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Address by the Comptroller General of the United States, Elmer B. Staats, to the Ninth Annual Institute on Government Contracts, Dallas, Texas, September 11, 1969

IS IT FEASIBLE TO APPLY UNIFORM COST ACCOUNTING PRINCIPLES AND STANDARDS IN GOVERNMENT CONTRACTS?

You have asked me to talk this evening on the subject of whether it is feasible to develop uniform cost accounting standards to be applied in the negotiation of Government contracts. If your reaction is that this is a highly technical subject for an evening address, you are of course correct!

I assume that you are less interested in the technical ramifications of the subject itself than you are in what it means for Government policy--what it means for those who supply the needs of the Government through contracts. You are interested because the subject is part of the broader subject of increased defense spending and the Federal budget problem as a whole.

Government procurement this year, to speak in general terms, is approaching a 60 billion dollar business. For fiscal year 1970 the total Government procurement budget for supplies, materials, and equipment amounts to more than 57 billion dollars. Approximately 86 percent of this amount is for national defense. This means that DOD's procurement this year amounts to over 49 billion dollars.

An understandable concern of the Congress is whether procurement dollars are being spent efficiently, whether the lowest cost contractor gets the contract, and whether the profits allowed are reasonable.

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Only about 11 percent of defense procurement is carried out through the formally advertised competitive contract, and this is down from about 14 percent 5 years ago. The 89 percent remainder--representing about 40 billion dollars--is carried out in the form of negotiated, noncompetitive procurements. More than one half of these are from a single source.

A majority of these negotiated procurements are noncompetitive and are priced on the basis of cost information available to the Government which, obviously, must be derived from the accounting data of contractors. Since contractors' cost accounting standards differ widely, they are not presently comparable. How, then, can the Government be assured as to the validity and equity of the costs allowed?

This was the question posed by Vice Admiral H. G. Rickover, Deputy Commander for Nuclear Propulsion, Naval Ship Systems Command, who testified in hearings before the House Banking and Currency Committee on the extension of the Defense Production Act last year. His testimony that there were no uniform accounting standards for determining costs largely provided the impetus for the legislation directing the General Accounting Office to undertake the study which is the subject of our discussion this evening.

Many of the examples of the results of this lack of uniformity used by Admiral Rickover in his testimony were drawn from General Accounting Office reports. These reports emphasized inconsistencies in the application of the Armed Services Procurement Regulation (ASPR) to the detriment of the Government.

Admiral Rickover has recently summarized his point succinctly in a letter to me as follows:

> "In the absence of true competition, the Government must rely on contractor cost estimates and cost records in pricing its contracts. However, under today's procurement rules, it is virtually impossible to discover what it costs to manufacture defense equipment and what profit industry makes in producing it--unless months are spent reconstructing suppliers' books. Government officials repeatedly face the Hobson's choice of delaying important work to analyze thoroughly and negotiate costs or placing the contract without understanding fully the basis for the price."

PROBLEM OF DIVERSITY

We all know that the diversity of accounting practice in use today throughout business, finance, and industry is based on the diversity of products and services sold or provided. This diversity is based also on management preferences, historical tradition, and indeed philosophical disagreement among accountants and financial managers. These differences in viewpoints are deep-seated. The professional accounting organizations for many years have attempted to bring about greater uniformity or consistency in accounting practices. Their success has been limited.

In fact, no group in industry, or in the accounting profession, both of whom have a vital interest in equitable contractor costing practices, has thus far been able, or has seen fit, to develop a set of specific standards to be followed which can be understood and can be relied upon. It is now the turn of the Federal Government to see whether it is feasible to apply uniform standards--or to have greater uniformity in standards--in one sector of the economy at least, that of defense procurement.

The new law became effective July 1, 1968. It directed the Comptroller General, in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget, to "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."

This is GAO's charter for the feasibility study.

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

Next--as the law also provided--we began consultations with representatives of industrial and professional associations. Their advice and counsel has been essential and important to our study and their cooperation has been gratifying.

EXAMPLES OF CONTRACTOR DEVIATIONS

One of the first steps we took was to request the Defense Contract Audit Agency (DCAA)--the agency that audits DOD contracts--to provide us with examples from its audit reports of how contractors have deviated from their consistent accounting practices in defense contract cost proposals or have treated cost incurred inconsistently with practices in their commercial business.

