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STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON PRODUCTION AND STABILIZATION
SENATE COMMITTEE ON BANKING AND CURRENCY
ON
[COST-ACCOUNTING STANDARDS
FOR NEGOTIATED CONTRACTS]

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Mr. Chairman and Members of the Subcommittee:

We appreciate being given the opportunity to comment on Senate Bill 3302 and to summarize our report evaluating the feasibility of establishing cost-accounting standards for negotiated Federal procurement contracts. You will note we have not used the word "uniform." We have done this deliberately for the reason that uniformity is inherent in the word "standard." A standard is an object considered by an authority or by general consent as a basis of comparison.

In negotiating contracts the estimate of contractor costs plays an important role in the establishment of the price. Under such conditions, cost-accounting practices followed can make a substantial difference in results; hence, variations in the accounting treatment of cost estimates and expenditures can become a matter for concern. In such

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situations equitable agreements depend heavily upon logical, consistent, and valid cost measurements.

In directing the General Accounting Office in 1968 to make our study, the Congress recognized the significance of valid cost measurements in the contract negotiation and administration processes.

Total Government procurement for the fiscal year 1969 amounted to \$53 billion, of which \$45.9 billion, or 86.6 percent, represented negotiated procurements. 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.

Our report dated January 19, 1970, on "The Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts" has been distributed widely within the Government, defense industries, accounting associations, universities and to other interested professional groups and individuals.

I welcome the opportunity to review the highlights of the study with you today.

Such cost principles as are available today are very general in nature and are contained in Section XV of the Armed Services Procurement Regulation (ASPR) of the Defense Department. These general principles and procedures are also used as a guide in the evaluation of costs of certain negotiated fixed-price-type contract and contracts terminated

for the convenience of the Government. Similar, though not identical, guides are contained in the Federal Procurement Regulations (FPRs) which apply to procurements made by civilian agencies.

We have concluded that ASPR Section XV is not an effective document for contract cost-accounting purposes for the following reasons:

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

"Generally accepted accounting principles" are concerned primarily with those reports of financial condition and results of total operations for a company. The reports are principally for stockholders and others interested in the financial and operating results of the company as a whole. Such principles are directed at cost allocations between fiscal years to assure 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 allocating indirect costs between the various products and services furnished under Government contracts and other work of the contractor. These allocations are highly important in negotiating a contract.

Consequently, "generally accepted accounting principles" are being called upon by the Armed Services Procurement Regulation and by the Federal Procurement Regulations to serve a function they were never intended to serve.

Likewise, the regulations or rules of three Government agencies concerned with cost-accounting matters--the Internal Revenue Service, the Securities and Exchange Commission, and the Renegotiation Board--are not adequate for contract costing purposes because they, too, were designed for different purposes.

POTENTIAL BENEFITS

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

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

Standards could require that

- the basis upon which forecasts of costs are predicated be disclosed;
- that final reported costs incurred be supported by, or be readily reconcilable with, the contractor's accounting records; and

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

Standards could also:

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

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

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

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

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.

If the Congress should decide to apply uniform cost-accounting standards to all negotiated Government contracts, differences between the various Government agencies as to what constitutes acceptable cost-accounting practices could be largely eliminated.

LIMITATIONS

There are certain things cost-accounting standards could not be expected to achieve. They could not, by themselves, ensure that contracts will be effectively negotiated, administered, and settled. They could not ensure that costs will be determined in accordance with those standards.

But cost-accounting standards could assist those responsible for contract negotiation, administration, and settlement in reaching a common understanding of contract terms and in holding contractors to report in accordance with such terms.

Cost-accounting standards could not and should not 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. This appears to be an essential minimum requirement. Cost-accounting standards should be expected to accomplish more.

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

PROBLEM AREAS

A recurring problem in Government contracting is that contractors may select from alternative accounting methods without specific criteria governing such selection. Contractors sometimes present cost data in pricing proposals differently from the way they record their cost of performance.

