



**Feasibility Of Applying Uniform
Cost-Accounting Standards To
Negotiated Defense Contracts** B-39995 (1)

Public Law 90 - 370

**BY THE COMPTROLLER GENERAL
OF THE UNITED STATES**

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This is our report on the feasibility of applying uniform cost-accounting standards to negotiated defense prime contracts and subcontracts of \$100,000 or more.

Our study was performed pursuant to the provisions of section 718 of the ~~Defense Production Act of 1950~~, as amended (50 U.S.C. app. 2167).

James B. Stacks

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT ON
FEASIBILITY OF APPLYING UNIFORM COST
ACCOUNTING STANDARDS TO NEGOTIATED
DEFENSE CONTRACTS 8-39995(1)

Public Law 90-370

D I G E S T

WHY THE STUDY WAS MADE

A 1968 amendment to the ~~Defense Production Act of 1950--Public Law 90-370~~ directed the General Accounting Office (GAO) to study the feasibility of applying uniform cost accounting standards to negotiated defense contracts of \$100,000 or more.

A growing proportion of purchases--or procurements--by the Department of Defense (DOD) have been contracted for on a negotiated, rather than a formally advertised bid basis.

In the last five (fiscal) years an average of over 86 percent of DOD procurements by contract were obtained through negotiation. Out of an average of approximately \$38 billion a year awarded for military procurements, approximately \$33 billion was committed through negotiated contracts.

In fiscal year 1969, 89 percent of military procurement--over \$36 billion--was obtained by contract negotiation. In the same year, Government-wide negotiated procurement represented \$46 billion out of a total procurement of \$53 billion or more than 86 percent.

During the Congressional debate prior to enacting the legislation views were expressed that uniform cost-accounting standards are necessary mainly because of substantially increased costs of procurement and difficulties in contract administration. In a negotiated bid situation the estimate of a contractor's cost plays an important role in the establishment of the price. The cost of any specific order can only be measured by the application of cost accounting principles.

In the Senate debate the view was expressed that 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.

It was pointed out in the debate that 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 cost standards recognized by Government and industry.

FINDINGS AND CONCLUSIONS

"General cost principles and procedures" for use in negotiated Defense contracts are contained in Section XV of the Armed Services Procurement Regulation (ASPR). However, the effectiveness of section XV is impaired because:

- It makes frequent references to generally accepted accounting principles and/or regulations of the Internal Revenue Service, neither of which was intended to serve contract costing purposes.
- It lacks specific criteria for the use of alternative accounting principles and indirect cost allocation methods.
- It is of limited applicability, since it is mandatory for only cost-reimbursement type contracts. (See p. 10.)

Uniform cost-accounting standards could provide a common framework for estimating prospective cost or for the determination of the actual cost of a contract. They could provide the guidance, support, and coordination required for better understood estimates and subsequent reports of actual costs. (See p. 13.)

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. (See p. 22.)

However, under all the wide variety of circumstances involved in Government contracting, it is not feasible to establish and apply cost-accounting standards in such detail as would be necessary to ensure a uniform application of precisely prescribed methods of computing costs for each of the different kinds of cost. (See p. 22.)

Cost-accounting standards should not be limited to Defense cost-type contracts. They should apply to negotiated procurement contracts and subcontracts, both cost-type and fixed price. They should be made applicable Government-wide. (See p. 23.)

Cumulative benefits from the establishment of cost-accounting standards should outweigh the cost of implementation. (See p. 23.)

New machinery should be established for the development of cost-accounting standards. The objective should be to adopt at an early date the standards of disclosure and consistency and to strive for the elimination of unnecessary alternative cost-accounting practices. (See p. 24.)

Contractors should be required to maintain records of contract performance costs in conformity with cost-accounting standards and any approved practices set forth in a disclosure agreement or be required to maintain the data from which such information could be readily provided. (See p. 25.)

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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.~~ 279, ~~July 1, 1968~~).

WHY THE CONGRESS PASSED THE LAW

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

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> pro- <u>urement</u>	<u>Nego-</u> <u>tiated</u> pro- <u>urement</u>	<u>Percent</u> nego- <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 by 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 Regula-~~
~~tion (ASPR)~~ contains general cost principles and procedures
for the determination and allowance of costs in the

negotiation and administration of cost-reimbursement-type contracts and contains guidelines for use, where appropriate, in the evaluation of costs of certain negotiated fixed-price-type contracts¹ and contracts terminated for the convenience of the Government. (See app. II.) Similar, though not identical, guides are contained in the Federal Procurement Regulations (FPRs) which apply to procurements made by civilian agencies. The civilian agencies are permitted to implement or supplement the FPRs with their own procurement regulations.

Section XV relies heavily on the conventional practices of contractors. It provides that, in ascertaining what constitutes costs, any "generally accepted method" of determining or estimating costs that is "equitable under the circumstances" may be used. Elsewhere, it places a dependence upon "generally accepted accounting principles." In some areas, section XV also accepts, generally, the accounting methods accepted by the Internal Revenue Service for income tax purposes.

The following are not adequate for contract costing because they have been designed for different purposes.

- Generally accepted accounting principles.
- Regulations of the Internal Revenue Service.

¹A change in section XV which would have the effect of fully applying the cost principles to negotiated fixed-price contracts, rather than their being general guidelines, is under consideration by the Department of Defense.

--Regulations of the ~~Securities and Exchange Commis-~~
sion.

--Rules adopted by the Renegotiation Board.

Generally accepted accounting principles are concerned primarily with those reports of financial condition and results of total operations for a company, developed principally for stockholders and others interested in the financial condition and operating results of the company as a whole. Such principles are directed at cost allocations between fiscal years so that a company's net income is fairly stated for each successive year. Except as may be necessary for determining the amount of inventory reported in the contractor's balance sheet, they do not go into such details as cost allocations between products and services within a fiscal year; for example, indirect cost distributions between Government contracts and other work of the contractor.

Consequently, "generally accepted accounting principles" are being called upon by ASPR and the FPRs to serve a function they were never intended to serve. There are many indirect cost allocation methods available and in use today; however, generally accepted criteria for each method used in specific circumstances have not been developed or established. Hence, even in the valuation of inventories, there is a need for specific criteria for the indirect cost allocation methods used in contract costing.

Regulations of the ~~Internal Revenue Service~~ are intended to implement the laws in taxing the income of corporations and individuals. Tax laws, in addition to

raising revenue, are intended to achieve a variety of social goals quite foreign to the purposes of contract costing. In addition, tax assessment and collection are continuous so that, except for differences in tax rates, shifts of income or expense from one year to another generally do not have a significant effect on total tax paid over a period of time. However, similar shifts of cost from one year to another, as well as other shifts of costs, could have a decided impact on the costs chargeable to a Government contract.

The Securities and Exchange Commission (SEC) has been concerned primarily with reporting of the financial condition and results of total operations of corporations which are required to file reports pursuant to the Securities Exchange Act of 1934. SEC has the authority to prescribe the accounting rules for financial reporting to the public but has made it known that it expects the accounting profession to assume the main part of this task. Recently SEC issued a notice of a proposed revision (Release No. 8682, dated September 15, 1969) to expand the form of reporting in annual reports to be filed with SEC to include data on sales and revenues and income or loss attributable to major lines of business. Comments received on the proposal are now under consideration by SEC. The furnishing of data such as income or loss by lines of business will require the use of generally accepted methods of cost allocation.

The function of the Renegotiation Board is to eliminate excessive profits derived by Government contractors and subcontractors in connection with the National Defense

Program. The Board conducts its proceedings on an overall fiscal-year basis for all renegotiable business of each contractor rather than on an individual contract basis. Costs allocable to a contractor's renegotiable business are to be determined in accordance with the method of accounting employed by the contractor in determining net income for Federal income tax purposes or in accordance with such other method as the Board and the contractor may agree upon.

In summary, neither generally accepted accounting principles nor the regulations of the three Government agencies discussed above meet the need for contract costing purposes.

While the provisions of section XV of ASPR are intended to provide general cost-accounting guidance and procedures for defense contracting, its effectiveness is impaired because:

- It makes frequent references to generally accepted accounting principles and/or regulations of the Internal Revenue Service, neither of which, as indicated above is intended to serve contract costing purposes:
- It lacks specific criteria for the use of alternative accounting principles and indirect cost allocation methods.
- It is of limited applicability, since it is mandatory for only cost-reimbursement-type contracts.

APPENDIXES TO THIS REPORT

Appendix I contains section 718 of the Defense Production Act of 1950, as amended, and our interpretation of the terms "Cost-Accounting Standards" and "Uniform" based upon the legislative history of the act. It contains also a

description of the many-faceted features of the study including the participation of many organizations and individuals both within and outside the Government.

Appendix II contains an excerpt of ASPR, section XV, representing part 1 and a portion of part 2 which contains the general cost principles and procedures for use in Department of Defense contracts with commercial firms.

Appendix III contains an analysis of current problem areas in the assignment of Government contract costs, reference to related parts of ASPR, section XV, and matters for consideration in the formulation of cost-accounting standards. It contains also some general conclusions relative to cost-accounting standards.

Appendix IV contains a summary of the significant comments the GAO received on an earlier draft report.

Appendix V is an evaluation of responses to a questionnaire which was circulated to a fairly large segment of industry doing both defense work and nondefense work. The questionnaire was designed to obtain information on current cost-accounting practices and other information relevant to the question of feasibility. The evaluation of the responses was prepared by Professor Robert K. Mautz (Department of Accountancy, University of Illinois, and consultant to the GAO) and his associates Professor K. Fred Skousen (The University of Minnesota) and David L. Smith (The University of Illinois).

Appendix VI is a research study entitled "Standards for Cost Analysis" prepared by Professor William J. Vatter (The University of California, Berkeley, and consultant to

the GAO). This study was addressed to the question of what cost-accounting standards are or should be and how such standards would affect the processes of cost analysis.

All the appendixes, with the exception of V and VI are included as a part of this report. Appendixes V and VI, because of their size, are separately bound.

CHAPTER 2

COST-ACCOUNTING STANDARDS

POTENTIAL BENEFITS AND LIMITATIONS

When prices are established under something less than fully competitive conditions and the restraints of the market operate imperfectly--as in the case of many negotiated Government contracts--cost data must play a large role in contract negotiation, administration, and settlement. Under such conditions, cost-accounting practices followed can make a substantial difference in results and variations in cost assignment can become a matter for concern. In such situations equitable agreements depend heavily upon logical, consistent, and valid cost measurements.

POTENTIAL BENEFITS

In contract negotiations, an understanding of the contractor's cost-accounting practices--those in general use and those claimed to be unique to a particular industry or individual enterprise--is of importance to negotiators. Cost-accounting standards, 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, could supply the guidance, support, and coordination required for better understood cost estimates and subsequent reports of actual costs.

Standards could facilitate the preparation and reporting of cost information by contractors and its audit and evaluation by the Government. They could provide guidance in helping to ensure that items of costs on a given contract are reported on a consistent basis and are comparable with

(1) costs originally proposed or projected and (2) costs cited in financing arrangements, interim and final reports, change orders, claims for reimbursement, price redeterminations or adjustments, and termination claims. Standards could also require that the basis upon which forecasts of costs are predicated be disclosed; 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 for use in Government procurement operations could improve the communicative process now existing between the Government, the Congress, industry, and the public generally.

Standards could 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.

Standards could 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 disclosure by the contractor of his cost-accounting practices and agreement thereto by the responsible Government representative, could do much to promote a common understanding as to the methods of cost determination to be used consistently under the specific.

circumstances and thereby minimize subsequent controversy in the administration and settlement of the contract. For example, no single method of overhead cost allocation suits all contractors' situations equally well. Standards could provide underlying criteria for determining when certain methods are appropriate and when they are not. For some situations there may be no one best method and the question of the method to be adopted can best be solved by an advance disclosure agreement.

Cost-accounting standards, if adopted by all Government departments and agencies for use on all negotiated Government contracts, could eliminate, to a considerable extent, differences within the Government as to interpretations of acceptable cost-accounting practices.

LIMITATIONS

Cost-accounting standards could not, by themselves, ensure that contracts will be effectively negotiated, administered, and settled or, for that matter, that costs will be determined in accordance with those standards. But cost-accounting standards could assist those responsible for contract negotiation, administration, and settlement to reach a common understanding of contract terms and then hold contractors to report in accordance with such terms.

Neither could nor should cost-accounting standards eliminate the diversity in the way contractors do business or require them to keep uniform accounts. Different experiences have led different contractors to adopt different accounting practices. Within such environment cost-accounting standards necessarily have limitations.

As an example, consistency is considered a standard by most accountants. A requirement for consistent cost-accounting practices from negotiation through performance of a given contract would be an improvement over present practices. Such a requirement appears to be an essential minimum requirement, although cost-accounting standards should be expected to accomplish something more. On the other hand, to require consistent uniform cost-accounting practices for all contractors, whatever the circumstances, involved in contract performance, goes to such an extreme as to be unreasonable and unenforceable. Consistency in the cost-accounting practices for all contractors in similar contracting situations appears to be a desirable objective.

Because of the complexity and diversity of the operations of different contractors, cost-accounting standards cannot be stated in sufficient specificity to recognize all cost-accounting problems arising from such diverse operations. Because they must of necessity be stated somewhat broadly, they cannot anticipate and provide specific guidance for all types of cost-accounting questions that might be involved.

CHAPTER 3

MAJOR COST ACCOUNTING PROBLEM AREAS

Our study indicates that a recurring problem in Government contracting is that, in reporting to the Government on both proposed and incurred costs, contractors may select from alternative accounting methods without specific criteria governing such selection. Moreover, there is no statutory procedure governing the maintenance of Government contract records or the manner in which contract costs will be recorded. Contractors sometimes present cost data in pricing proposals differently from the way they record their cost of performance. This makes the execution of several administrative responsibilities quite difficult.

One such difficulty concerns verification of supporting cost data in proposals submitted by contractors in compliance with Public Law 87-653, the Truth-in-Negotiations Act, approved September 10, 1962. That act provides, with certain exceptions, that a prime contractor and any subcontractor be required to submit cost or pricing data prior to the award of any negotiated prime contract of over \$100,000 and any subcontract thereunder of over \$100,000 and to certify that to the best of his knowledge and belief the cost or pricing data he submitted was accurate, complete, and current.

Under ~~Public Law 87-653~~, the prime contractor must agree also that the price to the Government, including profit or fee, be adjusted to exclude any sums by which the price of the contract was increased because the data furnished were inaccurate, incomplete, or noncurrent.

Second, since there is no requirement that a contractor or subcontractor 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, as would seem to be reasonable to require, meaningful audits of negotiated contracts by the Government agencies and GAO are rendered more difficult.

In that regard, ~~Public Law 90-512~~, approved September 25, 1968, provides that--for the purpose of evaluating the accuracy, completeness, and currency of cost or pricing data required to be submitted under Public Law 87-653--any authorized representative of the head of the agency who is an employee of the U.S. Government shall have the right to examine all books, records, documents, and other data of the contractor or subcontractor related to the negotiation, pricing, or performance of the contract or subcontract.

Also, section ~~2313~~ of Title 10, ~~United States Code~~, provides that every contract negotiated by the Defense agencies, the ~~Coast Guard~~, and the ~~National Aeronautics and Space Administration~~ contain a provision that the Comptroller General and his representatives be entitled to examine any books, documents, papers, or records of the contractor or any of his subcontractors that directly pertain to, and involve transactions relating to, the contract or subcontract. A similar requirement is applicable to contracts negotiated by the civilian agencies. (~~41 U.S.C. 254 (c)~~)

Attachment V, appendix III, sets forth a list of the principal contract costing problem areas reported to us by the field offices of the Defense Contract Audit Agency and

GAO. Among the most common of these are inconsistencies in distinguishing between direct and indirect costs and allocation of indirect costs.

In some of the cases studied, contractors charged directly to Government work costs of a nature which were normally handled as indirect costs but did not adjust indirect charges to eliminate similar costs which were also charged to the contractor. Sometimes this occurred when costs had been included in the indirect cost rates which were used for pricing of prior and subsequent contracts. The effect therefore was to recover the same charges twice.

