



Address by the Comptroller General of the United States,  
 Elmer B. Staats, before the Stuart Cameron McLeod Society  
 of the National Association of Accountants, Doral Country  
 Club, Miami Beach, Florida, October 29, 1968

UNIFORM COST ACCOUNTING STANDARDS IN NEGOTIATED DEFENSE CONTRACTS

Early in the Spring of this year, the General Accounting Office was extremely busy from one end of the United States to the other conducting a comprehensive series of reviews in connection with various "anti-poverty programs" of the Office of Economic Opportunity and the Department of Labor. We had received this assignment under amendments to the Economic Opportunity Act in December 1967. By Spring, therefore, we were heavily engaged on this project, one of the most comprehensive that the GAO has undertaken. At the same time, of course, we were carrying on dozens of other audits and reviews of activities of the Executive Branch of the Government as we regularly do as an arm of the Legislative Branch.

Under the circumstances, we were not perhaps quite prepared for action taken unexpectedly in May by the House Banking and Currency Committee. Following hearings by the Committee on a relatively routine bill to extend the Defense Production Act of 1950, which comes up biennially, the House Committee reported the bill with an unusual amendment.

The amendment directed the Comptroller General to develop uniform accounting standards to be applied to all negotiated prime contract and subcontract procurements by the Department of Defense in excess of

18p.

710077  
 094488

DLG 04423 (Ad.)  
 GAO 02001

\$100,000--including standards by which an accurate showing of production costs and profits by individual orders could be determined.

Little information concerning this proposal had been available prior to the time the Banking and Currency Committee reported the bill. There had been no invitation to Government agencies or representatives of industry and the accounting profession to make known their views. The bill was passed by the House on June 4, 1968 in the form recommended by the Committee.

As I mentioned, the General Accounting Office at that time was concentrating much of its energies in the direction of the comprehensive OEO review. GAO has a February 1, 1969 deadline on completion of this assignment. We were not expecting a new assignment of such large proportions and unforeseeable demands. Of course, to all of us here the challenge of applying uniform cost accounting standards in negotiated defense contracts is as clear as a bolt of lightning. However, after the thunder rolled away, we recovered our auditor's aplomb without unreasonable loss of time and prepared to make our views known on the proposed legislation when the time came for the Senate to consider the bill.

The Committee amendment to the Defense Production Act extension had its origins in testimony by two witnesses before the House Banking and Currency Committee: Mr. Price Daniel, Director, Office of Emergency Planning, and Vice Admiral H.G. Rickover.

The Admiral's testimony was frequently critical of the manner in which Government procurement was being accomplished, as well as of groups involved. These included elements in the Department of Defense, industry, and the accounting profession.

It is not necessary here to review in detail the Admiral's testimony. It is perhaps, best summed up with regard to accounting practices by his statements

- that "the lack of uniform accounting standards is the most serious deficiency in Government procurement today";
- that "industry will not establish such standards because it is not to their advantage to do so";
- that the accounting profession "has had ample time and opportunity to establish effective standards" but pays "only lip service to the concept"; and
- that "if uniform accounting standards are ever to be established the initiative will have to come from Congress."

Admiral Rickover then recommended an amendment to the Defense Production Act "to require contractors to account for costs under Government contracts in accordance with a uniform accounting standard." He also recommended that the legislation "require that defense contractors provide a report of costs and profit for each contract over \$100,000."

When the Senate Banking and Currency Committee conducted its hearings in June about a dozen witnesses testified, including the General Accounting Office, and the Committee received almost 100 statements

and letters. While a few favored the legislation, at least in part, the overwhelming weight of views expressed by witnesses opposed the legislation. It should be recognized that the opposition may have been predicated upon the belief or understanding that the bill was directed to uniform accounting systems rather than cost standards.

#### THE PROXMIRE AMENDMENT

Following the hearings, the Senate Committee reported the House bill but deleted all language having anything to do with "uniform accounting standards." However, when the bill was debated on the Senate floor, Senator William Proxmire of Wisconsin offered a modified amendment designed to accommodate some of the objections raised and recommendations offered during the testimony. Senator Proxmire's amendment was adopted by the Senate, agreed to by the House, and became law July 1, 1968 as a part of Public Law 90-370.