This creates difficulties in administration. An example is the difficulty concerning verification of supporting cost data in proposals submitted by contractors in compliance with Public Law 87-653, the Truth-in-Negotiations Act of 1962. The Act provides, with certain exceptions, that a prime contractor and any of his subcontractors be required to submit cost or pricing data prior to any negotiated award of \$100,000 and over. They must also certify that to the best of their knowledge and belief the data 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.

Cost-accounting standards would make the administration of this Act more effective since they would provide the underlying criteria in the specific circumstance, for the presentation of cost data which should result in better understood cost estimates by the contracting parties.

Currently 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. Meaningful audits of negotiated contracts by the Government agencies and GAO are thus rendered more difficult. For example, in many cases administrative and audit personnel find it difficult and time-consuming to reconcile incurred cost information with proposal data. Such action is required to properly audit, review, and evaluate price redeterminations, follow-on procurements, and termination claims.

In some of the cases studied, contractors charged directly to Government work costs normally handled as indirect costs but did not adjust indirect charges to eliminate similar costs which were also charged to the contract. 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.

Conversely, costs normally handled as direct charges were sometimes 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.

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. 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. 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.

DISCLOSURE

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

The determination of which types of costs 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, an important cost-accounting requirement would be an advance disclosure by the contractor as to its proposed method of determining and distinguishing direct costs from indirect costs and the basis for allocating indirect costs. The contractor should also agree that the disclosed cost

classifications and allocation methods would 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 contract and appropriate adjustment in price if warranted.

EFFECT ON ACCOUNTING SYSTEMS

Some have expressed the fear that the adoption of cost-accounting standards would not permit necessary and desirable flexibility for management's needs or would require a company to maintain a separate cost information system for management use. In some cases minor modification to existing cost-accounting systems may be necessary. However, we want to emphasize our belief that separate accounting systems should not be necessary. Cost-accounting standards for contract costing purposes should evolve from sound cost-accounting concepts, many of which are in use today. This 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. Again I want to make it clear that, in our opinion, cost-accounting standards should not result in uniform cost-accounting systems. In fact, much of the contract cost information can be accumulated through work sheet analysis from cost data recorded in the normal basic accounting system. It is our conclusion, as stated in our report, that 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. Thus we have hoped to allay any fears that cost-accounting standards would result in over-rigidity in cost-accounting practices and require separate accounting systems not useful to management.

CONCLUSIONS AND RECOMMENDATIONS

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

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. Further, they should be made applicable Government-wide.

New machinery should be established to develop cost-accounting standards applicable to procurement by all Government agencies, and to perform the continuing research and updating that will be required for effective administration. 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.

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.

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.

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 statement or be required to maintain the data from which such information could be readily provided.

LEGISLATIVE PROPOSALS

Mr. Chairman, you have asked us to express our views on Senate Bill 3302 introduced on December 23, 1969. In addition to extending the Defense Production Act of 1950 for two years, Section 2 would require the Comptroller General--in cooperation with the Secretary of Defense and the Director of the Bureau of the Budget--to promulgate uniform cost-accounting standards for use in all negotiated prime contract and subcontract defense procurements of \$100,000 or more and to report thereon to certain committees of the Congress within 18 months. It also provides that in carrying out this authority the Comptroller General shall consult with representatives of both the accounting profession and industry.

We look with favor upon the objective of this Bill to establish cost-accounting standards. It is our view that the issuance of cost-accounting standards without provision for modification, interpretation, broad application, and enforcement will not be fully responsive to the objective of attaining a greater degree of uniformity and consistency in cost accounting. In our opinion, this is a continuing process requiring the attention of a Board or other mechanism such as would be provided for in the legislative proposals prepared by us for the Committee and which was inserted in Congressional Record of March 20, 1970.