In some cases costs normally handled as direct charges were handled as indirect charges. This occurred in situations where the costs were not acceptable as direct charges due to a ceiling or other limitation on costs of the contract to which they were directly related. For example, as noted in appendix III, attachment I, page 7, a contractor, faced with a loss on a firm fixed-price contract, charged \$1.6 million in direct costs of the contract to overhead. The \$1.6 million in costs consisted of salaries of persons working directly on the contract and reproduction work and briefing film which were specifically called for in the contract. By handling these direct costs as indirect costs, they were charged to all the contractor's business, including other Government contracts. This, in turn, distorted the true cost of the related and other Government contracts.

When a cost applies to more than one objective, the relationship to any one of the objectives is considered to be indirect. Indirect costs, in the aggregate, represent

the largest single class of expense incurred under Government contracts. The allocation of indirect costs is one of the most controversial areas in cost accounting for Government contracts and is subject to alternative approaches. It is not a problem that can be solved by simple or rigid rules. Indirect cost assignments of necessity cannot be as accurately determined as direct ones, but they still must be based on some demonstrable relationships between the reasons why costs were incurred and the cost objectives to which they are assigned.

Because allocation of indirect costs first involves an accumulation process, each pool of such costs should contain only costs which are homogeneous--i.e., similar in the sense that they are amenable to adding together without distorting the significance of the results when spread among cost objectives on a single or common allocation base. For example, personnel-related costs, materials-related costs, and machine-related costs may not, in given situations, be logically grouped together and spread among cost objectives on a single common base.

In the cases we have examined, the problems involving the allocation of indirect costs are most numerous. They generally center on the homogeneity concepts noted above, i.e., (1) costs were improperly combined for allocation on a common base and/or (2) the allocation base did not provide for an appropriate assignment of the costs involved to the cost objectives charged. These situations arise in connection with both proposed and incurred costs. There were some instances where contractors in submitting cost data

in pricing proposals deviated from their normal indirect cost allocation practices.

NEED FOR DISCLOSURE

Underlying many of the cost-accounting problems we observed is a need for a written agreement of cost-accounting practices to be followed by the contractor.

The determination of which types of cost are treated as direct costs and which ones are treated as indirect costs and their bases of allocation depends largely upon the diverse methods of operation among contractors. Thus, it seems that an important cost-accounting requirement would be an advance disclosure agreement with the contractor as to its proposed method of determining and distinguishing direct costs from indirect costs and the basis for allocating indirect costs. The agreement should also provide that the agreed-upon classifications of "direct costs" and "indirect costs" and allocation methods be consistently applied. Appropriate changes in accounting practices needed because of significant changes in a contractor's operations could be recognized by a change in the agreement and appropriate adjustment in price if warranted.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

As a result of this study our conclusions and recommendations are as follows:

1. 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.

--It is not feasible to establish and apply cost-accounting standards in such detail as would be necessary to ensure a uniform application of precisely prescribed methods of computing costs for each of the different kinds of cost, under all the wide variety of circumstances involved in Government contracting.

--Emphasis should be directed to disclosure, consistency, and establishment of criteria for the use of alternative cost-accounting methods.

--To the extent that contractors or divisions of contractors could be grouped on the basis of similarities in the nature of their operations or in contracting situations, the standards for such groups could be stated in more specific terms.

--The cost-accounting methods to be used in the reporting of costs in support of the bid proposal and interim administrative actions and in the settlement of the contract or contracts of a particular contractor could be specified in greater detail by the use of advance written disclosure agreements. In

essence, these agreements would further elaborate upon the cost-accounting standards and thus would better ensure a mutual understanding as to the cost-measurement methods to be employed.

--More explanatory material and better criteria for identifying and measuring direct and indirect costs and for the allocation of indirect costs should have high priority in establishing cost-accounting standards in the interest of providing a better understanding among the users of cost data as to their meaning and significance.

2. Cost-accounting standards should not be limited to Defense cost-type contracts. They should apply to negotiated procurement contracts and subcontracts, both cost type and fixed price. They should be made applicable Government-wide.

3. Cumulative benefits from the establishment of cost-accounting standards should outweigh the cost of implementation.

--Cost-accounting standards for contract costing purposes should evolve from sound commercial cost-accounting concepts and should not be incompatible with generally accepted accounting principles. Therefore extensive modifications to present accounting systems would not seem to be necessary in most cases. Although some modifications to existing systems may be necessary, we do not see the need for new or separate accounting systems.

--Costs which might be incurred directly by the Government will depend largely on:

- a. The capabilities of the agency to which the responsibility for establishing and maintaining cost-accounting standards is assigned.
- b. The recognition of the need for continuing research into the use of cost-accounting standards to keep pace with changing technologies.
- c. The cooperation of the accounting profession, of industry, and of other Government agencies with the designated agency.

--Cost which might be incurred by contractors in implementing cost-accounting standards, whether they are ultimately borne by the Government or by the individual contractor, will vary from contractor to contractor and will depend largely on:

- a. The cooperation and capabilities of individual contractors' organizations.
- b. The extent to which present cost-accounting and management-information systems can produce cost data for negotiated contracts in accordance with cost-accounting standards.

4. New machinery should be established for the development of cost-accounting standards. The objective should be to adopt at an early date the standards of disclosure and consistency and to strive for the elimination of unnecessary alternative cost-accounting practices--alternatives not required for equitable recognition of differing circumstances.

- This should be a gradual process building upon past experience.
- Considerable research in actual operating situations will be necessary and should be done in close cooperation with contractors, procuring agencies, and professional accounting organizations.
- Cost-accounting standards should not be developed under the same mechanism or procedures now used for section XV of ASPR. Since they should be applied to procurement by all Government agencies, it is important that new machinery be established to develop the cost-accounting standards and to perform the continuing research and updating that will be required for effective administration. Cost-accounting standards should be issued as a separate document rather than as a part of or amendment to FPRs or to ASPR. However, such standards could be incorporated by reference in those regulations.
- Periodic reports to the Congress should be made to keep the interested members and committees informed as to the progress and status of the assignment.

5. Contractors should be required to maintain records of contract performance costs in conformity with cost-accounting standards and any approved practices set forth in a disclosure agreement or be required to maintain the data from which such information could be readily provided.

APPENDIX I
BASIC LEGISLATION, DEFINITIONS, AND
SCOPE OF FEASIBILITY STUDY

BASIC LEGISLATION, DEFINITIONS, AND
SCOPE OF FEASIBILITY STUDY

BASIC LEGISLATION

The General Accounting Office (GAO) study of the feasibility of applying uniform cost-accounting standards to defense procurements was undertaken pursuant to statutory direction contained in section 718 of the Defense Production Act of 1950, as amended July 1, 1968 (50 U.S.C. App. 2167), which provides that:

"The Comptroller General, in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget, shall 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."

DEFINITION OF TERMS

In the light of the legislative history, the term "cost accounting standards," as used in our study, embraces the related principles, standards, and general rules of procedures and the criteria for their usage. "Cost principles" suggests 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 which point toward accounting procedures or applicable governing rules. Cost-accounting standards are

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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 the Armed Services Procurement Regulation (ASPR) as a possible satisfactory starting point and since 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.

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.

SCOPE OF FEASIBILITY STUDY

Our study included a wide variety of activities, and our efforts were many faceted. They involved coordination within the Government and substantial contacts with representatives of industry and the accounting profession; the use of consultants for special purposes; the development and circularization of a questionnaire; and a number of other survey, review, and analytical procedures.

Coordination within Government

In accordance with the requirement of section 718 of the Defense Production Act, to perform the feasibility study in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget, GAO established a Coordinating Committee with these agencies that met from time to time during the study.

The members of the committee offered advice and counsel about their specific areas; arranged meetings with operating personnel; conducted special studies as requested; and, in turn, were kept apprised of the progress of the study.

Consultations with industry and
accounting profession

Also in keeping with the provisions of section 718, we consulted, during the study, with representatives of the accounting profession and of industry. We held meetings and discussions, encouraged the submission of written views, and provided opportunities for interested groups to research and report on particular aspects related to the problem of uniform cost-accounting standards. A questionnaire was developed, which was widely circularized to industry and others in order to provide, among other things, a further means of eliciting varied points of view on cost-accounting standards.

Meetings and discussions were held with the following organizations, some of whom also cooperated by providing written material or reports presenting information for consideration in the study.

ACCOUNTING PROFESSION:

American Accounting Association
American Institute of Certified Public Accountants
Federal Government Accountants Association
Financial Executives Inst.
National Association of Accountants
National Society of Public Accountants

INDUSTRY:

The Associated General Contractors of America
Council of Defense and Space Industry Associations:
Aerospace Industries Association, Inc.
Automobile Manufacturers Association, Inc.
Electronic Industries Association
National AeroSpace Services Association
National Association of Manufacturers
National Security Industrial Association
Scientific Apparatus Makers Association

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Shipbuilders Council of America
Western Electronic Manufacturers Association
Machinery and Allied Products Institute
National Council of Technical Service Industries
National Electrical Contractors Association, Inc.
Strategic Industries Association

OTHERS:

American Bar Association
Interagency Regulatory Accountants Committee

Specific contributions toward our feasibility study, as well as information on current research efforts in related areas, are summarized below.

The American Accounting Association appointed a task force to provide us with comments on a draft of this report and to be available for considering problems that might arise.

The American Institute of Certified Public Accountants (AICPA), through its Committee on National Defense, prepared a report for use in our study on its review of the strengths, weaknesses, and general acceptability of section XV of ASPR. This organization also provided us with a history of both generally accepted accounting principles and the work of the Accounting Principles Board.

AICPA has under way other research studies. One is a research study of basic cost concepts and implementation criteria. This research study deals with concepts used in cost determinations for all purposes, including costs of specific contracts and costs in financial statements. It should help define cost-accounting principles and their interrelationship to generally accepted accounting principles. This project is expected to be completed by the end of 1970.

The Accounting Research Division of AICPA is currently conducting studies relating to inventory pricing, depreciable assets, and industrial research and development expenditures, with the objective of narrowing the alternatives currently available in accounting for these items. Although these studies are directed primarily to financial accounting

considerations, they will also have an important bearing on cost accounting.

The Federal Government Accountants Association, through an ad hoc committee, prepared a research report for our study setting forth its views and comments on such matters as (1) the need by the Government, in general, for valid and consistent cost data, (2) the relationship of uniform cost-accounting standards to generally accepted accounting principles, (3) the nature and specificity of standards, (4) administration of standards, once they have been established, (5) suggestions for implementing standards, and (6) the impact of uniform cost-accounting standards on the regulatory agencies.

The Financial Executives Institute provided us with a report prepared by its Government Procurement Policies Committee on the results of a review of section XV of ASPR and other Government agency procurement regulations. The report contains that committee's views with respect to the use of such regulations as a starting point for the development of uniform cost accounting standards and problem areas in achieving uniformity.

The National Association of Accountants made a review of its research studies, articles, and reports from its membership and committees and provided selections from those which seemed relevant 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. This association is making a research study on "Relevant Cost Concepts and Their Applications in Government Contract Pricing." The plan of this study includes a review of contract pricing practices and problems arising in the determination of contract costs.

The Associated General Contractors of America furnished us with a brief concerning the views of that association on the applicability of the cost principles contained in section XV of ASPR to the construction industry.

The Council of Defense and Space Industries Association prepared for us an analysis of paragraphs 201 to 204

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of section XV of ASPR. The analysis was made to determine whether the provisions of such paragraphs could be used as a basic starting point for the development of uniform cost-accounting standards.

Use of consultants

To assist us in our research efforts, we engaged the services of the following consultants.

Professor William J. Vaster, University of California (Berkeley): to perform a study of cost-accounting concepts in a search for what cost-accounting standards are or should be and how such standards would affect the processes of cost analysis, especially as to their impact on the determination of product or activity costs. His report is included as appendix VI.

Professor Robert N. Anthony, Graduate School of Business Administration, Harvard University: to review section XV of ASPR in an effort to seek ways and means of establishing improved cost principles and their applications. (This research is incomplete.)

Professor Robert K. Mautz, University of Illinois: to assist the staff of GAO in the preparation of a questionnaire and, with the assistance of Professor K. Fred Skousen, School of Business Administration, University of Minnesota, and David L. Smith, Department of Accountancy, University of Illinois, to analyze the responses to the questionnaire and to prepare a report summarizing the responses. His report is included as appendix V.

Questionnaire

The specific purposes of the questionnaire may be listed as follows:

1. To test, for both present and possible future usefulness, a four-way cost classification model which, if feasible, might provide sounder bases for associating given costs with specific contracts or with other cost objectives.

2. To obtain certain kinds of information about cost-accounting practices now in use.
3. To invite respondents to volunteer information regarding criteria which they now apply in their cost-accounting practices that might provide a basis for the development of cost-accounting standards.
4. To obtain from respondents their opinions of a number of suggested cost-accounting standards as an indication of the specificity with which cost-accounting standards might be formulated.
5. To seek opinions from respondents about the feasibility of using advance agreements on accounting standards to be applied to Government contracts.
6. To obtain respondents' opinions regarding the acceptability of section XV of ASPR as a starting point for developing uniform cost-accounting standards.

Representatives of the Coordinating Committee, trade associations, and the accounting profession and certain individuals provided helpful suggestions during the development of the questionnaire. Several trade associations and the Financial Executives Institute furnished us with the addresses of companies to which the questionnaire could be sent.

Questionnaires were circulated to about 1,400 plants, divisions, and affiliates of defense contractors and to about 750 nondefense companies. Also, questionnaires were sent to about 200 Defense Contract Audit Agency (DCAA) auditors, 84 Department of Defense (DOD) procurement officers, 16 GAO regional managers, heads of Federal departments and agencies, representatives of Federal regulatory agencies, and members of the Interagency Regulatory Accountants Committee.

To ensure the confidentiality of responses to the questionnaire, industry recipients, DCAA auditors, and DOD procurement officers were requested to submit their completed questionnaires to Professor Mautz at the University of

Illinois Professor Mautz, in addition to the duties mentioned earlier, was charged with responsibility for holding confidential all individual responses to the questionnaire and for making available to us summarized tabulations, representative illustrations, and various comments deemed by him to be of interest to us.

Responses to the questionnaire from Government agencies other than DOD were made directly to us.

Survey work by members of the Coordinating Committee

Department of Defense

DCAA prepared reports for use in our study covering (1) troublesome areas in applying the cost principles contained in section XV of ASPR, (2) a history of principles for determining costs of performing Government military contracts, (3) decisions by the Armed Services Board of Contract Appeals and the Federal courts relating to accounting matters, (4) a comparison of the contract cost principles of ASPR, Federal Procurement Regulations, National Aeronautics and Space Administration Procurement Regulations, and the Atomic Energy Commission Procurement Regulations, (5) examples of contractors' deviations from consistent accounting practices or differing accounting treatments as cited in DCAA audit reports, (6) accounting principles and practices in other countries, (7) industry views regarding major revisions to ASPR and the feasibility of uniform cost-accounting standards, and (8) views on a variety of subjects by its contract audit personnel.

The Office of the Assistant Secretary of Defense, Installations and Logistics, provided us with a report on the history of military procurement and arranged briefings with procurement and contracting officials of the various services within DOD.

General Accounting Office

Other efforts during the study by GAO included (1) a review of the legislative history of section 718 of the Defense Production Act, (2) a survey of problem areas shown by GAO reviews that pertained to the application of cost

principles to Government contracts, (3) a survey of procurement cost principles of selected Federal departments and agencies, (4) an analysis of the differences between provisions of section XV of ASPR and the regulations followed by the Renegotiation Board, (5) a survey of the contract cost records maintained by 45 selected contractors, (6) an analysis of over 100 cases resulting from prior GAO and DCAA reviews to determine the types of problems which might be lessened by cost-accounting standards, (7) visits to selected procurement offices of DOD, contractors plants, and DCAA offices, (8) visits and discussions with procurement, auditing, and accounting representatives of various Federal departments and agencies, (9) analyses of responses to the questionnaire which were submitted directly to GAO, and (10) contacts with 81 different trade associations throughout the continental United States to elicit information as to whether they had prescribed or advocated, directly or indirectly, specific cost standards or principles for use by member companies.

