cases involved 21 cost proposals, 12 fixed-price, and 9 cost type. Further, there is currently no requirement that a contractor apply the same standards to both the preparation of cost or pricing data submitted in support of price proposals and the accounting for contract performance costs. Therefore, even if ASPR was followed in the preparation of a cost proposal, there ^{was} ~~is~~ no assurance that performance costs ^{would} ~~will~~ be so recorded. It would seem reasonable to have such a requirement so that meaningful audits could be readily performed.

The cases included in our report were intended only to identify and demonstrate cost-accounting problem areas existing under the contract cost guidelines of ASPR, Section XV. Considering Section XV's heavy reliance on "generally accepted accounting principles," we were interested in learning how well this general guidance has served ^{in settling disputes between} the contracting parties.

Accordingly, we reviewed the decisions of the Armed Services Board of Contract Appeals and of the Federal Courts for the past several years. We found that the Board and the Courts have had difficulty in adjudicating controversies involving cost determinations on Government contracts because of lack of an authoritative body of cost-accounting principles or standards.

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Concerning the representativeness of the cases selected, we took the view that it was important to identify areas in cost-accounting treatment which have resulted in controversies between contractors and the Government and to determine whether cost-accounting standards were needed and feasible in the solution of such problem areas. The cases presented in our report illustrate such problem areas; they are not intended to be representative of the 200,000 or so annual contract actions.

We did not attempt to determine the outcome of all the cases because we felt that the outcome would have little, if any, impact upon a conclusion as to the feasibility of adopting cost-accounting standards, and therefore would not justify the time and effort involved. The fact that there are many controversies is manifest of divergent views and a lack of understanding between the contracting parties. It can also be said the contractors' position as well as that of the Government representatives is clearly indicated, in the sense that they have expressed their views, albeit divergent, on the treatment of the costs at issue.

In view of this, and the deficiencies in ASPR discussed previously, we believe that neither the contractors' comments on the cited cases nor the ultimate outcome would materially assist in solving the underlying problem--an absence of cost-accounting standards.

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Comments on HR 17880

June 12, 1970
Ralph Ke

(Handwritten initials)

Mr. Chairman, you have asked ^{me} ~~me~~ to comment on H.R. 17880 which you and your colleagues introduced on June 2, 1970. ~~We shall be~~ pleased to do so.

With your permission ^{we} ~~we~~ will comment briefly on the main points which ~~we~~ feel require discussion and will introduce for the record our detailed comments ^{on H.R. 17880 and} ~~Also, with your permission, we will introduce for the record our detailed comments on the~~ Senate Bill, S. 3302.

Title I of H.R. 17880 extends the Defense Production Act of 1950 for an additional 2 years and requires the Comptroller General, as an agent of the Congress, to promulgate cost-accounting standards. To assist the Comptroller General in this responsibility, a Cost-Accounting Standards Advisory Board of no more than five members appointed by the Comptroller General would be established.

~~We~~ believe the responsibility for promulgating cost-accounting standards should rest in the Executive Branch of the Government. ~~We~~ favor this course of action because we question whether the GAO should become deeply involved in the ^{administration of negotiated contracts.} responsibility for administering contracts, including promulgating, interpreting, and administering cost-accounting standards seems basically an Executive Branch function.

Having both the responsibilities for promulgation and administration of the cost-accounting standards would greatly simplify their implementation and ancillary responsibilities of a cost-accounting board within the Executive Branch could be delegated by it to other agencies within the Executive Branch without raising constitutional questions regarding the separation of powers between the Executive and Legislative Branches.

Though not specifically provided by H.R. 17880, ~~we~~^I believe the Cost-Accounting Board should be a permanent board with authority for its members to serve on part-time basis. An Executive Director, or Secretary would, of course serve on a full-time basis as would other staff as needed.

~~We~~ believe the Bill should be amended to include subcontractors in the definition of "defense contractors" and to make the legislation permanent rather than ^{be} subject to expiration every two years as is the ^{with all other provisions of} case ^{of} the Act.

Further, ~~we would~~^I recommend ^{that} the words "from indirect costs and the basis used for allocating indirect costs" be inserted after the words "direct costs" on line 24, page 2 of the Bill. This was an inadvertent omission of words in the copy of the alternate legislative proposal No. 1 which we furnished your committee earlier. These words are essential to a complete understanding of its provisions.

~~Mr. Chairman, we~~^I shall be glad to answer any questions you may have concerning our feasibility study and our expressed views on the legislative proposals.