The deviations from, and inconsistencies in, defense contractors' accounting methods were shown by DCAA to be in the following areas:

--allocation of indirect expenses,

--classification of costs between direct and indirect, and

--election of whether costs should be capitalized or charged to expense.

The DCAA provided us with more than 50 examples from audit reports issued since June 1968. Cases concerning the question of how a given cost should be allocated are by far the most numerous in the DCAA portfolio. Not only do contractors allocate costs of a similar nature differently, but they frequently do so in a predictable manner. This problem relates to incurred and proposed costs and can be subdivided into two parts: direct vs. indirect, and the bases of allocation of indirect costs.

Here are two DCAA examples in the area of incurred costs, showing difficulties encountered by Government procurement officers because of the lack of uniform standards of accounting for costs.

A contractor incurred rearrangement costs totaling $234,000 for expanding its production facilities, necessitated by two new contracts. The contractor, however, charged $132,000 of the costs to certain contracts which had been completed before the incurrence of the costs and which had not benefited from the rearrangement.

In addition to the obvious impropriety of charging costs to contracts which received no benefit, this procedure was contrary to the contractor's written policy.

In the second case a contractor charged to overhead as "rental of building services" fees of $276,000 for architectural and engineering services for the construction and alteration of various facilities. The treatment of the fees was not consistent with that for other costs of the facilities in question which had been capitalized as leasehold improvements. The cost was clearly of a capital nature and should have been capitalized.

In case after case, instances were noted where a contractor identified various direct costs in submitting proposals for fixed-price contracts while at the same time including costs of a similar nature identifiable to other work of the contractor in overhead and allocating a portion thereof to the proposed contract.

Where a cost is allocated directly to a contract, costs of a similar nature should be deleted from overall pools when submitting proposals. In short, a contractor should not ask, or be permitted, to "have it both ways."

Another problem arises when contractors deviate from their existing cost-reporting and accumulation practices in presenting cost proposals. There are many recorded instances of contractors allocating costs, for purposes of submitting cost proposals, in a manner different from the way they ultimately record costs for cost performance.

In one case, a contractor normally used one plant wide overhead rate for its commercial work. However, in submitting a proposal for a fixed-price contract with the Government, the contractor proposed a series of overhead rates by different product lines. The contractor indicated that it did not intend to change its accounting system to record costs in the manner proposed. More importantly, although it had been proposing overhead on the product-line basis for 3 or 4 years, the contractor had made no attempt to maintain even an informal record that would reflect the actual costs by product lines.

Inconsistencies and deviations such as these take on, as I have suggested, various forms, but they usually have two characteristics in common--(1) Government contracts are burdened too frequently with excessive charges and (2) it is difficult for Government negotiators to compare costs of contractors that are capable of performing the work desired.

Obviously, the question of narrowing the areas of difference and inconsistency continues to be a controversial one. Some hold that diversity in accounting among independent business entities is a basic fact of life. And one of the reasons the subject is controversial is that the word "uniform" does not convey a precise concept and certainly not a common understanding.

GAO'S DEFINITIONS OF ACCOUNTING TERMS

Because accounting terminology is not universally understood, it seemed necessary that the term "cost accounting standards" and the term "uniform"--which are included in the basic law I quoted earlier--be defined. For the purposes of our study, we have adopted the following definitions:

Cost Accounting Standards

> Cost accounting standards 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 Cost Accounting Standards

> 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.

Accordingly, our approach has been to see whether it is possible to provide greater uniformity and consistency in cost accounting principles and standards used in presenting cost proposals and the accumulation of costs for Government contracts. We are not considering--nor did the Congress intend that we consider--uniform cost accounting systems. I think we could also point out that we have approached the problem on the assumption that there may be room for alternative standards to be applied in accordance with specified criteria.

We have held innumerable conferences with organizations and individuals concerned from industry, accounting, universities, and Government. We sought their attitudes and opinions concerning the entire problem of adopting "uniform cost accounting standards" through the use of a questionnaire. Some of you may now be familiar with the questionnaire. The responses to it from business, industry, and others are fundamental to our study.

PURPOSE AND DEVELOPMENT OF GAO QUESTIONNAIRE

The questionnaire is best understood as a tool for obtaining reliable, first-hand information necessary in deciding the feasibility of establishing uniform cost accounting standards. The questions we asked were designed for the specific objectives of the study.