APPENDIX II
EXISTING "CONTRACT COST PRINCIPLES AND PROCEDURES"
IN THE ARMED SERVICES PROCUREMENT
REGULATION

EXISTING "CONTRACT COST PRINCIPLES AND PROCEDURES"

IN THE ARMED SERVICES PROCUREMENT REGULATION

The present cost principles used in Department of Defense procurements are contained in section XV of the Armed Services Procurement Regulation. That section is divided into several parts. There are individual parts (1) for use in cost-reimbursement-type supply and research contracts with commercial organizations, (2) for research and development under grants and contracts with educational institutions, (3) for construction and architect-engineer contracts, (4) for contracts for industrial facilities, (5) for determining cost under grants and contracts with State and local governments, and (6) for cost determinations applicable to training and other educational services under grants and contracts with educational institutions. There is also a part dealing with the application of the principles to the negotiation and administration of fixed-price-type contracts and to the negotiation or termination settlements.

Part 1, Applicability, and portions of Part 2,¹ Principles and Procedures for Use in Cost-Reimbursement Type Supply and Research Contracts with Commercial Organizations (current as of December 15, 1969), are reproduced herein. Omitted from Part 2 is section 15-205 which deals more specifically with some 47 selected items of cost.

¹ 15-201 Basic Considerations
15-202 Direct Costs
15-203 Indirect Costs
15-204 Application of Principles and Procedures

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SECTION XV

CONTRACT COST PRINCIPLES AND PROCEDURES

15-000 Scope of Section. This Section contains general cost principles and procedures for the determination and allowance of costs in connection with the negotiation and administration of cost-reimbursement type contracts and contains guidelines for use, where appropriate, in the evaluation of costs in connection with certain negotiated fixed-price type contracts and contracts terminated for the convenience of the Government.

Part 1—Applicability

15-101 Scope of Part. This Part describes the applicability of succeeding Parts of this Section to the various types of contracts in connection with which cost principles and procedures are used.

15-102 Cost-Reimbursement Supply and Research Contracts With Concerns Other Than Educational Institutions. This category includes all cost-reimbursement type contracts (3-405) for supplies, services, or experimental, developmental, or research work (other than with educational institutions as to which 15-103 applies, and other than with state and local governments as to which 15-108 applies), except that it does not include facilities contracts (see 15-105) or construction contracts (see 15-104). The cost principles and procedures set forth in Part 2 of this Section shall be incorporated by reference in cost-reimbursement supply and research contracts with other than educational institutions as the basis—

- (i) for determination of reimbursable costs under such contracts, including cost-reimbursement type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts (3-406.1) except in such contracts where material is priced on a basis other than at cost in accordance with 3-406.1(d);
- (ii) for the negotiation of overhead rates (Section III, Part 7); and
- (iii) for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" his costs (Section VIII, Part 4), and for settlement of such contracts by determination (S-210.7).

15-103 Cost-Reimbursement Research Contracts With Educational Institutions. This category includes all cost-reimbursement type contracts (3-405) for experimental, developmental, or research work with educational institutions. The cost principles and procedures set forth in Part 3 of this Section shall be incorporated by reference in cost-reimbursement research contracts with educational institutions as the basis—

- (i) for determination of reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;

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- (ii) for the negotiation of overhead rates (Section III, Part 7); and
- (iii) for the determination of costs of terminated cost reimbursement type contracts where the contractor elects to "voucher out" his costs (Section VIII, Part 4), and for settlement of such contracts by determination (8-210.7).

In addition, Part 3 is to be used in determining the allowable costs of research and development performed by educational institutions under grants.

15-104 Construction Contracts.

(a) Part 4 of this Section contains principles and procedures for the evaluation and determination of costs in connection with contracts and subcontracts for construction, and other than with state and local governments as to which 15-108 applies. This category includes all contracts for the construction, alteration, or repair of buildings, bridges, roads, or other kinds of real property. It also includes contracts for architect-engineer services related to such construction. It does not include contracts for vessels, aircraft, or other kinds of personal property.

(b) The applicability of Part 4 to fixed-price type contracts and subcontracts is set forth in Part 6 of this Section.

(c) Part 4 applies to all cost-reimbursement type contracts (3-405) for construction, as described in (a) above. The cost principles and procedures set forth in Part 4 of this Section shall be incorporated by reference in cost-reimbursement construction contracts as the basis—

- (i) for determination of reimbursable costs under cost reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;
- (ii) for the negotiation of overhead rates (Section III, Part 7); and
- (iii) for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" his costs (Section VIII, Part 4), and for settlement of such contracts by determination (8-210.7).

15-105 Facilities Contracts. Part 5 of this Section contains principles and procedures for the evaluation and determination of costs under facilities contracts (13-101.11) and subcontracts thereunder. Such principles and procedures shall be incorporated by reference in facilities contracts as the basis—

- (i) for determination of reimbursable costs under facilities contracts including cost-reimbursement type subcontracts thereunder;
- (ii) for the negotiation of overhead rates (Section III, Part 7); and
- (iii) for the determination of costs of terminated facilities contracts where the contractor elects to "voucher out" his cost (Section VIII, Part 4), and for settlement of such contracts by determination (8-210.7).

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APPLICABILITY

15-106 Use of Cost Principles for Fixed-Price Contracts. Part 6 of this Section provides guidance for the use of Parts 2, 3, and 4 where appropriate, in the evaluation of costs in connection with the negotiation of certain fixed-price type contracts and termination settlements.

15-107 Advance Understandings on Particular Cost Items. The extent of allowability of the selected items of cost covered in Parts 2 through 5 has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in connection with firms or separate divisions thereof which may not be subject to effective competitive restraints. In order to avoid possible subsequent disallowance or dispute based on unreasonableness or non-allocability, it is important that prospective contractors, particularly those whose work is predominantly or substantially with the Government, seek agreement with the Government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Such agreement may also be initiated by contracting officers individually, or jointly, for all defense work of the contractor, as appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts, or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost treatment covered thereby throughout the performance of the contract. But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. Examples of costs on which advance agreements may be particularly important:

- (i) compensation for personal services;
- (ii) use charge for fully depreciated assets;
- (iii) deferred maintenance costs;
- (iv) precontract costs;
- (v) research and development costs;
- (vi) royalties;
- (vii) selling and distribution costs;
- (viii) travel costs, as related to special or mass personnel movement;
- (ix) idle facilities and idle capacity; and
- (x) leasing of automatic data processing equipment (ADPE).

15-108 Grants and Contracts With State and Local Governments. Part 7 of this Section provides principles and standards for determining costs applicable to grants and contracts with State and local governments. They are designed to provide the basis for a uniform approach to the problem of determining costs and to promote efficiency and better relationships between grantees and the Government. These cost principles apply to all programs that involve grants and contracts with State and local governments. They do not apply to grants and contracts with:

- (i) publicly financed educational institutions subject to Part 3 of this Section; or
- (ii) publicly owned hospitals and other providers of medical care subject to requirements promulgated by the sponsoring Government agencies. Any other exceptions will be approved by the Bureau of the Budget in particular cases when adequate justification is presented.

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Part 2—Principles and Procedures for Use in Cost-Reimbursement Type Supply and Research Contracts With Commercial Organizations

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits. In ascertaining what constitutes costs, any generally accepted method of determining or estimating costs that is equitable under the circumstances may be used, including standard costs properly adjusted for applicable variances.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of individual items of cost include (i) reasonableness, (ii) allocability, (iii) application of those generally accepted accounting principles and practices appropriate to the particular circumstances, and (iv) any limitations or exclusions set forth in this Part 2, or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Definition of Reasonableness.

(a) *General.* A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to effective competitive restraints. What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, consideration shall be given to

- (i) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;
- (ii) the restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and State laws and regulations, and contract terms and specifications;
- (iii) the action that a prudent business man would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government and the public at large; and
- (iv) significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs.

(b) *Application of "Contractor Weighted Average Share in Cost Risk" (CWAS).*

(1) Except as provided in (2) and (3) below, to the extent that the allowability of an indirect cost is based on reasonableness of the nature and amount, the reasonableness shall be determined by reliance upon the approved "contractor weighted average share in cost risk" (CWAS) (see Section III, Part 10, for the definition of CWAS), computed from data of the year in which the cost was incurred, as follows:

- (i) if the profit center within which the cost was incurred has a CWAS rating of 65 points or higher, 35 points or more of which rating were derived from competitive firm fixed-price contracts or commercial sales, the reasonableness of the cost will not be questioned (but see 3-1004(b)); but

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- (ii) if the profit center within which the cost was incurred has a CWAS rating of 50 or higher but less than 65, the provisions of (i) above may be applied at the discretion of the administrative contracting officer.

(2) The cost principles contained in 15-205, or in certain cases their subparagraphs, carry either a "(CWAS)" or a "(CWAS-NA)" indicator. Those cost principles or subparagraphs subject to CWAS are preceded by the indicator "(CWAS)" and those to which CWAS is not applicable are preceded by the indicator "(CWAS-NA)". In all cases where cost reasonableness is not determined under CWAS because of its express inapplicability, the determination will be made in accordance with (a) above.

(3) The determination of cost reasonableness will be made in accordance with (a) above in all cases where the contractor could not qualify or does not choose to qualify under CWAS.

(4) Questions involving the charging off of assets or setting up of other than normal year-end accruals or reserves will be considered to be questions of allocability or accounting practices rather than reasonableness.

(5) If the profit center incurs costs (e.g., travel, relocation, personnel compensation) on the basis of prescribed corporate-wide policy uniformly applied to all profit centers, consideration should be given to the corporate CWAS in determining the reasonableness of such locally incurred costs.

(6) The CWAS rating for the company shall be used in testing the reasonableness of corporate type expenses which are allocated to the profit centers. If the contractor has intermediate management organizations, such as Groups, he shall develop a CWAS rating for such intermediate management organizations, which rating shall be applicable to the expenses allocated by such intermediate organizations to the profit centers.

(7) Indirect costs incurred in cost centers which are applied to specific contracts without relation to total profit center operations may be eliminated by the ACO from the application of CWAS.

15-201.4 Definition of Allocability. A cost is allocable if it is assignable or chargeable to a particular cost objective, such as a contract, product, product line, process, or class of customer or activity, in accordance with the relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it—

- (i) is incurred specifically for the contract;
- (ii) benefits both the contract and other work, or both Government work and other work, and can be distributed to them in reasonable proportion to the benefits received; or
- (iii) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

15-201.5 Credits. The applicable portion of any income, rebate, allowance, and other credit relating to any allowable cost, received by or accruing to the contractor, shall be credited to the Government either as a cost reduction or by cash refund, as appropriate.

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**SUPPLY AND RESEARCH CONTRACTS WITH COMMERCIAL ORGANIZATIONS
15-202 Direct Costs.**

(a) A direct cost is any cost which can be identified specifically with a particular cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work.

(b) This definition shall be applied to all items of cost of significant amount unless the contractor demonstrates that the application of any different current practice achieves substantially the same results. Direct cost items of minor amount may be distributed as indirect costs as provided in 15-203.

15-203 Indirect Costs.

(a) An indirect cost is one which, because of its incurrence for common or joint objectives, is not readily subject to treatment as a direct cost. Minor direct cost items may be considered to be indirect costs for reasons of practicality. After direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs are those remaining to be allocated to the several classes of work.

(b) Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring the costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative expenses are separately grouped. Similarly, the particular case may require subdivisions of these groupings. *e.g.*, building occupancy costs might be separable from those of personnel administration within the manufacturing overhead group. The number and composition of the groupings should be governed by practical considerations and should be such as not to complicate unduly the allocation where substantially the same results are achieved through less precise methods.

(c) Each cost grouping shall be distributed to the appropriate cost objectives. This necessitates the selection of a distribution base common to all cost objectives to which the grouping is to be allocated. The base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives. This principle for selection is not to be applied so rigidly as to complicate unduly the allocation where substantially the same results are achieved through less precise methods. Once an appropriate base for the distribution of indirect costs has been accepted, such base shall not be fragmented by the removal of individual elements. Consequently, all items properly includable in an indirect cost base should bear a pro rata share of indirect costs, irrespective of their acceptance as Government contract costs. For example, when a cost of sales base is deemed appropriate for the distribution of G&A, all items includable to cost of sales, whether allowable or unallowable, shall be included in the base and bear their pro rata share of G&A costs.

(d) The method of allocation of indirect costs must be based on the particular circumstances involved. The method shall be in accord with those generally accepted accounting principles which are applicable in the circumstances. The contractor's established practices, if in accord with such

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accounting principles, shall generally be acceptable. However, the method used by the contractor may require re-examination when—

- (i) any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or
- (ii) any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances.

(e) A base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. Normally, the base period will be the contractor's fiscal year; however, use of a shorter period may be appropriate in case of (i) contracts whose performance involves only a minor portion of the fiscal year, or (ii) where it is general practice in the industry to use a shorter period. In any event the base period or periods shall be so selected as to avoid inequities in the allocation of costs. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

(f) Special care should be exercised in applying the principles in (b), (c), and (d) above when Government owned contractor operated (GOCO) plants are involved. The distribution of corporate division or branch office general and administration expenses to such plants when they operate with little or no dependence on corporate administrative activities, may require more precise cost groupings, detailed accounts screening, and carefully developed distribution bases.

15-204 Application of Principles and Procedures.

(a) Costs shall be allowed to the extent that they are reasonable (see 15-201.3), allocable (see 15-201.4), and determined to be allowable in view of the other factors set forth in 15-201.2 and 15-205. These criteria apply to all of the selected items of cost which follow, notwithstanding that particular guidance is provided in connection with certain specific items for emphasis or clarity.

(b) Costs incurred as reimbursements to a subcontractor under a cost-reimbursement type subcontract of any tier above the first fixed-price subcontract are allowable to the extent that allowance is consistent with the Part of this Section XV which is appropriate to the subcontract involved. Thus, if the subcontract is for supplies, such costs are allowable to the extent that the subcontractor's costs would be allowable if this Part 2 were incorporated in the subcontract; if the subcontract is for construction, such costs are allowable to the extent that the subcontractor's costs would be allowable if Part 4 of this Section XV were incorporated in the subcontract.

(c) Selected items of cost are treated in 15-205. However, 15-205 does not cover every element of cost and every situation that might arise in a particular case. Failure to treat any item of cost in 15-205 is not intended to imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related selected items.

APPENDIX III
PROBLEM AREAS IN THE ASSIGNMENT
OF GOVERNMENT CONTRACT COSTS

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INTRODUCTION

The Comptroller General was directed by Public Law 90-370 to undertake a study to determine the feasibility of applying uniform cost-accounting standards to all negotiated defense prime contracts and subcontracts of \$100,000 or more.

Shortly after the passage of Public Law 90-370, the General Accounting Office (GAO) and the Defense Contract Audit Agency (DCAA) requested our respective field offices to identify, in general terms, the principal problem areas in the costing of defense contracts, with particular reference to the cost principles contained in section XV of the Armed Services Procurement Regulations (ASPR). DCAA field offices submitted 341 comments, and GAO field offices submitted 95. A tabulation of these 436 comments, by problem areas, is contained in attachment V.

The hearings held prior to the enactment of Public Law 90-370 also highlighted problems confronting Government contract negotiators. These stemmed largely from inconsistencies in the assignment of costs to and among Government contracts. Several of the contracts involved were awarded prior to the enactment in 1962 of the Truth-in-Negotiations Act (10 U.S.C. 2313(b)). Some have argued that the act has gone far toward alleviating the problems.

To obtain a further insight into the specific cost-accounting problems currently involved in contract costing, we again explored the experiences of DCAA and GAO auditors, but this time on a more detailed, case-by-case basis. Further, to obtain some more specifics regarding inconsistent treatment of costs by defense contractors, we asked DCAA to provide us with such cases as might be readily available in which changes from contractors' normal accounting practices had taken place for purposes of submitting cost proposals or where deviations had been noted between cost accounting for cost-type and fixed-price contracts.

DCAA subsequently provided us with summaries of 53 audit reports, most of which had been issued subsequent to

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June 1968, covering both proposed and incurred costs. As reported to us by DCAA, the cases selected constituted a limited effort by its field offices and had been selected on the basis of the field offices' "recollection of such audit reports having been issued." To ensure confidentiality, contractor names were deleted from the cases submitted to us.