Alternative No. 1 would give the Comptroller General the responsibility for promulgating cost-accounting standards. To assist him the proposed legislation provides for an advisory board composed of representatives from both the Federal Government and from the outside. Alternative No. 1 is a redraft of S. 3302 to incorporate our views if it is the desire of the Congress to go this route. We would prefer Alternative No. 2 which provides for the establishment of an independent board to be selected by the President to promulgate the standards. Such a board would be composed of members from the executive branch and from the outside.

Otherwise, the two legislative proposals are relatively the same in that they are designed to substantially carry out the recommendations contained in our feasibility report. A copy of each of these legislative proposals is attached to this statement.

A discussion of the common provisions of these proposals may be an appropriate means of providing the Committee with our views.

In both of the legislative proposals, cost-accounting standards would apply to negotiated contracts with all Federal agencies. The legislative proposals would also authorize the promulgation of rules and regulations for the implementation of cost-accounting standards. Such regulations may require contractors and subcontractors to disclose in writing their cost-accounting practices and to agree to contract price adjustment with interest for any increased cost incurred by the Government because of their failure to comply with the cost-accounting standards promulgated.

The rules or regulations would also cover such administrative matters as the problem of phasing in the newly promulgated cost-accounting standards, including the question of their effect upon existing contracts. They might also include rules and procedures for seeking interpretations or clarifications of cost-accounting standards when desired by contractors, Government auditors, and contracting officers. The question of any necessity to waive the applicability of the cost-accounting standards to contracts with foreign contractors could also be included.

Written disclosures would do much toward achieving consistency between the cost-accounting support for the price proposal and accumulation of subsequent cost information on contract performance cost. Initially the disclosures would assist in the research of existing cost-accounting practices and criteria for such practices. Ultimately the disclosure would serve the purpose of assisting in reaching agreement that each contractor's cost-accounting practices implement the promulgated standards.

We feel that advance disclosure of accounting practices and a requirement for consistent application of approved practices to be the basic essentials for successful implementation of cost-accounting standards.

Both legislative proposals would recognize the importance of assigning the best talent available to the development of cost-accounting standards. The Board would be devoted solely to developing cost-accounting standards and rules for their implementation. The Board would be a permanent Board with responsibility to supervise the conduct of research necessary for the initial promulgation of cost-accounting standards and for continuing updating of the standards. Members may be drawn from the public accounting professions, the academic field, or private industry, and from the Government.

Unlike Senate Bill 3302, the two legislative proposals would not limit the application of cost-accounting standards to contracts of \$100,000 and over. We believe that the dollar size of a particular contract should not have any necessary bearing on the applicability of cost-accounting standards.

Currently, in cost-reimbursement type contracts, there are incorporated by reference the cost principles contained in the procurement regulations for the purpose of settling all claims--whether over \$100,000 or under. Similarly, the instructions for using the cost principles as a guide in the negotiation of prices under fixed-price contracts and in settlements under terminated contracts are not limited to prices or settlements of \$100,000 and over.

We think all negotiated contracts should be subject to the same cost-accounting standards.

Again, unlike Senate Bill 3302, the two proposals would not put a time limit on the promulgation of cost-accounting standards. We feel that with due recognition to the importance and complexity of the task, 18 months is insufficient. The promulgation and updating of cost-accounting standards will be a continuous effort. We would hasten to add, however, that a requirement for disclosure of accounting practices and a requirement of consistency in the application of such practices could be achieved within a very short period of time and this would do much toward betterment of conditions as they stand today.

Considerable research in actual operating situations will be necessary and should be done in close cooperation with contractors, procuring agencies, and professional accounting organizations. How long it will take to substantially complete the promulgation of standards will depend largely on the willingness of all concerned to cooperate.

We recommend that the Committee give favorable consideration to alternative 2 which would establish a board within the Executive Branch of the Government to promulgate cost-accounting standards. We favor this proposal for the following reasons:

--We question whether the GAO should become deeply involved in the administration of negotiated contracts. The responsibility for administration of contracts, including promulgating, interpreting and administering cost-accounting standards seems basically an Executive Branch function. Rules and regulations covering Federal Government procurement are now a function of the Executive Branch. There does not appear to be any reason to divorce the promulgation of cost-accounting standards from the Executive Branch.