The questionnaire requested opinions and invited suggestions from representatives of companies as to propositions or statements which guide them in their cost accounting practices. Such propositions, if existing, would be helpful in the development of uniform cost accounting standards for all defense contracts.

The questionnaire had other purposes. It provided a means of obtaining substantial amounts of factual information regarding cost accounting practices followed in industry generally.

A decision made early in the development of the questionnaire was that it should be designed to be answered by contracting units rather than by companies. In some cases these are corporations, in some cases divisions of corporations, and in some cases a portion of a large corporative group.

Rather than attempt to get a single questionnaire response from a contracting company or family of companies, the decision was made to seek answers from those people most likely to be working directly with Government contracts. Thus, the questionnaire would be answered by those best informed on the problem of accounting for Government contracts--usually the chief accounting officers of units contracting with the Government.

This method had the further advantage of providing information on the variety of practices followed by contracting units and on the extent of similarity and dissimilarity in their accounting problems.

Responses received bear out the wisdom of this decision.

DISTRIBUTION OF QUESTIONNAIRE

The basis of distribution of the questionnaire was a Department of Defense listing of companies awarded negotiated contracts in fiscal year 1968. All contractors receiving contract awards of 100 million dollars or more were sent questionnaires. An average of 12 percent of all contractors receiving awards between $100,000 and $10 million, selected on a sampling basis, were sent questionnaires.

Contractors representative of every program in the Department of Defense list were included.

We included companies other than Government contractors in the questionnaire sample because we wanted to obtain some indication of the extent to which that part of industry having no Government contract business has developed uniform cost accounting standards. In addition, any company which indicated it wished to receive a questionnaire was sent one. Its response was tabulated along with the others.

To provide confidentiality for all responses and to relieve those to whom questionnaires were sent of any feeling of Government pressure, questionnaires were returned when completed to an independent research staff at the University of Illinois headed by Professor Robert K. Mautz for processing, interpretation, and a report thereon. I will have more to say about this in a moment.

Classification of returned questionnaires by size of company, type of activity, and experience with Government contracts indicates that returns are satisfactorily representative. These returns were as follows:

Companies with Contracts Issued 1968	Mailed	Response	Percent of Returns
Awards over $50 million	96	84	88
Awards $10 million to $50 million	330	266	81
Awards under $10 million	947	474	50
	1373	824	60

A great many people obviously gave generously of their time and thought in responding to the questionnaire. Question after question brought carefully considered, well-expressed views. Any questionnaire distributed broadly is subject to a fair amount of misinterpretation. Certain respondents did read into individual questions points which we had no intention of raising; for example, that the questionnaire was developing a basis for cost accounting systems rather than standards. Even in these cases, responses in general were restrained and constructive. Only in a few instances did respondents take a hard-line position opposing any effort to establish cost accounting standards. Almost without exception, respondents found one or more of the proposed cost accounting standards acceptable. Many noted that certain ones were directly in accord with what they were now doing.

There is of course an understandable fear that standards might be imposed which could interfere with the development of useful management information and/or be used to the disadvantage of contractors in negotiations with the Government.

Answers did indicate that clearly stated standards do exist for some areas and that for others procedural or definitional rules effectively provide control over cost determination. Some companies reported the existence of procedural manuals which serve the purposes of cost accounting standards within their companies.

The existence of underlying ideas on which practices and definitions are based is strongly implied. In some instances, formulation of these ideas into stated propositions approaches the nature of cost accounting standards.

PROCESSING RESPONSES TO THE QUESTIONNAIRE

Early in the development of the questionnaire, consideration was given to the most appropriate processing of questionnaire returns. Should they be returned to the GAO? Would industry representatives be willing to respond candidly and completely to a questionnaire which was to be returned to Government representatives? Would the results of the questionnaire study be looked upon as unbiased by all concerned if they were received and interpreted by members of an organization which might be considered to have some interest in the establishment of uniform cost accounting standards?

We came to the conclusion that the responses should be received, tabulated, and interpreted by an independent research organization to which I referred a moment ago. Bv this method, respondents could be assured of confidentiality in the handling of their answers to the several questions. Completed questionnaires were not made available to members of the General Accounting Office staff or any other Government representatives, in any way. This procedure protected the General Accounting Office from any charge of bias in interpretation of the returned questionnaires.