The Proxmire amendment provides that the Comptroller General, in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget, shall--and here I shall quote the language of the statute--

"undertake a study to determine the feasibility of applying uniform cost accounting standards to be used in all negotiated prime contract and subcontract defense procurements of \$100,000 or more. In carrying out such study the Comptroller General shall consult with representatives of the accounting profession and with representatives of that segment of American industry which is actively engaged in defense contracting. The results

of such study shall be reported to the Committees on Banking and Currency and the Committees on Armed Services of the Senate and House of Representatives at the earliest practicable date, but in no event later than eighteen months after the date of enactment of this section."

This is GAO's charter for the feasibility study we have now undertaken. We must make our report to the Congress by December 31, 1969.

The major compromise, of course, is found in the elimination of any requirement for establishment of uniform accounting standards and the substitution of a "study to determine the feasibility of applying uniform cost accounting standards . . ." Also, this was the first time the word "cost" appeared in the proposed legislation in conjunction with accounting standards.

The problem of attaining comparability of accounting results has been one which accountants have been attempting to solve for many years. As long ago as 1932 a committee of the American Institute of Certified Public Accountants and representatives of the stock exchanges met jointly to consider ways to improve corporate accounting and financial reporting and achieve better comparability of financial statements. The conclusion reached at that time was that the arguments against attempting to establish a detailed set of accounting rules to become binding on all corporations of a given class were overwhelming.

Since that time, accountants have continued to be concerned with the problem of uniformity and comparability of financial reports

and today the same conclusion, stated in different terms, still prevails for the reason that diversity in accounting among independent business entities is a basic fact.

The concept of uniformity, particularly as it relates to the costs and profits of Government contracts, is an attractive concept. There are potential benefits and advantages to be attained. These will have to be weighed however against possible increased costs, loss of supply sources, and burdensome duties of assuring compliance and reviewing results.

Over the years, the General Accounting Office has not been unmindful of the need for firm and well developed guidelines for contractors to follow in determining costs under Government contracts. We have worked closely with the Department of Defense toward that end. We long have believed that before any requirement is established by law that uniform cost accounting standards be developed for imposition on Government contractors, considerable research and study would be necessary. The practicability of developing uniform cost accounting standards, the variations and methodology involved in the various production processes and managerial techniques, and possibly the detail in which such standards should or could be prescribed all would have to be determined.

I need hardly remind this sophisticated audience of the extremely complicated definitions, questions, and related problems we face in the preparation, execution, and final determination of this study and what it will include. As we all know, defense contracts cover an almost unimaginable range of products and services ranging from very large single items such as one-of-a-kind warships and space launch vehicles to small items such as hand weapons and special tools produced by the tens of thousands.

## MANY TYPES OF INDUSTRIES AFFECTED

The electronics, food, aerospace, steel, aluminum, machinery and scientific instrument industries, among many others, are involved. The contracts represent a diversity of products such as services, scientific research, development of new products, production of hardware, chemicals, and some not even recognizable by laymen.

Almost as great a diversity is found in the manufacturing processes used by the contractors and as great a variety of management techniques is used in controlling their production.

Contractors' accounting systems are developed to satisfy the contractors' own requirements with respect to production methods, managerial techniques, and other needs imposed by the type of industry, its board of directors, and its stockholders. Each accounting system serves several purposes not all of which are defined with the same degree of importance or degree of need even in the same industry.

Government contractors range from the nation's largest business enterprises to the smallest of the small business men. Many single contractors produce a variety of products for Government consumption under as great a variety of manufacturing processes and managerial methods.

Now I would like to say a few words about our approach to the task. First, I appointed a Special Assistant to devote full time to this project until it is completed. He is Mr. William A. Newman, Jr., for many years the Director of GAO's Defense Division.

Second, in keeping with the provisions of the law, we have formed a coordinating committee composed of representatives of GAO, Department of Defense, and the Bureau of the Budget.