There were 37 GAO cases, about equally divided between matters occurring before and after 1965, which, when added to those provided by DCAA, gave us a total of 90 cases involving about 70 different defense contractors. In some of these cases amounts considered to be excessive had been included either in requests for reimbursement or in pricing proposals. In some cases corrective action had been taken during the administrative process. Other cases were representative of the inconsistencies in accounting practices followed by the contractors for contract purposes in comparison with costing practices for other purposes.

We have also included suggestions for consideration during the formulation of uniform cost-accounting standards. These suggestions necessarily represent tentative views pending more comprehensive study in the development of such standards in cooperation with industry, the accounting profession, and Government agencies.

PROBLEM AREAS IN THE
ASSIGNMENT OF GOVERNMENT CONTRACT COSTS

A recurrent theme throughout the cases we examined was that alternative methods, without adequate criteria governing their use, are employed by Government contractors in reporting similar proposed and incurred costs for Government contract purposes. A related problem arises when contractors deviate from their existing cost accumulation and reporting practices in presenting cost proposals. During contract performance, however, they continue to record costs as in the past rather than in the manner in which costs were proposed. This makes verification difficult for purposes of determining compliance with the Truth-in-Negotiations Act. We believe that it would be highly desirable for the same guidelines to be applied to both the preparation of the price proposal and the accounting for cost of performance.

The 90 cases revealed 120 separate problems bearing on the presentation of both proposed and incurred costs, which can be summarized as follows:

	<u>Problems</u>		
	<u>Total</u>	<u>DCAA</u>	<u>GAO</u>
Distinctions between direct and indirect costs	40	32	8
Allocation of indirect costs	56	25	31
Accounting for tangible capital assets	13	8	5
Accounting for credits	<u>11</u>	<u>6</u>	<u>5</u>
	<u>120</u>	<u>71</u>	<u>49</u>

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Digests of the cases reviewed are contained in attachments I through IV, arranged by the subject matter designations shown in the above table. These cases are similar to, or are the same as, those mentioned in hearings held prior to the enactment of Public Law 90-370 and are similar also to those problems reported initially by DCAA and GAO field offices referred to on page 1 of this appendix.

The basic problem, as we see it on the basis of the cases we reviewed, is one of inconsistency by contractors in the assignment of Government contract costs. We believe that, to assist in overcoming this difficulty, a standard of consistency is needed in cost-accounting practices as they relate to Government contracts. This standard of consistency should be enunciated as applying to both Government-versus-commercial business and all types of Government contracts. To implement this standard, a requirement for improved cost accounting should be an advanced-disclosure agreement with the contractor as to its proposed method of determining and distinguishing direct costs from indirect costs, indirect cost groupings, bases of allocation, and methods of allocation. If conditions change, the agreement between the contractor and the Government should be amended.

DISTINCTIONS BETWEEN
DIRECT AND INDIRECT COSTS

Contractors sometimes charge indirectly costs which should be charged directly, because the costs are specifically identifiable with either Government or commercial work. Conversely, costs are sometimes charged directly even though no specific identification to a cost objective exists. Specific illustrations of indirect costs charged directly are included in attachment I.A. Illustrations of the converse situation--direct-type costs charged indirectly--are listed in attachment I.B.

Most of the cases cited in attachment I.A. point up situations wherein the contractors charged directly to Government work costs which were normally handled as indirect costs and did not adjust their indirect charges to eliminate similar costs from indirect costs also charged to the contract. Sometimes these costs had been included in the indirect cost rates which were used for the pricing of prior and subsequent contracts. The effect therefore was to recover the same charge twice.

In some cases costs normally handled as direct charges were handled as indirect charges because they would not be acceptable as direct charges due to ceilings or other limitations on charges to the contracts to which they were directly related. By handling these costs as indirect costs, they were charged, in part, indirectly to the contractors' other business, including other Government contracts. (See att. I.B.)

Comments on applicable
provisions section XV of ASPR

Subsection 202(a) of section XV of ASPR is applicable to the issues posed in the above cases.

"A direct cost is any cost which can be identified specifically with a particular cost objective. Direct costs are not limited to items which are incorporated in the end product as material and labor. Costs identified specifically with the contract are direct costs of the contract

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and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the costs of like items applicable to work of the contractor must be eliminated from indirect costs allocated to Government work." (Underscoring supplied.)

The basic problem as we see it on the basis of the cases we reviewed, is one of inconsistency. The above definition of a direct cost is, in our view, adequate in principle, and ASPR provides that consistency be considered by the Government in evaluating the reasonableness of charges by the contractor. There is, however, no specific overall requirement on the contractor for consistency with its usual costing practices and for consistency between Government and commercial work or between the various types of Government contracts.

Also, there is no requirement that the contractor maintain competent evidential matter in support of those costs included in the proposal, nor is it required to be consistent in the accounting used in presenting cost proposals and for costs subsequently incurred. This becomes a problem in those cases where, as noted above, the contractor proposed as a direct charge, costs it traditionally records as indirect, and vice versa. As a result, there is a difficult and costly series of implementation and administrative problems from an accounting and auditing standpoint.

Matters for consideration

It should also be noted that subsection 202(a) has been interpreted to mean that direct costs are any costs which were incurred for the exclusive benefit of a single cost objective. This definition should recognize that some costs, although not incurred solely for a single cost objective, are so closely identifiable with the cost objective benefited that they should be classified as direct costs.

The concept of a direct cost should be modified to recognize the principle that a direct cost can be not only a cost incurred for the inclusive benefit of a single cost objective but also a cost having a close relationship to a single cost objective. Were this done, guidance would also have to be provided for identifying such close relationships.

The determination of which types of costs are treated as direct costs and which are treated as indirect costs depends primarily upon the methods of operation of diverse contractors. Thus it seems that the first requirement of improved cost accounting would be an advance-disclosure agreement with the contractor as to its proposed method of determining and distinguishing direct costs from indirect costs. All significant deviations from this agreement would require amending the agreement with the Government. The agreement should also provide that the agreed-upon classification of "direct costs" and "indirect costs" be consistently applied.

We feel that, to resolve disputes associated with the negotiation of original agreements and more particularly with the reopening of such agreements, provision should also be made for some form of administrative review at an appropriate level within the agency charged with the administration of such agreements.

ALLOCATION OF INDIRECT COSTS

When a cost applies to more than one cost objective, its relationship to any one of the objectives is considered to be indirect. Indirect costs, in the aggregate, represent the largest single element of cost incurred under Government contracts. The allocation (assignment) of indirect costs is one of the most controversial areas in cost accounting for Government contracts and is subject to many and varied alternative approaches. It is not a problem that can be solved by simple or rigid rules. The allocation of an indirect cost, of necessity, is not as accurately determined as is the allocation of a direct cost. It still, however, must be based on some demonstrable relationship between the reasons the cost was incurred and the basis upon which the allocation of the cost is made.

The allocation process normally consists of (1) the aggregation of indirect costs in an account, or series of accounts, known as an overhead pool(s) and (2) the prorating of the pool over an appropriate base.

Because allocation of indirect costs first involves an accumulation process, each pool of such costs should contain only those costs which are homogeneous--i.e., similar in the sense that they are amendable to adding together without distorting the significance of the results when spread among cost objectives on a single- or common-allocation base. Moreover, in allocating pooled costs (i.e., distributing them over a base), the base employed should be closely related both to the pooled costs and to the cost objective.

In the cases we examined into, the problems involving the allocation of indirect costs were most numerous. These difficulties generally centered on the homogeneity concepts noted above. Consequently, in attachment II.A. we discuss cases wherein either (1) costs were improperly combined for allocation on a common basis or (2) the allocation base did not provide for an appropriate assignment of the costs involved to the cost objectives charged. These situations arise in connection with both proposed and incurred costs. The cases discussed in the attachment also cite instances of contractors deviating from their existing cost allocation practices.

Several types or classes of indirect costs present special problems. These problems are discussed below.

General and administrative expenses

General and administrative (G&A) expenses are essential to the overall operation of an enterprise. Attachment II.B. cites a number of cases dealing with problems in the allocation of G&A expenses. Many of the problems associated with other indirect costs also apply when dealing with G&A expenses, the most prevalent problem being the selection of the proper allocation base. This problem is particularly evident in connection with the "cost of sales" base for allocating G&A expenses, because of the inconsistent treatment some contractors accord to the timing of the recognition of cost of sales under Government cost-type contracts, as compared to fixed-price contracts and commercial work. Contractors using the cost-of-sales base often record costs under Government cost-type contracts as cost of sales immediately upon the costs' being incurred or billed but record costs under fixed-price and commercial work as work-in-process inventory and transfer such costs to cost of sales only at the time of delivery or contract completion.

Under these circumstances, and particularly where there is a large buildup of fixed-price and commercial inventories, the use of the cost-of-sales base results in allocating substantial amounts of G&A expenses incurred in a given year to Government cost-type contracts in process but little or none to fixed-price and commercial work undertaken, though not completed, in the same year.

We found that some contracts had been overcharged because costs incurred mainly or exclusively for commercial operations had been included in the pool of G&A expenses. Other contracts were overcharged because the bases of allocation did not include the cost of commercial operating activities and hence little or no G&A expenses were charged to such activities.

Independent research and development

Independent research and development (IR&D) is that portion of a contractor's research and development that is

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not directly sponsored by Government contract, grant, or other arrangement. Because of the significant level of such costs, agreements governing the maximum amount (ceiling) for which the Government will compensate the contractor are fairly common among major defense contractors. Difficulties arise when ceilings are exceeded (overrun).

We think that any IR&D overrun should not be charged, directly or indirectly, to the Government. In practice, some contractors change the classification of the IR&D expenditure and/or the account, which, in effect, defeats the intent of such agreements. Appendix II.C. indicates some of the more common problems, notably:

- IR&D work tasks are often similar or identical to bidding and proposal (B&P) costs. B&P costs are usually not subject to a ceiling; consequently, IR&D projects are sometimes identified as B&P projects.
- IR&D overruns are sometimes included in indirect costs for allocation to both commercial and Government work.

Also noted in appendix II.C. are cases involving the failure to charge overhead to IR&D. The situation is equally applicable to B&P. Some contractors do not charge factory overhead and/or G&A expenses to IR&D costs, particularly that portion of IR&D costs to be absorbed by the contractor. Consequently, the applicable factory overhead and G&A expenses (which often are as much or more than the ceiling amount charged direct to the Government) are allocated to all Government and commercial work, exclusive of IR&D. Since IR&D is a distinct work project, we believe that it should bear its proportionate share of indirect costs including G&A expenses, just as do all other work projects.

Comments on applicable provisions of section XV of ASPR and matters for consideration

In view of the varied organization and operating patterns of defense contractors and the impact of such patterns upon indirect-cost allocation practices, there is a real need to sharpen the criteria for indirect-cost groupings, the bases for distribution, and the methods of allocation. In our opinion, however, standards for indirect costs cannot be

stated with sufficient specificity to not also require an advance understanding (i.e., disclosure agreement) between contractor and Government representatives if we are to achieve the desired objectives of cost-accounting standards for cost-analysis purposes.

The following provisions of section XV of ASPR bear upon the problems discussed above.

With general reference to cost allocability subsection 15-201.4 provides that:

"A cost is allocable if it is assignable or chargeable to a particular cost objective, such as a contract, product, product line, process, or class of customer or activity, in accordance with relative benefits received or other equitable relationship." (Underscoring supplied.)

This provision seems to apply to situations involving incompatibility between pooled costs and the allocation base but, in our view, permits too many alternatives. There is nothing in the section, moreover, that provides any definitive guidance as to measuring "relative benefits received or other equitable relationship." For example, a cost is considered allocable if it "benefits both the contract and other work." But nothing contained in the section provides any guidance with regard to the measurement of benefits.

The following subsections of section XV of ASPR bear upon the composition of cost pools and their bases for distribution.

Subsection 15-203(b) states that:

"Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring the costs. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses and general and administrative expenses are separately grouped. Similarly the particular case may

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require subdivisions of these groupings e.g. building occupancy costs might be separable from those of personnel administration within the manufacturing overhead group. The number and composition of the groupings should be governed by practical considerations and should not be such as to complicate unduly the allocation where substantially the same results are achieved through less precise methods."

Subsection 15-203(c) provides that:

"Each cost grouping shall be distributed to the appropriate cost objectives. This necessitates the selection of a distribution base common to all cost objectives to which the grouping is to be allocated. The base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives. This principle for selection is not to be applied so rigidly as to complicate unduly the allocation where substantially the same results are achieved through less precise methods." (Underscoring supplied.)

These provisions represent an effort to provide guidance for the accumulation of costs in cost pools and for subsequent distribution on an appropriate base. On the basis of the experience we have had with contractors in implementing this section, it is our view that the section does not provide sufficient guidance to ensure that costs in a pool are homogeneous. For example, most defense contractors combine into one manufacturing overhead pool such heterogeneous costs as machine-related costs (e.g., power, lubricants, coolants), space-related costs (e.g., depreciation and building maintenance), and people-related costs (e.g., indirect labor) and then distribute them among cost objectives on a single, common base.

Consequently, consideration should be given to the establishment of homogeneous subgroupings in the allocation of costs. We think that this would be considerably more preferable to the current provision of subsection 15-203(c)

which speaks in terms of "a distribution base common to all cost objectives ***."

Subsection 15-203(d) is pertinent to the method of allocation of indirect costs.

"The method of allocation of indirect costs must be based on the particular circumstances involved. The method must be in accord with generally accepted accounting principles which are applicable in the circumstances. The contractor's established practices, if in accord with such accounting principles, shall generally be acceptable." (Underscoring supplied.)

Except for recognizing the need for allocating indirect costs in the determination of inventory values for financial statement purposes, "generally accepted accounting principles" do not generally address themselves to indirect cost allocations between products and services within a fiscal year. Instead, these principles are generally concerned with the allocation of indirect costs in the aggregate between fiscal years. Also, there are many indirect cost allocation methods available and in use today; however, criteria for each method used in specific circumstances have not been developed or established. Hence, even in the inventory area, there is a need for specific criteria for the indirect cost allocation methods used in contract costing.

There is no separate provision in ASPR dealing specifically with G&A expenses. Consequently, the aforementioned sections of ASPR must be looked to for guidance.

ASPR touches on the subject of IR&D in subsections 15-205.35 and 15-107(v). In general, the former section discusses the nature and allowability of such costs and the latter section recommends advance agreements governing their allowability. The two sections do not adequately address themselves to the problems disclosed by the cases into which we examined.

--There is no definitive guidance provided as to the distinction between IR&D and B&P costs.

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--Similarly, there are no guidelines as to isolating IR&D costs or excluding overruns from indirect costs.

--The charging of overhead to IR&D is dealt with in ASPR subsection 15-205.35(f). This subsection provides that IR&D absorb the appropriate share of overhead unless the contractor consistently follows another policy.

TANGIBLE CAPITAL ASSETS

Contractors have considerable latitude of choice as to whether to expense or capitalize the cost of such items as office equipment; machinery; tools; and plant repairs, rehabilitation, and rearrangement. There is a tendency on the part of some contractors to charge the cost of capital assets to expense rather than to defer such costs to future periods. This happens despite established corporate policy to the contrary. These matters are discussed in attachment III.

Comments on applicable
provisions of section XV of ASPR

Subsection 15-205.20 provides that:

"(a) *** Costs necessary for the upkeep of property (including Government property unless otherwise provided for) which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see 15-205.9):

- (i) normal maintenance and repair costs are allowable,
- (ii) extraordinary maintenance and repair costs are allowable, provided such are allocated to the periods to which applicable for purposes of determining contract costs.
(But see 15-107).

"(b) *** Expenditures for plant and equipment, including rehabilitation thereof which, according to generally accepted accounting principles, as applied under the contractor's established policy, should be capitalized and subjected to depreciation, are allowable only on a depreciation basis."
(Underscoring supplied.)

This subsection is stated in a conventional manner, but its provisions are stated at such a high level as to lack specificity to achieve the reasonable objective of

cost-accounting standards. Neither is the reference to generally accepted accounting principles of much assistance, since such principles are essentially no different than those expressed in subsection 15-205.20(a).

Matters for consideration

Consideration should be given to the development of criteria for setting the minimum dollar limitations of property to be capitalized. Such criteria should give consideration to the issue of whether and how differences in size and type of operations of an enterprise impact upon the setting of the minimum dollar limitations and the related applications of such criteria to units of property. The cost-accounting standards should also call for the consistent following of the adopted criteria.