The research staff consisted essentially of three members of the academic staff of two universities--the University of Illinois and the University of Minnesota. Addressed envelopes were provided to respondents so that the questionnaires could be mailed directly to Professor Mautz at the University of Illinois. Upon receipt, the outer cover of the questionnaire, which was the only page on which designation of the respondent was called for, was removed. Through use of a code number, the cover was identified with the remainder of the questionnaire. The identifying covers were then filed separately from the questionnaires and were available only to the three senior members of the research staff.

Next, the statistical content of the questionnaire responses was transferred to machine-sensible coding sheets. This was a clerical process, calling for no interpretation and it required only that due provisions be made for adequate supervision and review. The machine-sensible coding sheets were then converted by electronic data processing equipment into punched cards from which various tabulations were prepared.

Once this clerical operation was completed, every narrative response was read by one or another of the senior members of the research staff. This required careful interpretation of each response, particularly as they were seeking any clues which might be found in the answers indicating that companies had already established guides which might properly be described as cost accounting standards. Following review of the narrative answers, the research staff members discussed their conclusions and collaborated in the interpretative report to GAO.

"ON THE RECORD" COMMENTS

In addition to completing the questionnaire, we invited professional and industrial organizations and some Government procurement agencies to comment on various aspects of our study. Among other things, we solicited their views specifically on the possibility of adopting Section XV of the Armed Services Procurement Regulation--ASPR--as a starting point for developing uniform cost accounting standards.

We wanted their opinions as to the strengths, weaknesses, and general suitability of Section XV as a starting point. Here are some excerpts from replies received from four of the organizations. These excerpts also shed some light on the attitude of these organizations toward the more basic question of whether or not uniform cost accounting standards are feasible for negotiated defense contracts.

The American Institute of Certified Public Accountants provided us with a series of thoughtful statements as to the suitability of Section XV as a starting point. These, developed by its Committee on National Defense, are too long to be quoted here. The central points of its statement seemed to us to be the following:

--Section XV is basically integrated with generally accepted accounting principles and cost accounting used by industry.

--Section XV contains a good statement of allocability concepts which have general applicability; it also contains some allocation rules. In practice, there are wide differences among contractors in how these concepts and rules are applied.

--Various rules are established in Section XV in certain selected cost areas where generally accepted accounting principles may need to be narrowed or reviewed, such as pension costs, depreciation, material costs, intercompany pricing, independent R&D, and bidding and proposal costs.

--Section XV contains pricing considerations which have nothing to do with cost accounting. * * * (These) pricing considerations need to be clearly differentiated from cost accounting considerations.

--Section XV seems to offer a number of suitable cost accounting concepts for use in developing uniform cost accounting standards. Finding such good starting points and proceeding with care, research and testing offer the best chance of success in developing a good set of cost accounting standards.

--If the cost accounting elements of Section XV were to become the core of uniform cost accounting standards, it is possible that specific guidelines could be developed which would provide guidance beyond the general allocability criteria and beyond generally accepted accounting principles.

FGAA (Federal Government Accountants Association) likewise provided us with a statement much too long and intricate to be quoted here. It was prepared by a special five-member AD HOC Committee. Its points salient to our review this evening appeared to be these two, which I am quoting:

--"This committee has concluded, on the basis of its review and collective experience, that a more definitive set of uniform cost accounting standards than now contained in the FPR (Federal Procurement Regulation) or ASPR (Armed Services Procurement Regulation) is required to assure that proposals received from responding sources are consistent accountingwise.

--"The committee believes uniform cost accounting standards for defense contracts are feasible and should be definitively formulated to provide the Government with greater assurance that cost data received from responding bidders and contractors are comparable and reflect real operating differences rather than the use of different accounting principles and practices."

AGCA (The Associated General Contractors of America) said that statements on cost accounting principles should be limited to general policy that provides guidelines for the determination of those costs which constitute direct and indirect charges and overhead or general and administrative expense. AGCA said that "the purpose of Section XV does not fulfill this application for the construction industry."

SIA (Strategic Industries Association) stated:

> "Our position is that Section XV of the ASPR is not a basis for the adoption of uniform cost accounting standards; nor can we suggest, within the context of the immediate question, improvements in that section."

CODSIA (Council of Defense and Space Industry Associations) asked a task group representing eight industry associations and member companies for their views concerning the use of Section XV as a basis for development of uniform cost accounting standards. CODSIA told us that some task group members and their companies felt that certain paragraphs of ASPR XV already go as far as possible in establishing standards "heterogeneous" for defense industry. Others, CODSIA said, "have a strong conviction" that ASPR XV cannot be used as a basic document for establishment of standards, as that term was defined and illustrated by GAO.