Third, we have--as the law provides--begun consultations with representatives of nine national accounting and industrial associations.

These include:

- The National Association of Accountants
- The Federal Government Accountants Association
- The American Institute of Certified Public Accountants
- The American Accounting Association
- The National Society of Public Accountants
- The Financial Executives Institute
- The Machinery and Allied Products Institute
- The Associated General Contractors of America, and
- The Council of Defense and Space Industry Associations

With few exceptions, all of these associations are participating, in some manner, in the feasibility study. Their cooperation is gratifying, to say the least. We will meet with representatives of other national professional and trade groups as their interest becomes known to us.

With some contractors, Government work represents the totality of the company's business; with others, it is only a fraction of their total business. For those for which Government business represents a large share of their total volume, any burdens imposed by such Federal requirements would be borne along with the present requirement of technical specifications and delivery dates.

However, the argument has been made that for those contractors for whom Federal procurement represents but a small part of their total volume, the addition of another Federal requirement such as we are discussing

might result in some of them refusing to accept further Government business and a drying up of valuable sources of supply.

This is an endeavor, therefore, in which we feel the advice and counsel of the professional accounting and trade associations is of paramount importance to its success. We will be leaning heavily upon these consultants and associations.

In addition, special consultants are making conceptual studies on cost accounting standards.

#### PURPOSES OF GAO STUDY

What are the objectives of the feasibility study? The coordinating committee has prepared a statement of such objectives.

Study will be directed to the feasibility of applying uniform cost accounting standards as a means of enhancing the comparability, reliability, and consistency of cost data used for negotiated procurement contract purposes. Such purposes include

- preparation and evaluation of cost-reimbursement claims under cost-type contracts;
- preparation of pricing proposals and related cost data support for negotiated contracts and repricing proposals under escalation, incentive, price redetermination clauses; and
- preparation of claims under contract terminations and contract financing.

Feasibility will be judged in terms of the capability of the standards to provide valid cost data generally acceptable and fair to all parties in an expeditious and economical manner.

To be feasible the standards must be workable, rather than merely having a quality of being possible without any consideration of the short and long range implications, both from the viewpoint of the public

and private sectors.

Major differences among various Government agencies in the promulgation of cost accounting standards will be identified and analyses made of the reasons for these differences.

The feasibility study will include consideration of those factors which bear upon the administrative costs of implementing uniform cost accounting standards.

The study will not concern itself with the cost/profit consequences on negotiated contracts. It will not attempt to relate the prescription of uniform cost accounting standards to the various reporting requirements of the Government other than indicated above or stand in judgment of the adequacy of such reporting.

Because some accounting terminology such as the terms "accounting standards" or "accounting principles" are not universally understood, it seemed necessary that the term "cost accounting standards" and the term "uniform" which are included in the basic statement be defined for the purposes of our study.

We have adopted the following definitions for these terms:

#### Cost Accounting Standards

As used in this study, "cost accounting standards" will embrace the related principles, standards, and general rules of procedures and the criteria for their usage. "Cost principles" suggest self-evident truths and axioms which have a degree of universality and permanence and which underlie, or are fundamental to, the derivation of cost accounting standards. "Cost accounting standards" relate to assertions which guide or point toward accounting procedures or applicable governing rules. Cost accounting standards are not the same as standardized or uniform cost accounting which suggests prescribed procedures from which there is limited freedom to depart.

Since the legislative history suggested Section XV of ASPR as a possible satisfactory starting point and Section XV includes many general rules of procedures, the term "cost accounting standards" is considered to include all three concepts; namely, principles, standards, and general rules of procedure.

### Uniform

The term "uniform" in the phrase "uniform cost accounting standards" should also be defined in terms of the legislative history. For the purpose of this study, "cost accounting standards" shall be deemed to be uniform when stated with the goal of achieving comparability, reliability, and consistency of significant cost data in similar circumstances and with due regard to the attainment of reasonable fairness to all parties concerned in such circumstances.