CREDITS

The practices of contractors in applying credits accruing to them in connection with incurred costs showed variations which sometimes did not agree with the principles of equity and fairness. Credits were usually charged back not to the work which generated the credits but to the various activities and mixes of work current at the time of the credit. The credits most frequently involved were refunds from group insurance premiums, volume discounts, cash discounts, and State taxes. (See att. IV.)

Comments on applicable provisions
of section XV of ASPR

Subsection 15-201.5 provides that:

"The applicable portion of any income, rebate, allowance, and other credit relating to any allowable cost, received by or accruing to the contractor, shall be credited to the Government either as a cost reduction or by cash refund, as appropriate."

This provision seems to be adequately stated but lacks specificity as to the manner in which various credits will be apportioned back to Government contracts.

Matters for consideration

The whole subject of credits seems to deserve greater treatment in all of its many facets. Those devising such a cost-accounting standard should determine how the various credits should be apportioned back. This standard should include consideration of whether the credits should be apportioned back in the same manner in which the original costs were charged.

CONCLUSIONS

Section XV of ASPR contains the only official codification of contact cost principles applicable to defense procurement. On the basis of our review of the cases submitted by GAO and DCAA auditors and the appropriate provisions of section XV, we believe that the section offers too little guidance. In other instances, section XV does not adequately deal with contemporary problems, since it does not reflect current conditions under which contracting is conducted.

The current version of section XV has been in effect for 10 years. In the interval it has been amended from time to time to take care of certain specific problems but has not been given a major overall review and revision. In the meantime, defense contracting has become more complex. The volume of procurement has increased, different kinds of contractual arrangements have been introduced, and the complexities of administering large weapon system procurements have increased.

The utility of section XV is further diminished because it has mandatory application to cost-reimbursement contracts only and is to be used as only a guide for fixed-price contracts. During fiscal year 1969, nonadvertised fixed-price contract awards represented about 65 percent of total Department of Defense procurements and cost-reimbursement-type contract awards represented about 24 percent. The remaining 11 percent represented formally advertised, fixed-price contract awards.

In view of the marked emphasis on fixed-price contracts and of the difficulties associated with fixed-price contract proposals as enumerated in this report, the desirability of a statement of cost-accounting standards, mandatory for all negotiated procurements, becomes apparent.

Section XV permits a contractor wide latitude in selecting from alternative, generally accepted accounting practices but does not provide adequate criteria to govern its selection. The whole general framework of cost accounting needs to be sharpened so that cost-accounting practices are more clearly stated and so that specific criteria for their establishment and use are enunciated. Section XV provides that in

ascertaining what constitutes costs, any "generally accepted method" of determining or estimating costs that is "equitable under the circumstances" may be used. Elsewhere, it places what we believe to be an overdependence upon "generally accepted accounting principles."

Under generally accepted accounting principles, as they stand today, there are many alternatives permitted in accounting for transactions but no definitive criteria for their applications. Generally accepted accounting principles are primarily applicable to overall financial reporting. They do not deal with cost-accounting standards to the extent necessary for contract costing purposes. Hence reference to generally accepted accounting principles in any statement of cost-accounting standards should be made only after careful consideration of their limited applicability to cost accounting.

Finally, and perhaps most important, the standard of consistency in direct-cost and indirect-cost allocation practices should be enunciated as applying to both Government-versus-commercial business and all types of Government contracts. A requirement for improved cost accounting should be an advanced-disclosure agreement with the contractor as to its proposed method of determining and distinguishing direct costs from indirect costs, indirect cost groupings, bases of allocation, and methods of allocation. If conditions change, the agreement between the contractor and the Government should be amended. The use of disclosure agreements would go far toward attaining consistency.

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ATTACHMENTS

CASE STUDIES

I - DISTINCTIONS BETWEEN
DIRECT AND INDIRECT COSTS

A. Indirect Costs Charged Directly

1. A Government firm fixed-price subcontract proposal included as direct costs, salaries and related expenses of the project manager, quality control engineer, financial man, etc. totaling \$150,000, which the contractor normally charges to overhead. Indirect costs of leasing quarters and expenses related to new hire, such as agency fees, moving expenses, etc., amounting to \$41,000, were similarly proposed as direct costs. The contractor did not adjust the overhead rate for similar costs included therein.

2. The contractor treated normally indirect expenses such as the costs of master crib, material handling and certain administrative functions totaling \$272,000 and "supervisory indoctrination" of \$69,000 as direct costs in a Government cost-type contract proposal.

3. Indirect costs of acceptance test operation aggregating \$98,000 were treated as direct costs in the contractor's firm fixed-price contract proposal. The operation is performed by indirect personnel whose wages were included in the proposed overhead.

4. Contrary to its regular practice, the contractor proposed normally indirect travel and subsistence costs of \$52,000 as direct costs in its cost-plus-incentive-fee contract proposal. The same costs were also included in the proposed overhead. The contractor's accounting system does not provide sufficient controls to adjust the applicable overhead rates when normally indirect costs are charged directly.

5. "Program management" costs amounting to \$24,000 which are normally charges to overhead were treated as direct costs in the contractor's firm fixed-price contract proposal. The Government contract proposal was also allocated a share of similar costs for other contracts and projects which had been included in the overhead.

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6. In its cost-plus-incentive-fee subcontract proposal, the contractor treated stenographic costs of \$51,000 as a separate direct charge. These costs represent clerical services to be rendered the prime contractor's representatives to be stationed at the subcontractor's plant and are normally included in G&A.

7. In its proposal to definitize two letter contracts, the contractor treated temporary duty costs (labor, related fringe benefits and travel and living expenses) totaling \$504,000 as "other direct costs." The contractor's normal accounting treatment is to include the labor portion of such costs as direct labor and to charge the remaining costs to overhead.

8. Contrary to the contractor's established practice, normally indirect costs such as factory supplies and building rentals were treated as direct preproduction costs in a cost-plus-incentive-fee contract proposal. The contractor, again contrary to its usual policy, also applied overhead to the preproduction costs. As a result, the proposal was inflated by \$88,000.

9. In its fixed-price contract proposals, the contractor treated packaging material costs and such hardware items as nuts, bolts and screws as direct costs. Since these costs had been included in the material-related overhead rates which were applied separately to the direct material costs proposed, the proposals were overstated by \$27,000.

10. Packaging labor costs of \$11,000 were proposed as a separate direct charge. Packaging is normally performed by indirect personnel whose wages had been included in the manufacturing overhead.

11. The contractor included in its proposed direct labor hours, normally indirect functions such as production support, packaging, shipping, shipping inspection and test acceptance. The proposed overhead rate was not adjusted. Accordingly, the proposing of these functions as direct charges would result in the contractor's duplicate recovery of the costs involved. (Dollar effect not readily determinable.)

12. In its proposal for an increase in the target cost under a cost-plus-incentive-fee contract, the contractor treated normally indirect material costs aggregating \$165,000 as direct costs.

13. In preparing a firm fixed-price contract proposal, the contractor departed from its normal practices, as follows:

a. Labor and material costs for maintenance, calibration and rehabilitation of tool and test equipment aggregating \$91,000 were charged as direct costs. These costs are normally charged to the tool and test equipment departments' overhead for redistribution to the "production labor overhead" and had also been included in the proposed overhead.

b. Labor costs for setup and starting load totaling \$60,000 were charged as direct production labor costs. Setup costs are normally treated as "production labor overhead" and the proposed overhead did include a provision for such costs.

14. In its claim for an equitable adjustment in contract price, the contractor treated such costs as the quality control manager's salary, holiday and vacation pay, night incentive and overtime premium pay totaling \$114,000 as direct costs. These costs are regularly charged to overhead.

15. The contractor duplicated overtime premiums of \$18,000 by treating them as part of its proposed direct manufacturing labor. Consistent with the contractor's policy, however, such premiums were also charged to overhead.

16. Several cost items of overhead nature such as bin stock items, freight and packaging, engineering labor and quality assurance labor totaling \$15,000 were proposed as direct costs without any adjustment to the overhead rate. In another Government contract proposal, the contractor treated similar overhead costs of \$21,000 as direct costs without adjustment.

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ATTACHMENT I

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17. The contractor treated normally indirect costs such as material department clerical effort and data processing costs aggregating \$68,000 as direct costs of a fixed-price-incentive contract proposal. The nature of the proposed work to be performed by the material department and the data processing center did not differ from their regular tasks and did not warrant a departure from normal practice.

18. In developing overhead rates, the contractor included various costs totaling \$966,000 which were similar to those proposed as direct costs. As a result, the proposed overhead was excessive by \$60,000. In addition, supervisory labor costs totaling \$11,000 were proposed as direct labor costs even though such costs had been included in overhead.

19. The contractor charged bidding and proposal labor and related fringe benefits amounting to \$96,000 as other direct costs of a termination settlement. The costs had been incurred prior to the termination and were included in the overhead and G&A rates of three previous years.

20. A contractor with preponderantly commercial business had proposed certain indirect material costs of \$113,000 as direct costs of a Government cost-plus-incentive-fee contract proposal. The cost had also been included in the overhead rates, thus representing duplicate charges.

21. The contractor treated indirect packing labor as a direct charge to a fixed-price contract proposal. Since such labor had been included in the composition of the overhead rate, the proposal was inflated by \$16,000 representing the overhead applied to the labor in question.

22. In its firm fixed-price contract proposal, the contractor proposed a separate "usage cost" of \$14,000 to recover scrap, breakage and production loss. All of these costs had been included in the proposed overhead.

23. The contractor charged most of its product engineering expenses to overhead and then allocated them among Government and commercial contracts on the basis of the estimated

costs of production. In some cases, however, product engineering costs were charged directly to the Government while at the same time these contracts also apparently absorbed their proportionate share of such costs through overhead.

24. The contractor accumulated "common" engineering and sundry costs in two sets of accounts--for distribution among fixed price and cost-type contracts respectively. The contractor's personnel admitted that there was no rational basis for distinguishing between the two types of contracts. Consequently, it seemed to the General Accounting Office that a single indirect cost pool, allocable to all types of contracts, was the more preferable way of dividing these costs. In one six month period, cost-type Government contracts were overcharged about \$57,000.

25. See III. 3.

26. See III. 4.

27. See III. 5.

28. See III. 6.

29. The contractor entered into a cost-type facilities contract to establish a production base, rather than for the production of an end item. The cost of salaried personnel (\$79,800), normally an overhead item, was charged directly to the contract on the basis that the services were essential to the scope of the work (one could always maintain that any allowable segment of overhead is "essential to the scope of work" under a Government contract).

B. Direct Costs Charged Indirectly

1. a. A contractor (i) was confronted with a loss in a 50/50 cost-sharing position under a combination cost-plus-incentive-fee and cost-sharing contract, and (ii) exceeded the ceiling amount of IR&D costs established in Tri-Service negotiations. In these circumstances, the following direct costs were charged to overhead in the hope of recovering them under other Government contracts (Government's share in the overhead was more than 90%):

(1) The cost of fabricating a test station amounting to \$219,000, which should have been charged directly to the foregoing contract, was charged to overhead. The test station was, according to a Government technical representative, a "special test facility" specifically required for contract performance and was being used exclusively for the contract.

(2) Similarly, an electrical equipment costing \$63,000 was charged to overhead even though the equipment was to be installed in an aircraft to be delivered under the contract. A Government technical representative's report also indicated that the equipment was specifically called for in the contract specifications.

(3) The "hardware" costs of a prototype equipment aggregating \$416,000 were improperly charged to overhead. Consistent with the treatment of (i) related "software" costs of the same equipment, which the contractor charged to the IR&D projects, and (ii) similar "hardware" costs of Government-sponsored development projects which were charged directly thereto, the costs should have been charged to the contractor-sponsored IR&D projects. The "hardware" costs of another prototype equipment totaling \$242,000 were also improperly charged to overhead under similar circumstances.

b. The contractor also charged the following direct costs to overhead:

(1) The contractor capitalized the costs for the purchase and modification of two special vehicles. One of the vehicles was leased to a municipality, and the related

depreciation and other costs were charged to a fixed-price job order set up to accumulate the costs and revenues under the lease. Subsequently, when both the vehicles were sold to a commercial firm, however, the contractor improperly charged the remaining depreciation of \$88,000 and demonstration cost of \$24,000 to engineering overhead. These costs should have been charged to a job order in the same manner as those for the foregoing lease. It is significant that the income derived from the sale was not credited to the overhead.

(2) Several cost items aggregating \$15,000 which had been incurred for and properly charged to certain fixed-price contracts were subsequently transferred to overhead. The reason for the transfer was found in the project manager's interoffice memo: "These cost factors were beyond my control and have now reached the point where anticipated profit. . . is no longer feasible."

2. For three consecutive years, the contractor, in claiming reimbursement for incurred costs, charged to engineering overhead, various direct costs which were incurred for and chargeable to specific projects and contracts:

a. Labor, travel costs, freight and other sundry expenditures totaling \$831,000 properly chargeable to a firm fixed-price contract which resulted in an "overrun" were charged to engineering overhead.

b. Apparently because of (i) the ceiling amounts established in an IR&D agreement with the Government, and (ii) the contracting officer's disapproval of precontract costs under other contracts, direct labor costs of these other projects and contracts aggregating \$175,000 were charged to engineering overhead.

3. The contractor was performing under a firm fixed-price contract. The contractor, however, had overrun the firm fixed-price by substantial amounts. The following types of direct costs of the contract aggregating \$1.6 million were improperly charged to overhead: salaries of sixty-seven employees who were working directly on the contract, "vendor labor" assigned to contract work, and costs

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of reproduction work and briefing film which were specifically called for in the contract.

4. The contractor departed from its normal practices or changed its procedures. As a result, travel costs of \$390,000 were charged to overhead which should have been charged directly to fixed-price contracts. This resulted in excess costs being allocated to Government cost-type contracts.

5. The contractor had a \$60 million research and development contract calling for cost-sharing on a 75/25 basis. This contract was to form the basis for a follow-on contract for a prototype program. The contractor, however, had overrun the contract amount by \$1 million and failed in its bid to secure the follow-on contract. Direct labor costs aggregating \$381,000 of normally direct personnel were charged to overhead. The contractor also charged to overhead \$911,000 of labor costs of normally indirect personnel who worked directly on the contract on the premise that the treatment was proper since the personnel usually performed indirect functions. The costs, however, were properly chargeable to the contract in question because the contractor's policy contemplated charging these costs directly under the particular circumstances of the research and development contract.

6. The contractor included premiums for product liability insurance in a pool of G&A expenses which were apportioned among Government and commercial work on the basis of the costs of production and development. Actual premium costs and rates (which were much lower for Government as opposed to commercial work) were readily identifiable and the premiums should thus have been directly charged. The method employed by the contractor resulted in a \$2.2 million overcharge to the Government over a seven year period. The overcharge was not recoverable by the Government.

7. In the case discussed at I.A. 23, it seemed that Government work usually involves little product engineering whereas commercial work involves extensive product engineering. By assigning such costs through overhead rather than directly, the contractor in effect arranged for the Government to subsidize its commercial work. Since the contractor

declined to disclose details on its commercial work, the adverse impact on the Government was not determinable. In one year alone, however, \$6.3 million in product engineering costs were included in overhead.

8. The contractor entered into a cost-type design contract containing a ceiling on direct costs. Almost \$655,000 in proposal costs were included in G&A, for allocation as an indirect cost both to this contract and other commercial and Government work. Investigation proved that the proposal costs were in fact assignable to the contract as direct costs and not reimbursable, since the contract ceiling on direct costs had been reached.

9. The prime contractor treated product engineering labor as a direct charge, whereas its subcontractor charged product engineering labor indirectly. As a result, when the prime contractor performed the product engineering and subcontracted the production to the subcontractor, the Government incurred a double charge--once for the product engineering work done by the prime, a second time as an overhead allocation by the subcontractor.

10. See II.A.13. Included in the \$1 million in overhead erroneously charged to Government cost-type contracts were labor fringe benefit costs such as pensions, vacations, holidays, and old-age insurance taxes. Charging such items directly would have reduced the overcharge by about \$700,000.

11. Overtime premiums incurred on a major Government subcontract were charged directly thereto as "other direct costs." Inconsistent with this practice, the contractor charged \$75,000 of overtime premiums incurred under other contracts to overhead for allocation in part to Government cost-type work.