In addition,

--An independent Board appointed by the President might well have greater prestige and attract more capable members. It could not be accused of having any bias by reason of having worked on the feasibility study or any preconceived ideas of what the standards should be.

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

Alternative 1 to S. 3302 - Directing GAO to establish
Cost-Accounting Standards.

"(a) The Comptroller General, as an agent of the Congress, shall promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost-accounting practices followed by contractors and subcontractors under Federal contracts. Such promulgated standards shall be used by all Federal agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with the pricing, administration, and settlement of negotiated contracts with the United States Government.

"(b) The Comptroller General is authorized to make, promulgate, amend, and rescind rules and regulations for the implementation of cost-accounting standards promulgated under subsection (a). Such regulations may require contractors and subcontractors as a condition of contracting to disclose in writing their cost-accounting practices including methods of distinguishing direct costs from indirect costs and the basis used for allocating indirect costs, and to agree to a contract price adjustment, with interest, for any increased costs incurred by the United States because of the contractor's failure to comply with duly promulgated cost-accounting standards or to follow consistently his disclosed cost-accounting practices in pricing contract proposals and in accumulating and reporting contract performance cost data.

"(c) The rules, regulations, cost-accounting standards, and modifications thereof promulgated hereunder shall have the full force and effect of law and shall become effective not less than 30 days after publication in the Federal Register.

"(d) For the purpose of determining whether the contractor or subcontractor has complied with duly promulgated cost-accounting standards and has followed consistently his disclosed cost-accounting practices, the contracting agency concerned and the Comptroller General or any representative of either shall have the right to examine and make copies of any documents, papers or records of such contractor or subcontractor.

"(e) (1) There shall be established in the Office of the Comptroller General a Cost-Accounting Standards Advisory Board of no more than five members to be appointed by the Comptroller General. The Board shall be comprised of members both from the Federal Government (with the consent of the head of the agency concerned) and from outside the Federal Government. One member shall be selected by the Board as its chairman. The Board shall advise and assist the Comptroller General in the preparation of cost-accounting standards and of regulations implementing such standards. The Board shall also review promulgated standards and regulations and, as it deems appropriate, make recommendations to the Comptroller General with respect to such existing standards or regulations.

"(2) The Comptroller General may appoint personnel from the Federal Government (with the consent of the head of the agency concerned) or from outside the Federal Government to serve on advisory committees and task forces to assist the Comptroller General and the Board in carrying out their functions and responsibilities under this section.

"(3) Members of the Board and other appointees under this subsection who are officers or employees of the Federal Government shall receive no compensation for their services as such but shall continue to receive the compensation of their regular positions. The appointment of Board members and others under this subsection from outside the Federal Government may be without regard to Chapter 51, Subchapters III and VI of Chapter 53, and Chapter 75 of Title 5, United States Code, and those provisions of such title relating to appointments in the competitive service. Appointees under this subsection from outside the Federal Government shall receive compensation at rates fixed by the Comptroller General not to exceed the rate prescribed for level V in the Federal Executive Salary Schedule if serving full-time and not to exceed 1/260 of such rate for each day of actual duty (inclusive of travel time) if serving on a part-time or intermittent basis. While serving on an intermittent basis away from their home or regular place of business, appointees under this section shall be allowed travel expenses in accordance with 5 U.S.C. 5703.

"(4) The Comptroller General, after consultation with the Chairman of the Board, shall have the power to appoint, fix the compensation of, and remove an Executive Secretary, without regard to Chapter 51, Subchapters III and VI of Chapter 53, and Chapter 75 of Title 5, United States Code, and those provisions of such title relating to appointment in the competitive service. The Executive Secretary of the Board may be paid compensation at a rate not to exceed the rate prescribed for Grade 18 of the General Schedule (5 U.S.C. 5332).