In considering the feasibility of applying uniform standards we are mindful of the trials and tribulations within the accounting profession in reaching agreement upon what constitutes "generally accepted accounting principles." We will look to our consultants and professional organizations to identify the relationship between "generally accepted accounting principles" and "cost accounting principles."

### FOUR STEP APPROACH

Briefly, here is our Four Step plan of approach:

First Step. We are conducting research as to the nature of cost accounting standards and their interrelationship to generally accepted accounting principles.

Your own National Association of Accountants plans to make available to us the results of a research project now under way. This involves identification of cost accounting practices applied to Government contracts and is being performed by Dr. James Bullock, University

of Michigan. NAA has agreed to formulate a statement of its recommended approach to cost accounting standards. The statement would point out the appropriate role of economic and engineering as well as accounting considerations in support of management's decision-making requirements.

The American Institute of Certified Public Accountants has undertaken a project to determine the relationship of cost accounting principles to "generally accepted accounting principles." The American Institute also is studying depreciation accounting and inventory accounting.

The Defense Contract Audit Agency has agreed to review for us the Armed Services Board of Contract Appeals and court decisions which tend to establish cost accounting principles through their interpretation of "generally accepted accounting principles."

As a consultant to the Comptroller General, we have obtained the services of Dr. Robert N. Anthony of Harvard University, until recently Assistant Secretary of Defense, Comptroller. He will study the Armed Services Procurement Regulation, Section XV, in an effort to seek ways and means of establishing improved criteria and guidelines for the use of various cost accounting principles.

We have engaged the consulting services of Dr. William J. Vatter, University of California, who has made cost accounting a lifelong pursuit, to prepare a paper setting forth certain basic ideas. We hope he will organize and present, from a distillation of what is accepted cost theory and practice, those generalizations that underlie cost analysis--generalizations to serve as standards for cost classification and assignment.

The Federal Government Accountants Association plans to study implications of the development and application of uniform cost accounting standards as they relate to the full-range of Government activities.

The FGAA study will include the areas of procurement, contract estimating and pricing, and financial reporting and program management.

The General Accounting Office will identify differences in the application of contract cost principles represented in the Armed Services Procurement Regulation, the Federal Procurement Regulations, and other implementing regulations by the several Government procurement agencies.

Second Step. We will seek attitudes and opinions from industry concerning the entire problem of adopting "uniform cost accounting standards." We hope to obtain some information concerning corporate attitudes and opinions through the use of a questionnaire. This will be designed to indicate from replies provided general attitudes of industry to two aspects of our study: (1) the feasibility of applying "uniform cost accounting standards" to negotiated defense contracts, and (2) what industry thinks of the present cost principles and procedures contained in ASPR Section XV.

We also will try to get a judgment from industry, if possible, on costs involved in adopting "uniform cost accounting standards" and information on individual experiences with the several Government procurement agencies as to differences in the cost principles which they have adopted.

Third Step. We will attempt to accumulate reliable information on various cost accounting methods and practices of industry relating to what we consider the more controversial or more difficult areas to the achieving of uniformity. We will see what light can be shed

upon these problems by means of the following two actions, taken or planned:

Through our own GAO Regional Offices and the regional offices of the Defense Contract Audit Agency, we have made a survey of the problem areas encountered in the application of the Armed Services Procurement Regulation, Section XV.

#### QUESTIONNAIRE TO INDUSTRY

We expect also to elicit from industrial firms--several hundred Government contractors and firms performing no Government work--information on cost accounting methods and practices. This will be done through the use of a questionnaire now being developed with the assistance of Dr. Robert K. Mautz, a consultant to the Comptroller General, who is currently at the University of Minnesota.

It is planned that an independent organization, probably a university, will have full control of the receipt, tabulation, and evaluation of the results of this questionnaire. This organization will be charged with responsibility of holding all responses confidential and making available to the Comptroller General and others, summaries and tabulations only. Thus, individual respondents in no way can be identified. This also will be the case with specific illustrations or particularly cogent comments included in the questionnaire findings.

The Comptroller General will issue the approved questionnaire which will be forwarded to respondent companies or organizational

segments, through their chief executive.