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II - ALLOCATION OF INDIRECT COSTS

A. General

1. A contractor with preponderantly commercial business had completely changed the method of indirect cost allocation for the purpose of a Government firm fixed-price contract proposal. The contractor's manufacturing overhead rate is normally developed on a plant-wide basis only and the books are kept accordingly. In its proposal, however, the contractor had developed an overhead rate for each of the plant's 15 product lines. The amount of indirect costs proposed was about \$130,000 higher than that computed on the basis of the contractor's consistent basis of allocation. It is also significant that the contractor stated that it had no intention of changing its accounting system to record costs by product lines.

2. The contractor's standard cost accounting system develops separate variances (differences between actual and standard costs) for manufacturing labor and inspection labor by product or product line. In manufacturing a product for the Government during a recent 20-month period, the contractor experienced an unfavorable variance (actual costs exceeded standard costs) on the manufacturing labor, but a favorable variance (actual costs were substantially less than standard costs) on the inspection labor. However, on three subsequent fixed-price contract proposals for the same product, the contractor applied the unfavorable manufacturing labor variance to both manufacturing and inspection labor but disregarded the favorable variance on inspection labor. As a result, the proposed costs were inflated by \$592,000.

3. In addition, the contractor in 2. above, included in the direct labor base of its proposed overhead rates unfavorable variances on Government direct labor but excluded unfavorable variances on commercial direct labor. This inconsistent treatment resulted in a higher allocation of overhead to departments in which Government work was to be performed. (Dollar effect not readily determinable.)

4. The contractor deviated from its normal practice and removed (i) product development labor costs amounting to \$172,000 from the allocation base of engineering and manufacturing overhead, (ii) related expenses totaling \$391,000 from the expense pools, and (iii) transferred these amounts to the G&A base and pool. These adjustments resulted in increasing the proposed overhead for the Government contract by about \$28,000 and allocating little or no overhead to the product development project.

5. The contractor normally develops labor variances (difference between actual and standard costs) by productive departments and allocates such variances to work performed in the departments generating the variances. In computing the overhead for a firm fixed-price contract proposal, however, the contractor allocated unfavorable variances generated in departments engaged solely in commercial work for all departments. As a result, \$11,000 of the variances applicable to commercial work was allocated to the Government contract proposal.

6. In preparing its firm fixed-price contract proposals, the contractor inflated the costs by applying two additional overhead rates: "purchasing overhead" and "material overhead." These overhead rates added costs that had already been included in the proposed manufacturing overhead. Accordingly, the Government contract proposals contained duplicate costs amounting to \$28,000.

7. The contractor excluded direct labor costs of \$920,000 applicable to non-Government work from the labor base used for overhead rate computation. This had the effect of decreasing the proportionate share of overhead borne by non-Government work and increasing the share borne by the Government. The direct labor costs had been incurred under the contractor's "nonrecurring planning and tooling" work orders for the manufacture of certain vehicles. The contractor applied a special rate designed to cover fringe benefits only to the direct labor in question on the basis that this was consistent with its policy regarding in-house fabricated or manufactured capital equipment. However, the practice was contrary to the treatment accorded to similar vehicles manufactured under a Government contract and to

contracts requiring planning and tooling. Direct labor costs under these other contracts had been included in the base and had borne their full share of overhead. In addition, the vehicles were manufactured as inventory stocks for sale or lease to potential commercial or Government customers, not as capital equipment for general use.

8. In addition to a single freight rate for both outbound and inbound freight charges, the contractor proposed a separate outbound freight rate which resulted in duplicate charges. (Dollar effect not readily determinable.)

9. In its overhead rate proposal for Government cost-type contracts, the contractor had included \$1 million of field service costs which was applicable solely to its commercial business. The contractor is reimbursed for field service support for its Government products under separate contracts.

10. Material overhead was applied to Government furnished materials, even though the contractor's normal practice is to exclude such materials from the allocation base. As a result, the proposal was overstated by \$21,000.

11. In its proposal for a cost-plus-fixed-fee research and development contract, instead of its normal single overhead rate, the contractor developed five separate rates for engineering, shop methods, toolroom, manufacturing, and technical publications.

12. In proposing a refund of excess profits, the contractor deviated from its normal practices and overstated its costs, thereby reducing profits. As a result, the contractor's proposed refund was \$191,000 less than that computed on the basis of its normal accounting practices.

13. The contractor's division had two distinct departments, performing dissimilar work functions. One department performed dominantly under cost-type Government contracts, whereas the other worked mainly on commercial work and Government fixed-price contracts. Despite this dissimilarity in both work function and work load, the contractor employed one division-wide overhead rate applicable

to both departments. Had separate overhead rates been devised, the department with dominantly Government work would have had a substantially lower rate than the commercial department. The erroneous equalization in rates resulted in charging about \$1 million to Government cost-type contracts over a four-year period which was more appropriately chargeable to commercial work and Government fixed-price contracts. The overpayment was recovered by the Government.

14. See 13. above. Within one of the contractor's departments, three branches performed dissimilar work functions--administrative, engineering, and construction. Though one branch had the lowest proportion of Government cost-type contracts of the three, it had the highest separate overhead rate, had such a separate rate been used. The effect of erroneously equalizing the overhead rates in the three branches by use of a division-wide rate was, consequently, to overcharge Government cost-type contracts about \$1,370,000 over a four-year period, in addition to the overcharges discussed in 13. above. GAO was informed by the cognizant administrative agency that action would be taken to collect the overcharge to the extent necessary to protect the Government's interest.

15. By agreement with the Government, the contractor was to pay \$284,000 of the \$305,000 in costs incurred under several research and development contracts. These contracts were for work that would primarily benefit the contractor rather than the Government, but contracts were necessary so that the contractor could obtain the free use of Government-owned technical data. The contractor absorbed only \$40,000 (rather than \$284,000), the remaining \$244,000 being charged to the G&A expense pool for ultimate apportionment to all of the contractor's work--commercial and Government. This resulted in a net overcharge of \$188,000 to cost-and incentive-type Government contracts. The charge to G&A was predicated on the theory that the work performed was IR&D rather than R&D. Corrective action was taken when the matter was brought to the contractors attention.

16. See I.B.6. By commingling costs readily identifiable to commercial and Government work, the contractor, in

effect, violated the concept that costs in the pool should be homogeneous and closely related to the allocation base.

17. The contractor had eight plants in one metropolitan area with varying levels of Government work. Instead of using individual plant rates for use and occupancy expenses (e.g. depreciation, real estate taxes, maintenance), the contractor lumped all expenses and used an average rate for all plants, based on square footage. This resulted in charging the Government \$146,250 more in one year than had individual rates for each plant being used. The principle reason for the overcharge was that one plant, with about 83 percent Government business was a rent-free Government-owned facility, and thus did not have any applicable depreciation, real estate taxes and similar expenses chargeable to its operations. By commingling the dissimilar costs of the eight plants, this one particular plant absorbed a disproportionately high share of the total use and occupancy expenses of all eight plants.

18. The contractor's recorded costs such as employees salary and related payroll taxes, travel and living allowances, relocation expenses, tools and supplies, amortization of improvements, and depreciation of capital assets (except furniture and fixtures) by the department incurring these costs. In proposing annual overhead rates, the contractor used one division-wide rate rather than separately identifiable departmental rates. Thus, low overhead departments with a relatively heavy workload of Government cost-type contracts were picking up overhead costs of high overhead departments with low cost-type workloads. Actual overhead costs reimbursed by the Government were overstated by \$111,000 in one year alone. No recovery was made since the contractor maintained that the agreement for that year was conclusive. The following year, the use of two separate rates, applicable to apparently dissimilar fabrication and R&D work, reduced overhead by \$400,000, vis-a-vis the single division-wide rate.

19. The contractor used differing methods for arriving at the allocation base of common costs, with no one method being technically preferable to another. The deviation

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From a previously used and approved procedure under another contract resulted in an \$11.4 million overcharge to the Government under the contract reviewed. This matter is now in litigation.

20. The contractor made an almost complete overhaul in its method of charging various types of overhead to contracts including (a) additions and deletions from the base(s); (b) changes in the base for allocating direct labor; and (c) changes in the composition of overhead pools. These changes made after the proposal thwarted any effort to perform a pricing review under P.L. 87-653 for contracts negotiated prior to the change, short of expending an inordinate amount of time.

21. See II.B.16. The commingling of costs incurred exclusively for commercial work with those that are applicable to both Government and commercial work violates the concept of homogeneity of overhead pools. Also, the allocation of these exclusively commercial costs, using as a base both Government and commercial work, runs contrary to the principle that a close relationship should exist between the pooled costs and the allocation base.

22. Over a three-year period, costs of about \$81,000 applicable solely to commercial work were included in G&A and allocated between commercial and Government work. The Government absorbed \$51,000 of the amount under cost-type contracts.

23. The contractor maintained two distinct facilities performing different work functions. Overhead was accumulated in one pool, however, and distributed among all contracts on the basis of direct labor hours. Since one of the activities was far more active than the other, this procedure had the effect of transferring fixed and variable costs of the less active activity to the more active activity. Included in the amount of fixed costs transferred were costs applicable to idle capacity of the less active facility.

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24. The contractor was awarded a multi-year fixed-price production contract at a time when its capacity was fully engaged under several contracts. Subsequently, activity declined, and after four years the particular contract was the only one the contractor was performing under. Consequently, change orders would incur an excessive amount of costs applicable to idle plant and as a result, the contract was terminated. This case indicates a need to consider, in formulating cost accounting standards, the effect of idle capacity on the allocation of fixed costs to Government contracts, particularly where such fixed costs are relatively significant.

25. "Past-service pension costs" are those current costs resulting from unfunded pension cost liabilities applicable to prior periods. The contractor apportioned such costs among Government and commercial work on the ratio of current sales, rather than on the basis of relative sales during the period wherein the pension cost liability related. This resulted in allocating \$2.1 million to Government contracts over a 5-year period, or almost \$1.6 million more than had the contractor allocated such costs on the basis of relative sales during the period that the pension cost liability related. During this 5-year period about 65 percent of this contractor's sales were to the Government; during the preceding 20 years, only 16 percent of its sales were to the Government. In formulating cost accounting standards, this case points up a need to establish the most equitable basis for allocating past-service pension costs.

In addition, the contractor's estimated liability for unfunded pension costs was about \$60 million. Assuming that the 65 percent sales rate to the Government is maintained, the Government will incur \$39 million worth of such costs, or about \$29 million more than seems warranted.

26. Procurement burden identifiable to two subcontracts was about \$500,000. However, the contractor allocated procurement burden on the basis of total direct material and procurement dollars, and this resulted in \$2.7 million being allocated to the contract as applicable to these two major subcontractors, or \$2.2 million more than the costs identifiable with these procurements.

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27. The contractor entered into agreements governing the sharing and ceiling of IR&D and B&P direct costs; also, appropriate overhead, though the term was not defined. The contractor's normal method of allocating overhead was on the basis of direct labor cost. For purposes of the IR&D and B&P agreements, however, the contractor proposed changing its allocation method and in effect allocated most of these costs to other Government contracts. A further reduction in the amount of overhead allocated to IR&D and B&P stemmed from the omission of certain costs from the allocable pool of expenses for purposes of establishing the overhead rate on the grounds that the costs (a) had no direct relation to the IR&D and B&P work and/or (b) were minor. Neither contention was correct.

As a result of all this, about \$10.9 million was charged to IR&D and B&P over a four-year period, whereas \$19.5 million should have been charged. Since cost ceilings had been reached in all four years, the \$8.6 million was charged to other Government contracts rather than absorbed by the contractor, as they properly should have been.

28. See III.10.

B. General and Administrative Expenses

1. The contractor's operations include three divisions engaged almost 100% on Government work which used the cost of sales base in allocating their IR&D and G&A expenses. Under cost-type contracts, costs were charged to cost of sales on a monthly basis as incurred and billed; under fixed-price contracts, costs were transferred to cost of sales only when the products involved were delivered.

Prior to 1964, because of the short production cycle of fixed-price contracts there was little fluctuation between opening and closing inventories. However, beginning in that year, large, long-lead-time fixed-price contracts were awarded to Division A and B, and since no significant shipments would be made for three years, the procedures would produce low cost of sales and resulting very high IR&D and G&A rates, making the two divisions less competitive in bidding for new business. As a result, Divisions A and B changed to the percentage of completion method, under which cost of sales is recorded on the basis of periodic estimates of the percentage of contract completion.

Division C, on the other hand, adopted the percentage of completion basis with respect to only one of its contracts and continued to charge costs incurred under its fixed-price contracts to cost of sales at the time of shipment. During 1966, because of the added fixed-price work, this method of accounting resulted in increasing inventory from \$19 million to \$67 million. This meant that the cost of production exceeded the recorded cost of sales by \$48 million, but little IR&D and G&A expenses were allocated thereto. Rather, it was allocated to cost-type contracts in the amount of \$450,000. In 1967, the inventory increased an additional \$58 million, bringing the ending inventory up to \$125 million. The continued use of the same accounting procedures would further increase the IR&D and G&A expenses allocated to cost-type contracts.

It is significant to note that although Division C computes the IR&D and G&A expense rates on the basis of cost of sales and applies such rates to the cost of sales on its books, it employs a different method for progress payment

purposes. The division has regularly applied these rates to the work in process, or input costs, on its billings to secure additional working capital. The amount of IR&D and G&A expenses received through progress payments in this manner during a recent three-year period has been about \$3 million more than that computed on the basis of Division C's normal accounting system.

2. The contractor's Division A uses the direct labor hour base to allocate its G&A expenses. This basis is inconsistent with the Corporate headquarters and all other divisions of the contractor which use the input cost base. Moreover, the direct labor hour base was not consistent with the practices of most similar companies. A special survey of 29 companies in the same industry disclosed that only two used direct labor hours, one used direct labor dollars and 26 used either a cost of sales or input cost base.

Division A's work was previously almost all Government business. However, the division's commercial work began to increase in 1964--from 1.4% of total sales to 14.7%, 29.2%, and 21.6% in 1965, 1966, and 1967 respectively. The commercial work requires almost five times as much direct material and subcontract costs as Government work and proportionately less direct labor hours. As a consequence, during a recent three-year period the use of the direct labor hour base resulted in shifting \$2 million of G&A expenses from commercial to Government work.

3. Costs for Government cost-type contracts are recorded as cost of sales when incurred or billed, whereas similar costs for commercial work and Government fixed-price contracts are charged to, and remain as, inventories until delivery or contract completion. There is little difference in the work between the cost-type and fixed-price contracts.

Prior to 1968, the contractor's business was comprised primarily of Government cost-type contracts. Beginning in that year, however, the contractor started to undertake commercial work as well as work under Government fixed-price contracts. This led to substantial increase in inventory. For example, whereas the closing inventory had never exceeded \$6 million previously, it increased to \$20 million

in 1968 and is expected to reach \$55 million in 1969. The significant buildup of the inventories, coupled with the contractor's use of the cost of sales base of allocation will result in an additional \$3 million of G&A expenses being allocated to Government cost-type contracts in 1968 and 1969.

4. Tooling costs under a Government subcontract are recorded as cost of sales when incurred or billed to the prime contractor, from whom progress payments are received. On the other hand, the contractor plans to charge similar costs under a commercial program to inventory accounts and amortize them on the basis of units produced over a 5 to 10-year period. Under the present or planned procedures, a disproportionate share of the G&A expenses would be allocated to the Government tooling costs and other cost-type contracts, while that portion of the commercial program to be completed in 1969, for example, would be charged with little or no expenses of that year. Unless a consistent method is used to record the cost of sales for all work, or a more equitable allocation base is used, Government work would be allocated \$413,000 of excessive G&A expense in 1969 and 1970.

5. Certain materials were proposed at list prices in a firm fixed-price contract proposal. In computing the proposed G&A expense, however, the contractor applied the G&A rate to the list prices of the materials, which prices already included G&A expense as well as profit. As a result, the proposed cost was inflated by \$186,000.

6. The contractor did not perform certain inspection and maintenance work required under a facility contract, and proposed to refund the Government an amount equal to the cost of performing similar functions in a subsequent period. As computed by the contractor, however, the proposed refund was understated by \$13,000 because it did not include an allocable share of G&A expenses. The contractor regularly includes such allocable expenses when billing the Government for similar work.