"(f) All departments and agencies of the Government are authorized to cooperate with the Comptroller General and the Board and to furnish information, appropriate personnel with or without reimbursement, and such other assistance as may be requested by the Comptroller General.

"(g) There are authorized to be appropriated such sums as may be necessary to carry out the provisions of this section."

Alternative 2 to S. 3302 - Establish an independent board in the Executive Branch.

"(a) There is hereby established a Cost-Accounting Standards Board of not more than five members to be appointed by the President. A majority of the Board shall be appointed from the executive branch of the Government and the remainder from private life. The President shall designate one member as Chairman. Board members appointed from private life shall receive compensation at the rate of 1/260 of the rate prescribed for level IV in the Federal Executive Salary Schedule for each day of actual duty (inclusive of travel time).

"(b) The Board shall have the power to appoint, fix the compensation of, and remove an Executive Secretary and two additional staff members without regard to Chapter 51, Subchapters III and VI of Chapter 53, and Chapter 75 of Title 5, United States Code, and those provisions of such title relating to appointment in the competitive service. The Executive Secretary and the two additional staff members may be paid compensation at rates not to exceed the rates prescribed for levels IV and V of the Federal Executive Salary Schedule, respectively.

"(c) The Board is authorized to appoint and fix the compensation of such other personnel as the Board deems necessary to carry out its functions.

"(d) The Board may utilize personnel from the Federal Government (with the consent of the head of the agency concerned) or appoint personnel from private life without regard to Chapter 51, Subchapters III and VI of Chapter 53, and Chapter 75 of Title 5, United States Code, and

those provisions of such title relating to appointment in the competitive service, to serve on advisory committees and task forces to assist the Board in carrying out its functions and responsibilities under this section.

"(e) Members of the Board and officers or employees of other agencies of the Federal Government utilized under this section shall receive no compensation for their services as such but shall continue to receive the compensation of their regular positions. Appointees under subsection (d) from private life shall receive compensation at rates fixed by the Board, not to exceed 1/260 of the rate prescribed for level V in the Federal Executive Salary Schedule for each day of actual duty (inclusive of travel time). While serving away from their homes or regular place of business, Board members and other appointees serving on an intermittent basis under this section shall be allowed travel expenses in accordance with 5 U.S.C. 5703.

"(f) All departments and agencies of the Government are authorized to cooperate with the Board and to furnish information, appropriate personnel with or without reimbursement, and such financial and other assistance as may be agreed to between the Board and the agency concerned.

"(g) The Board shall promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost-accounting practices followed by contractors and subcontractors under Federal contracts. Such promulgated standards shall be used by all Federal agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with the pricing, administration and settlement of negotiated contracts with the United States.

"(h) The Board is authorized to make, promulgate, amend, and rescind rules and regulations for the implementation of cost-accounting standards promulgated under subsection (g). Such regulations may require contractors and subcontractors as a condition of contracting to disclose in writing their cost-accounting practices including methods of distinguishing direct costs from indirect costs and the basis used for allocating indirect costs, and to agree to a contract price adjustment, with interest, for any increased costs incurred by the United States because of the contractor's failure to comply with duly promulgated cost-accounting standards or to follow consistently his disclosed cost-accounting practices in pricing contract proposals and in accumulating and reporting contract performance cost data.

"(i) The rules, regulations, cost-accounting standards, and modifications thereof promulgated hereunder shall have the full force and effect of law and shall become effective not less than 30 days after publication in the Federal Register. The functions exercised under this section shall be excluded from the operation of the Administrative Procedure Act.

"(j) For the purpose of determining whether the contractor or subcontractor has complied with duly promulgated cost-accounting standards and has followed consistently his disclosed cost-accounting practices, any authorized representative of the head of the agency concerned or of the Board and of the Comptroller General of the United States shall have the right to examine and make copies of any documents, papers or records of such contractor or subcontractor.

"(k) There are authorized to be appropriated such sums as may be necessary to carry out the provisions of this section."