At the present time a first draft of this questionnaire prepared by Dr. Mautz, assisted by members of our staff, is under consideration at our Washington office.

As soon as completed the revised draft will be submitted to the participating trade associations, professional accounting organizations, and our coordinating committee for comment.

Upon receipt of their replies and revisions completed as may be desirable, a limited test of the practicability of the questionnaire by submission to a few industrial organizations, will be made. Final approval of the questionnaire will be made by the Comptroller General.

This questionnaire

- will ask for identifying information to provide bases for classification in tabulating responses.
- will seek factual information about cost accounting practices followed by respondent contractors which will enable the research staff to discern both patterns of similarity among companies and industries and significant dissimilarities.
- will request indications of acquaintance with and experience under Armed Services Procurement Regulation Section XV and evaluations of its effectiveness both in general and in terms of selected specific provisions.
- will provide an opportunity for expressions of opinion on such matters as the nature of "uniformity," the meaning of "cost accounting standards," and the overall feasibility of establishing and applying "uniform cost standards."

Throughout the questionnaire, an effort will be made to obtain answers relating to practices followed in accounting for U. S. Government contracts separate from practices followed in accounting for non-Government work. This should help to judge the necessity, if any, for separate standards for U.S. Government contracts.

Individual companies from whom data will be requested will be selected from

- lists of large, medium, and small government contracts prepared by the Council of Defense and Space Industry Associations (CODSIA), and Strategic Industries Association;
- a listing of prime government contractors for fiscal year 1968 having contracts over \$100,000 prepared by DoD and DCAA; and
- a listing of companies having little or no government contracts furnished by the Financial Executives Institute.

Fourth Step. We will get an evaluation of Section XV of the Armed Services Procurement Regulation as to its possible suitability as a starting point for the development of "uniform cost accounting standards."

The legislative history of the act creating the GAO study (Public Law 90-370) indicates the intent of Congress that we explore the possibility that the Armed Services Procurement Regulation, Section XV, could be used as a starting point for the development of "uniform cost accounting standards." As I have indicated, we have asked various professional accounting and trade organizations to study Section XV to identify its strong points or its weak points; to express opinions

as to its suitability as a starting point; and to suggest what would be needed if it were used as a basis for developing uniform cost accounting standards.

While I may not have made the point as directly as I might, or perhaps forcefully enough, let me say in conclusion that this study is an undertaking of unknown--as yet--possibilities for progress for Government and, I believe, for industry and the accounting profession.

The 20th century is a time when men do things that have not been done before. This dictum applies quite as much to the accounting profession as to any other.

There has been, as we all know, in effect a raising of protesting hands at the prospect of uniform cost accounting standards, a verdict before the evidence is in that such a thing cannot be done because it never has been done. Have we not heard this before?

Doubtless it will take time to find and understand ways to develop more uniform accounting practices in the diverse area of negotiated defense contracts. Through research, review, and application of the facts uncovered and understood to the test of feasibility or practicality, I am hopeful that our study will produce concrete results. For example, I believe a great service could be rendered to the accounting profession if better guidelines for the use of alternate methods could be developed for contractors in reporting the cost of performance under negotiated contracts with improved comparability, reliability, and consistency.

This year's step is to see what we can find out--as the law requires. All of us together must take this step; you in the profession, we in Government, those in hundreds of industries from whom we must receive the basic information. The more support we give each other, the more responsive all parties and individuals are to this undertaking, the surer we will be of the facts we uncover and the more satisfactorily we should be able to apply these facts toward improving financial management of the Federal Government's procurements.

I would urge that each and every one of you give the subject of "uniform cost accounting standards" serious thought. Keep in mind that "feasibility" as we view it does not mean merely having the quality of being possible. Nor does "uniform" mean simply a strait jacket. In my opinion, we should be working toward a goal of lessening those alternative methods just mentioned and prescribing the conditions for the use of those alternatives. If this cannot be done, put yourselves in our shoes and ask: "What can the GAO tell Congress that will not adversely reflect upon the accounting profession?"