7. The contractor normally develops two budgeted G&A rates: one for cost-type contracts and a "book" rate. The former, which excludes certain costs unallowable by ASPR

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Section XV, is used for proposing G&A expense on cost-type contracts, whereas the latter is used for overall cost control purposes. For its firm fixed-price contract proposal, however, the contractor developed a third rate which was unjustified on its merits and which was higher than the other two. The use of the third rate resulted in an additional \$32,000 being allocated to the Government contract proposal.

8. See I.B.6.

9. See I.B.8.

10. See II.A.15.

11. See II.A.22.

12. Warehousing costs for commercial operations, but not Government operations, were omitted from the G&A cost of sales base and consequently were not allocated any part of G&A. Inclusion of these costs in the allocation base would have been appropriate since the contractor's Parts Division was as much an operating segment of the company as manufacturing and assembly operations and received the same house office supporting services. Corrective action was not taken.

13. The contract provided for the Government to bear the indirect costs allocable to direct IR&D costs, but did not specify whether indirect costs would be allocated to all IR&D costs or merely those within the IR&D ceiling. There was a \$1,067,000 overrun of direct IR&D costs, and related overhead was \$1,034,000. Rather than charging overhead to the overrun (where it would have been absorbed by the contractor) the contractor sought to charge the \$1,034,000 through "normal" overhead, where it would be absorbed by all work, Government and commercial.

14. Although IR&D activities benefited from home office direction, etc., no G&A was allocated to such activities, thus resulting in G&A being distributed over a narrower base (adverse monetary impact on the Government not readily ascertainable).

15. For internal purposes, G&A was distributed on a basis which took into account assets, gross income, and personnel employed. The cost of sales base was used to allocate G&A for contract billing purposes. This is an illustration of inconsistency in practice, and under the alternative selected, almost \$316,000 more was charged to the Government.

16. About \$265,000 in incorporated product management expenses, related to two commercial product lines, were included in G&A expenses for distribution to all work--Government and commercial. The justification given for this practice was that commercial products were included in the G&A allocation base and that it would be inequitable to exclude expenses related to product lines making up the distribution base. We believe that because these were commercial costs they should have been excluded from the G&A cost pool.

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C. Independent Research and Development

1. In one year alone, the contractor charged costs totaling almost \$8 million to such indirect cost accounts as Sales Proposals, Technical Operations Services, Basic Studies and New Technology, Conceptual Studies, and Development. Since the contractor performed almost exclusively for the Government, he received reimbursement for practically all costs. These tasks are so closely related to IR&D that, in the opinion of most experts, it is virtually impossible to determine what is or is not an IR&D expenditure. The matter of distinguishing between IR&D and B&P should be considered in establishing cost standards.

2. See II.A.27.

3. The contractor undertook, and subsequently abandoned, the construction of a test facility. According to the contractor, the facility

"*** was intended to improve (1) the company's position in future competition ***, and (b) a very important segment of [IR&D]."

Costs of \$239,000 were not charged to IR&D but rather to a manufacturing overhead account and 75 percent, or about \$179,000, were allocated to Government contracts.

4. GAO has noted that where contractors engage simultaneously in IR&D and B&P work, the ceiling on the former coupled with the absence of a ceiling on the latter, has created a tendency on the part of contractors to classify IR&D-type costs as B&P. In one notable situation, at least half of a contractor's claimed \$3.8 million in annual B&P costs were similar to IR&D and not clearly necessary to support bids and proposals per se. DOD at one time was considering a ceiling on B&P also, but abandoned the idea. DOD currently has under consideration a new ASPR formula to provide ceilings for both IR&D and B&P.

5. See II.A.15.

6. See I.B.1.a.

7. See I.B.2.b.

8. See II.B.1.

9. Commercial IR&D costs aggregating \$200,000 incurred by the contractor's Central Engineering Division were allocated to its defense division in the ratio of defense/space cost of sales to corporate-wide cost of sales. However, the contractor did not allocate any IR&D costs incurred by the defense division to commercial activities.

10. The contractor charged to overhead independent research costs totaling \$249,000 which exceeded the ceiling amount of an advance agreement with the Government.

11. See II.B.13.

12. See II.B.14.

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III. TANGIBLE CAPITAL ASSETS

1. A survey of 20 contractors on the East Coast disclosed variances in the capitalization policies of these contractors, the low dollar value limit for capitalizing ranging from \$0 to \$1,000, with 18 contractors at \$250 or less. One problem is the expensing of quantity purchases of low value assets. At one plant with a \$200 minimum capitalization policy, about \$3.3 million in low value items were expensed in two years. Our tests showed that roughly two-thirds of the low cost items expensed were for purchases in quantity. The variation in practices, and the substantial values involved, indicate a need for consideration of capitalization policies in the formulation of cost standards.

2. A similar need was observed in a survey conducted of four West Coast contractors (with virtually 100 percent Government sales) showed minimum capitalization policies ranging from \$100 to \$500. Differences in depreciating capital assets were also noted including, for similar classes of assets, the use of different useful lives and depreciation methods. The expensing of large quantity buys of low value assets was also noted.

3. The contractor treated capital expenditures totaling \$578,000 (for such items as firewalls and electrical and heating systems for its buildings) as direct "special tooling" and preproduction" of a cost-plus-incentive-fee contract proposal. The expenditures constituted betterments of or additions to the existing facilities and should have been capitalized in accordance with the contractor's capitalization policy. Furthermore, the related depreciation should have been charged to overhead consistent with the treatment of other related costs of the facilities.

4. In its cost-type contract proposal for preproduction costs, the contractor expensed and charged as direct costs various items and production aids totaling \$445,000 which met its established criteria for capitalization.

5. The contractor expensed and charged a "special test equipment" valued at \$68,000 as a direct cost of a

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fixed-price-incentive contract proposal. The equipment should have been capitalized because it met the contractor's unit cost criterion for capitalization.

6. Acquisition and setup costs of \$30,000 for a "special equipment" were proposed as direct material costs. Similar type costs, however, have been regularly depreciated and charged to overhead.

7. The 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 also contrary to the contractor's written policy, which states, "... in those divisions in which the negotiation of overhead rates is a significant factor in contract pricing, major (\$100,000 or over) rearrangement and start-up expenses are deferred and amortized over 36 months."

8. Fees of \$276,000 for architectural and engineering services for the construction and alteration of various facilities were charged to overhead as "rental of building services." The treatment of the fees was not consistent with 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.

9. Contrary to its written policy, capital expenditures of \$40,000 (to connect plant facilities to the city water system) were charged to the engineering overhead of a plant, whose major efforts are directed to Government work. The cost constituted an improvement to the facilities and should have been capitalized. Furthermore, the contractor charged to overhead depreciation totaling \$1.4 million for assets ("emergency facilities" and others) which had been fully depreciated on the contractor's books).

10. The contractor's business was previously more than 90% Government work. Beginning in 1966, the mix of the contractor's business shifted to predominantly commercial; Government work dropped to 58.1%, 31.9%, and 20.0% in 1966, 1967, and 1968, respectively, whereas commercial work increased from 9.5% of 1965 to 41.9%, 68.1%, and 80.0% for the same years.

Apparently because of the major change in the mix of the contractor's work, the contractor made substantial revisions to its accounting system in 1966. The revisions consisted of increasing the overhead expense pools from 5 to 7 and the number of overhead rates from 2 to 5, and changing numerous accounts. More importantly, the contractor undertook mass plant rearrangement project, incurring costs totaling \$1.1 million. Analysis disclosed that "normal" rearrangement cost had never exceeded an average of \$216,000 annually in the past and that \$855,000 of the total amount was incurred for the specific purpose of meeting commercial production requirements. Accordingly, the latter amount should have been capitalized as an extraordinary rearrangement and the related amortization charged to the benefiting commercial work in the future periods. The contractor, however, charged the amount to overhead for allocation to all work. As a result, \$519,000 of the extraordinary rearrangement cost, which was incurred solely for commercial business, was allocated to Government contracts.

11. The contractor entered into a five-year lease with two two-year options to renew. The contractor also entered into a \$600,000 leasehold improvement agreement with the lessor, and sought to amortize the improvements over five rather than nine years. This resulted in an estimated \$83,000 overcharge over a 29-month period. There are no guidelines in ASPR or in Government contract law governing the amortization period for leasehold improvements. However, ASPR does provide for depreciation as an allowable cost subject to the limitations of the Internal Revenue Code of 1954, as amended. In accordance with section 178 of the Internal Revenue Code of 1954, a factor in determining the allowable deduction for amortization of improvements

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made to leased property would be the term of the lease. The taxpayer would be required to include in the term of the lease the period by which the lease could be extended pursuant to an option exercisable by the lessee, unless the lessee were to establish that it was more probable that the lease would not be continued. We found no evidence to indicate that the contractor established its intent with respect to exercising its options to renew the lease or that it was requested to do so by the procurement officials.

12. In connection with a pooling-of-interests through acquisition, the IRS permitted the successor corporation to revalue to \$12 million, assets of the predecessor corporation having a net book value of \$9,730,000. The \$12 million is currently allowable by DCAA auditors and the contracting officer for purposes of calculating depreciation, since ASPR allows depreciation on the basis used for Federal income tax purposes. Prior to the pooling, depreciation was based on the old net book value. In effect, therefore, the same assets are being depreciated on two bases. The contractor originally claimed that the assets should have been written up to \$25 million (rather than \$12 million) and is appealing the IRS valuation. All contracts entered into after acquisition have a clause permitting retroactive adjustments based on the final settlement of this issue. This case suggests a need for consideration of valuation of assets for depreciation purposes in formulating cost accounting standards.

13. One major defense contractor used three different methods of depreciating facilities, depending upon whether the data were being reported for corporate purposes, tax purposes, or contract costing. In the case of one building, the method employed for corporate purposes was "sum-of-the-years-digits" over a 35-year life. The same 35-year life was used for tax purposes, except that 60% was written off over five years and 40 percent over the remaining 30 years. Only a 12-1/2-year life was used for contract costing, 80 percent in the first five years and 20 percent on a straight line basis over 12-1/2 years. A recent (August 29, 1969) revision to ASPR should result in greater consistency by the contractor in the selection of depreciation bases and methods.

IV. CREDITS

1. The contractor paid about \$19 million in group insurance premiums over a nine-year period. The carrier consistently refunded about 10 percent of these premiums, because of favorable claims experience. Employees paid a fixed premium, and the risk of upward premium fluctuations was borne almost exclusively by the Government through the contractor. However, the entire refund was not returned to the Government, rather, it was shared in proportion to employee-employer contributions. Corrective action was declined.

2. Volume discounts applicable to cost-reimbursement contracts were erroneously credited to fixed-price contracts and thus did not accrue to the benefit of the Government. Corrective action was taken.

3. Twelve of 33 contractors reviewed had over a 25 percent unrealized appreciation in excess of the book value of common stock held in pension funds. The excess amounted to about \$580 million, and the Government could realize about a \$100 million savings if, in computing the actuarial appraisals for contractors' annual contributions to the funds, appreciation was considered income and pension fund contributions were reduced accordingly.

4. The Government was overcharged \$139,000 because the contractor did not properly reduce material costs for appropriate cash discounts applicable to cost-type contracts. Reasons were: Incorrect method of allocation (\$107,000); discounts not given on interdivisional purchases (\$22,000); discounts not allocated to certain contracts (\$10,000). The major deficiency, the use of an incorrect method of allocation, resulted from the contractor using as a base transactions to which discounts are not applicable, such as Federal income taxes withheld, old age insurance contributions, and unemployment insurance taxes. By thus broadening the base, the discount rate on cost-type contracts was reduced. Corrective action was taken.

5. The contractor accumulated in a "preproduction bank" development, tooling and processing costs for a new product line which were to be recovered through the sales

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of such products. Investigation disclosed that the "bank" had not recorded such recoveries and consequently that pre-production costs included in a fixed-price proposal were probably overstated.

6. See I.B.1.b.(1).

7. See II.A.2.

8. See II.A.3.

9. Even though the original expenditures had been charged to overhead, the contractor did not credit the overhead for Federal gas tax refund and other income of \$13,000 and profits realized from vending machines totaling \$178,000.

10. The contractor received a refund of \$1.6 million, including interest, for state taxes previously paid on its military division's sales. The cost of the original tax payment had been reimbursed by the Government or Government prime contractors. Instead of refunding the entire amount to the Government, the contractor returned only \$449,000 as an offer of a compromise settlement.

11. See II.B.6.

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TABULATION OF PROBLEM AREAS

<u>Subject</u>	<u>Number</u>		
	<u>Total</u>	<u>DCAA</u>	<u>GAO</u>
1. IR&D/B&P/Economic Planning	78	67	11
2. Allocation	64	51	13
3. Current Expensing vs. Deferral	23	21	2
4. Direct vs. Indirect	41	25	16
5. Depreciation Methods	23	17	6
6. Material Costs	21	16	5
7. System	23	15	8
8. Reasonableness/Allocability	20	13	7
9. Lease vs. Purchase	14	10	4
10. Advertising/PR	11	9	2
11. Compensation	9	8	1
12. Special Facilities/Idle Facilities	9	8	1
13. Organization/Merger	7	7	0
14. Standard Cost Accounting System	6	6	0
15. Selling Costs	6	6	0
16. Deferred Compensation	9	5	4
17. Patent	4	4	0
18. Taxes	4	4	0
19. Trade/Business	5	4	1
20. Travel/Relocation	6	4	2
21. Miscellaneous	27	16	11
22. Multiple Subjects	19	18	1
23. ASPR XV, Part 3	7	7	0
	<u>436</u>	<u>341</u>	<u>95</u>

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SUMMARY OF SIGNIFICANT COMMENTS ON
EARLIER DRAFT REPORT ON THE STUDY
OF THE FEASIBILITY OF ADOPTING
UNIFORM COST-ACCOUNTING STANDARDS

SUMMARY OF SIGNIFICANT COMMENTS ON EARLIER
DRAFT REPORT ON THE STUDY OF THE FEASIBILITY
OF ADOPTING UNIFORM COST-ACCOUNTING STANDARDS

An earlier draft of the report on our study was circulated for comment by interested Federal agencies, professional accounting associations, and various associations of industrial companies. This draft stated our preliminary conclusion that it is feasible to apply uniform cost-accounting standards to all negotiated defense contracts.

We received comments on the earlier draft from 10 Federal agencies, five professional accounting associations, and 12 industrial associations.

FEDERAL AGENCIES

Comments were received from:

Atomic Energy Commission
Bureau of the Budget
Department of Agriculture
Department of Defense
Federal Power Commission
Federal Maritime Commission
General Services Administration
Interstate Commerce Commission
National Aeronautics and Space Administration
Securities and Exchange Commission

The responses from Federal agencies indicated agreement with the tentative conclusion of the General Accounting Office (GAO) that it is feasible to adopt and apply uniform cost-accounting standards for use in defense procurements. The Department of Defense (DOD) stated:

"The report concludes that it is feasible to apply uniform cost accounting standards to all negotiated Defense contracts. It further concludes that the standards should (i) embody such cost accounting standards presently in ASPR [Armed Services Procurement Regulation] Section XV as have served well in the past, and

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(ii) be directed to accounting results, rather than accounting systems, through the establishment of specific criteria governing the use of cost accounting alternatives or a reduction in the number of such alternatives.

"We are in general accord with these conclusions and are of the opinion that the application of appropriate standards would assist in the negotiation of contract prices to the extent costs are a factor in the negotiation of price."

The Bureau of the Budget commented:

"We are cognizant of the fact, as we know you are also, that the feasibility of developing and adopting uniform cost accounting standards for use in negotiating Defense contracts is a highly controversial subject. Accordingly, we are pleased that your research and study of this matter has, as stated in the opening paragraphs of the draft report, not only led to the conclusion that it is feasible to apply uniform cost accounting standards that will be useful in negotiation, review, and administration of Defense contracts but may also prove helpful in advancing the art of cost accounting for general management purposes.

"While we concur in the draft report we have a few observations as indicated in the enclosure, which you may find useful in finalizing the report you submit to Congress."