MAPI (Machinery and Allied Products Institute) replied that it opposes the concept of uniform cost accounting standards and believes that legislation on the point is neither necessary nor desirable.

FEI (Financial Executives Institute), on the other hand, replied in part as follows:

> "We believe that certain portions of Section XV when separated from the rest of the Section and other Regulations

could, and in our opinion should, be incorporated into any body of cost accounting standards that might be developed if the (GAO) feasibility study indicated that this would be desirable. * * *

"With full industry participation, it should be possible to develop a set of cost accounting standards that could be generally applied and used by industry."

In another part of its statement, FEI went on to say that the two definitions in ASPR for direct costs and indirect costs could be used as a starting point for the development of a set of cost standards.

CHALLENGE OF WRITING STANDARDS

Whether our study leads us to the conclusion that uniform cost accounting standards are feasible, it is an understatement to say that it would be difficult to write standards that would be acceptable to everyone.

Any standards to be fully effective must be workable and must be generally acceptable.

Acceptability would depend chiefly on two factors.

One factor would be the ability of those who write the standards to communicate clearly the interest and purpose of those standards.

The other factor would be the necessity to develop standards general enough to be applied in diverse industrial activities but specific enough to achieve a greater degree of uniformity.

The most difficult problem is to write standards that would achieve this balance.

Standards must be stated in terms general enough so that contractors will not find themselves in "straightjackets." But contractors must accept some discipline in their choice of cost accounting practices.

Let me give you an example.

A dollar of direct labor should mean the same thing to all parties required to use the data. Data users should know either that the dollar of direct labor reported includes only the actual time the laborer worked or that it includes the actual time worked plus all normal nonproductive time, such as coffee breaks and downtime because of mechanical failures of machines. Data users should also know whether only the laborer's basic hourly wage is included or whether the basic hourly wage plus company-paid fringe benefits are included.

Cost data has little value to anyone if everyone uses different ground rules in its preparation.

We cannot claim that our feasibility study thus far has given us a precise "fix" as to how detailed or how general standards should be written. But we have brought together a vast amount of information and expert testimony bearing on the problem.

PROBLEM OF DEPRECIATION

Before closing, I would like to mention once more this matter of acceptability. General acceptance of a standard would certainly establish feasibility of adoption. But, as mentioned earlier, the different and built-in objectives of the participating parties to negotiated Government contracts create divergent views as to the acceptability of a standard. We are, therefore, faced with a fundamental question: Is general acceptance necessarily a prerequisite?

The Government is motivated to make the tax dollar buy as much defense material as it reasonably can. Therefore, Government officials, in looking at depreciation as a distribution of the cost of a fixed asset over its economic useful life, may, in a given case, view the expiration of such useful life as occurring evenly over each year of the asset's life--straight-line depreciation.

A contractor, on the other hand, being motivated to avoiding as much risk as possible and to maintaining as strong a financial position as he can, may favor accelerated depreciation as the most appropriate of accounting alternatives. There is another reason why a contractor might prefer the use of an accelerated method of depreciation: Speaking broadly, it generates a greater immediate cash flow as a result of reduced income tax payments.

It is clear therefore why financial managers are motivated to seek the highest depreciation rates allowable under current income tax regulations. It is also clear why the same financial managers would seek high depreciation rates, when product price negotiations are based upon estimated costs or where estimated costs are at least a predominant factor. This is management's prerogative.

On the other hand, it is more than the prerogative--it is the lawful duty--of Government contract negotiation officials to determine that cost data offered in support of negotiated contracts reflect actual costs. Where prices are based upon or are influenced by production costs--that is, where cost data becomes a "standard" for pricing--the cost data should represent true costs as accurately as possible.

Under conditions where there are opposing economic interests, it seems apparent that acceptability cannot be an essential criterion for judging feasibility.

CONCLUSION

All that we have been discussing boils down, essentially, to this: Government procurement officers should know what an article costs with some assurance that the costs have been determined according to uniform criteria, consistently applied.

That brings me to the end of my talk. Our draft report will soon be distributed for review by selected accounting and industry organizaations, Government agencies, and consultants. Their comments, criticisms, and suggestions will be solicited for consideration before the final report is written and sent to the Congress at the end of the year.

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