Three Government agencies which award a substantial volume of procurement contracts and which concurred in our conclusion on feasibility were the Atomic Energy Commission (AEC), General Services Administration, and National Aeronautics and Space Administration. For example, AEC commented:

"Our staff has reviewed your report with great interest and we agree with your conclusion

that it is feasible to develop cost accounting standards and apply them to Government contracts. We agree also that such standards should be helpful not only in the negotiation and the review and administration of Government contracts, but also in providing information for general management purposes.

ACCOUNTING ORGANIZATIONS

Comments were received from:

American Accounting Association
American Institute of Certified Public Accountants
Federal Government Accountants Association
Financial Executives Institute
National Society of Public Accountants

With respect to the accounting profession, all the respondents except one concurred in the conclusion on feasibility of adopting uniform cost-accounting standards. The American Institute of Certified Public Accountants (AICPA) qualified its endorsement of our conclusion by stating:

"We do not object to the major conclusion of your study that uniform cost accounting standards are feasible. But we cannot at this time give unqualified endorsement to this conclusion because of what we perceive to be continuing uncertainty as to the meaning and impact of uniform cost accounting standards."

The Task Force on Defense Contracts of the American Accounting Association stated:

"We were impressed by the thorough study that was made as well as by the well-organized presentation in the report. We concur with the conclusion that uniform cost accounting standards can be established for defense contracts, and that this is desirable provided that the standards are established and applied in a reasonable manner."

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The Financial Executives Institute did not express concurrence with the tentative conclusion in our draft report. It stated:

"We have seen no persuasive evidence that widespread abuses exist, or that uniform cost accounting standards likely to evolve from any future effort will improve the current practice of total cost determination in any meaningful way. In the absence of such evidence, we are not in a position to accept the conclusion of the report that uniform cost accounting standards are necessary or desirable. We continue to oppose on economic and practical grounds a determination that uniform cost accounting standards are necessary. We believe that current principles and practices are adequate to protect the Government from abuses. It is clear that the size and diversity of the defense contracting environment makes occasional problems inevitable. We do not believe, however, that a set of detailed standards designed to cover every conceivable situation can or should be developed."

In conclusion, however, Financial Executives Institute did indicate its willingness to participate in the development of standards, should this be undertaken, by stating:

"Finally, while we continue to oppose a project to develop standards as being unnecessary and therefore wasteful, we are prepared to participate, should it be undertaken, with other members of the accounting profession in both the research and decision-making phases of the project."

INDUSTRIAL ASSOCIATIONS

Comments were received from:

Council of Defense and Space Industry Associations:
Aerospace Industries Association, Inc.
Automobile Manufacturers Association, Inc.
Electronic Industries Association

National AeroSpace Services Association
National Association of Manufacturers
National Security Industrial Association
Scientific Apparatus Makers Association
Shipbuilders Council of America
Western Electronic Manufacturers Association
Machinery and Allied Products Institute
National Council of Technical Service Industries
Strategic Industries Association

With respect to the industrial associations, four indicated that uniform cost-accounting standards were not feasible and five indicated that the draft report did not adequately demonstrate the feasibility of uniform cost-accounting standards. The remaining three industrial associations indicated (1) that it was feasible to engage in further study, (2) that uniform cost-accounting standards were not feasible but that improvement could be made by further development of section XV of ASPR, and (3) that uniform cost-accounting standards were not feasible but that improvement could be made by narrowing accounting alternatives.

A review of the industrial association responses brings to light a number of recurring viewpoints in connection with the positions taken by the associations on the feasibility of uniform cost-accounting standards. The most repetitive and significant viewpoints expressed were that (1) the cost of implementation had not been adequately considered, (2) uniform cost-accounting standards would not permit necessary and desirable flexibility for management's needs, (3) adequate safeguards and controls already existed, (4) the cases on problem areas presented in our draft report were not representative of industry practices, and (5) there were problems of consistency within the Government. In the following paragraphs, these viewpoints are presented in greater detail together with a brief discussion regarding such viewpoints.

1. Cost of implementation not adequately considered

Nine industrial associations provided comments relating to the cost of implementing uniform cost-accounting standards. They commented, in general, on the lack of a

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demonstration in the draft report that the benefits would outweigh the administrative costs of implementation. Opinions, in general, were that costs were more likely to outweigh benefits. The respondents viewed probable implementing costs as "very substantial," "excessive," "prohibitive," "considerable cost to the economy," "exorbitant," "greatly increased," and "expensive." One respondent pointed out that, since the standards had not been defined or developed, the real cost could not be estimated; another indicated that an estimate of all related costs should be included in the report.

With one exception, no suggestions were made as to how one might arrive at some reasonable estimate of the implementing costs. That respondent stated:

"The report should include an estimate of all these related costs based on the experience of the accounting profession in developing and applying financial accounting principles."

Discussion

Uniform cost-accounting standards providing for allocations of costs to all products, services, or contracts, regardless of the type of contract or the identity of customer, do not exist. Since just what will be involved in getting from the present situation to the implementation of the cost-accounting standards which would be formulated in the development of suitable standards is not known, meaningful estimates of the costs of establishing uniform cost-accounting standards are not possible. The costs will vary by contractor. Some of these costs will be incurred directly by the Government. Others initially will be incurred by the contractors and ultimately will be borne by the Government. Other costs may be incurred and borne, in whole or in part, by the contractors. Present estimates of the value of the benefits to be obtained from the establishment of uniform cost-accounting standards also depend on factors which are yet to be determined.

From the outset of the study, we recognized that the cost of implementation was an important factor to be considered. In our questionnaire to industry, we proposed a cost model which would segregate and identify costs into

four general categories which we labeled (with definitions) as directly associated costs, objectively traceable costs, ascribable costs, and generally allocable costs. We requested respondents to comment on the extent to which they were already so identifying their costs and, if they were not, to give us their best estimate of the incremental cost to segregate and identify costs according to the model.

Most respondents did not give us an estimated cost, offering as their reason the difficulties they had in visualizing just what might be required. Professor Robert K. Mautz of the University of Illinois, in his report on the evaluation of the questionnaire responses, pointed out that the method of applying the classification and the extent to which detail would be expected under it obviously could not be specified in the questionnaire and that, as a result, a considerable burden of interpretation fell on the respondent. According to Professor Mautz, less than 5 percent of the respondents (of a total of 739) gave any dollar amount indications at all, and these varied remarkably--from as high as a million and more dollars to much smaller amounts. As some respondents to the questionnaire indicated that they not only understood but also were applying this classification to some extent in their practices now, some might have little additional cost of implementation. Others found the cost substantial.

A prominent public accounting firm, which believes there is a great need for cost-accounting standards and which strongly endorses the idea of a project to develop such standards, has expressed to us its view that the cost savings to the contractor, and hence to the Government, are very likely to exceed the expense of implementation. As support for this view, this firm indicated that at present a great deal of expense is incurred by contractors in the nature of public accounting fees for the preparation of cost proposals and claims for recoveries because of the necessity to reconstruct transactions and develop cost information by a laborious work-sheet analysis process. It visualizes that, if standards were adopted, eventually contractors would have accurate cost information readily available and that much outside assistance could be avoided.

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As to the cost of establishing and maintaining uniform cost-accounting standards for use in connection with negotiated procurements, we believe that:

1. Costs which might be incurred by the Government will depend largely on:
 - a. The capabilities of the agency to which the responsibility for establishing and maintaining uniform cost-accounting standards is assigned.
 - b. The recognition of the need for continuing research into the use of uniform cost-accounting standards to keep pace with changing technologies.
 - c. The cooperation of the accounting profession, of industry, and of other Government agencies with the designated agency.
 2. Costs which might be incurred by contractors in implementing uniform cost-accounting standards, whether they are ultimately borne by the Government or by the individual contractor, will vary from contractor to contractor and will depend largely on:
 - a. The cooperation and capabilities of individual contractors' organizations.
 - b. The extent to which present cost-accounting and management-information systems can produce cost data for negotiated contracts in accordance with uniform cost-accounting standards.
2. Uniform cost-accounting standards would not permit necessary and desirable flexibility for management's needs

Six industrial associations expressed the viewpoint that uniform cost-accounting standards would not permit necessary and desirable flexibility for management's needs.

Industrial associations have indicated that cost accounting is a tool of management necessarily adapted to the

character of the business, the nature of its manufacturing processes, the size of the enterprise, and the extent of management's need for detailed cost information. Because business and the circumstances of business are so varied, cost-accounting systems and cost-accounting practices are equally varied. The associations contend that, even if the development of uniform cost-accounting standards were feasible, such uniformity as might be achieved might come at the cost of sacrificing a necessary and desirable flexibility in practice and, perhaps, within the individual enterprise, with some loss of accuracy for management purposes. Some viewed the tentative standards included for discussion in our draft report and other statements therein as envisioning standards that would require costly modification to existing accounting systems which are not economically feasible or workable and which do not answer the data need of management and would result in further deterioration of the industrial base available to perform under Government contracts.

One association appraised the tentative outline in our draft report for developing standards as not only clearly contemplating rigidly uniform application of accounting practices but also that they be carried out in great depth and in detail. Another association believed that the type of information gathered under uniform cost-accounting standards would be so general as to require industry to maintain a separate cost information system for corporate management use.

Discussion

We believe that management has the right to accumulate and process whatever data it regards as important to its operations and to institute whatever reporting requirements as are useful to management. Uniform cost-accounting standards for contract costing purposes, which should evolve from sound cost-accounting concepts, would not preclude the contractors from maintaining whatever records they require. The accounting systems, practices, and procedures in use to

achieve management's objectives need not necessarily be limited to these purposes. They can accommodate other purposes such as the Government's contract cost data needs. Moreover, since the Government sustains, as part of contract costs, a portion of the cost of maintaining contractor's cost-accounting systems, it does not seem unreasonable for the Government to require such cost data as are needed for good contract administration.

3. Adequate safeguards and controls already exist

Five industrial associations indicated that existing safeguards and controls were adequate for protecting the Government's interest. They cited the Truth-in-Negotiations Act; cost and price analyses; congressional investigations; the Renegotiation Board; requirements of the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS); and audits by GAO, the Defense Contract Audit Agency (DCAA), and independent public accountants.

Discussion

Although respondents enumerated these controls, they did not indicate how such controls served to lessen the inconsistencies found to exist in the assignment of costs. Consistency in the treatment of costs and the disclosure by the contractor of changes in contractor accounting methods are not now required by ASPR for contract costing purposes but are included in SEC and IRS requirements. We believe that some requirement for disclosure of a contractor's cost-accounting practices should be instituted. The principal features of any disclosure requirement might well be directed toward achieving consistency in the treatment of contract costs and preventing significant changes in contract costing without notice to, or approval of, the Government.

With respect to the Truth-in-Negotiations Act, the principal difficulty is that, although contractors are required to certify as to the currency, accuracy, and completeness of cost and pricing data, there is a lack of adequate standards for use in the preparation of the cost and pricing data presented. Furthermore, there is currently no requirement to maintain data on costs incurred in the same manner as proposed in price negotiations, hence where they differ there is no realistic way to evaluate the accuracy of estimated performance by comparison with actual performance.

The effectiveness of cost and price analyses is severely hampered in that, under the present ground rules of ASPR, many accounting alternatives are permitted, particularly by ASPR's referring to generally accepted accounting principles, but no criteria for the use of alternatives are provided. Therefore we believe that cost-accounting standards which would set forth criteria for the use of particular accounting alternatives would facilitate a determination of what constitutes costs.

Renegotiation, by statute, is tied to the Internal Revenue Code and is concerned with total contract operations rather than a contract-by-contract approach. Consequently, the Renegotiation Board takes a broader view of cost allocation than is implicit in a contract-by-contract approach. In addition, the provisions of the Renegotiation Act and the Board's regulations are more liberal than ASPR. For example, what is considered a reasonable and proper cost for tax purposes may not be a reasonable and proper cost for contract costing purposes.

With respect to the requirements of SEC and IRS, it appears that the principal thrust of the comments received was to take issue with the statement in the draft report that there were "numerous alternatives currently available to contractors for the accounting treatment of contract costs." The respondents reasoned that this was not the case since the accounting convention of consistency requires that any changes in accounting methods be approved by IRS and that, if the company's shares are publicly owned, such changes be disclosed by independent public accountants. We agree with these comments as to approval by IRS and disclosure by independent public accountants. However, as was stated earlier, consistency in the treatment of costs and the disclosure by the contractor of changes in contractor accounting methods are not now required for contract costing purposes. Further, the reporting requirements for SEC and IRS are concerned only with total costs and revenues for a reporting period and not with separate product and contract costs. In determining costs by products, most of the complexities of indirect cost allocations are involved. In this connection, SEC has issued a proposed revision to its reporting requirements to include data on sales and revenues and income or loss attributable

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to major lines of business. Acceptable allocation methods will be needed should this proposed revision be adopted by SEC.

DCAA has responsibility for reviewing contract cost proposals prior to contract negotiation, as well as reported costs involved in the reimbursement and settlement of all contracts where incurred costs are factors. About half of DCAA's productive man-hours are devoted to reviews of cost proposals. GAO reviews only a limited number of individual contracts and contract costs on a highly selective basis. Whether selective contracts are audited or whether every contract is audited, the absence of an authoritative body of cost-accounting standards provides the contractors with latitude for the selection of methods, from the alternative methods of accounting available in arriving at contract costs, without generally agreed-upon criteria governing their selections.

Although public accountants are required to disclose material departures from acceptable accounting principles or significant departures from accounting practices previously employed, such disclosures do not necessarily extend to contract costing. Moreover, the public accountants' principal concern is with matters related to the presentation of financial statements and they are less concerned with contract costing matters.

4. Cases presented are not representative of industry practices and other comments on the cases presented

Ten industrial associations commented on the cases cited in the draft report on inconsistent treatment of contract costs. The most frequent opinion expressed was that the cases were not representative of DOD contractor accounting practices. Some respondents expressed the view that the cases were biased or were selective and liable to bias; others questioned the statistical-sampling techniques used or suggested that it was improper to create the impression that the cases were widespread.

Among other opinions expressed with respect to the cases cited in the draft report were that:

- The repetition of the cases cited could be prevented by improvements in existing statutes and regulations.
- The cases carried the erroneous inference that current audit procedures had been acceding to changes in accounting practices not justified by changed circumstances.
- The cases involved operating practices which were questionable under current ASPR criteria.
- The cases cited indicated a need for better contract administration.
- The cases cited represented instances where some party (Government or contractor) might not have discharged its responsibility properly or where honest disagreements had occurred.

Discussion

To determine whether inconsistent treatment of costs by DOD contractors was a current problem, we requested DCAA to canvass its regional offices for such cases as might be readily available in which (1) changes from contractors' normal accounting practices had taken place for purposes of submitting cost proposals or (2) deviations had been noted between cost accounting for cost-type and fixed-price-type contracts. This canvassing approach seemed to be the only reasonable means of obtaining an indication of current conditions within a relatively short period of time.

DCAA subsequently provided us with summaries of 53 audit reports, most of which had been issued subsequent to June 1968, covering both proposed and incurred costs. DCAA reported that the cases selected represented a limited effort by its field offices and had been selected on the basis of the field offices' "recollection of such audit reports having been issued." (See app. III.)

Similarly, selected audit reports issued by GAO over the years were reviewed and GAO regional offices were requested to provide us with any cases they recalled which pointed to a need for standards. (See app. III.) The cases reported are intended to illustrate the types of important problems existing in relation to cost-accounting standards for consideration of the types of corrective action needed.

5. Problems of consistency within the Government

Seven industrial associations commented on problems of consistency within the Government. Four respondents indicated that some lack of uniformity and consistency in cost-accounting treatment was being caused by demands of Government procurement and audit representatives in their efforts to reduce the Government's cost. Four respondents indicated that inconsistencies were due to the lack of uniform Government requirements and procurement and reporting procedures.

Discussion

In our study we surveyed the contract cost principles of the principal procuring agencies of the Federal Government and found that differences existed in such principles. We believe that, to the extent possible, the Government's regulations and requirements should be consistent so that the Government could be considered by contractors as a single customer, regardless of the Federal agency entering into the contract. We believe further that a solution to many of these problem areas could be achieved if the contractors were to disclose their underlying cost-accounting standards and techniques so that they could be evaluated in relation to uniform cost-accounting standards. Thereafter an agreement, subject to modification under appropriate circumstances, could be reached that would preclude utilizing accounting alternatives without adequate justification.