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STATEMENT OF

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NATIONAL SECURITY AND INTERNATIONAL AFFAIRS DIVISION

BEFORE THE

COMMITTEE ON GOVERNMENTAL AFFAIRS

UNITED STATES SENATE

ON

COST ACCOUNTING STANDARDS

Mr. Chairman And Members of the Committee:

I am pleased to have this opportunity to appear before the Committee on behalf of the General Accounting Office to discuss (1) a brief history of the Cost Accounting Standards (CAS), (2) issues involving Cost Accounting Standards 409 and 414, and (3) the desirability of reestablishing a CAS Board function.

HISTORY OF THE COST ACCOUNTING STANDARDS

In the 1960's a growing concern was expressed about differing cost accounting practices being followed under defense contracts. House Report 1455 dated May 23, 1968, observed that the absence of Standards for defense contract cost accounting was adversely affecting Government procurements. On the basis of hearings held in 1970, the Congress, in a bill extending and amending the Defense Production Act of 1950, included a new section (section 719 of that act) creating the Cost Accounting Standards Board as an agent of the Congress and independent of the executive department. The amendment was passed by the Congress and approved by the President as Public Law 91-379 on August 15, 1970. From 1970 to September 30, 1980, when it became inactive, the Board promulgated 19 Standards covering cost accounting matters.

In the several months prior to the Board becoming inactive and, for several months after, there were discussions about the need for continuing the Board function. Efforts to continue the Board failed and it ceased operations at the close of fiscal year 1980.

Concerned that the absence of an active Board function could have a negative impact on the Standards and their implementation and administration, then Comptroller General, Elmer B. Staats sent a letter to the heads of affected procurement agencies on October 3, 1980, alerting them to the fact that while the Board was not active, the Standards promulgated by the Board continue to have the full force and effect of law. Copies of the letter also were sent to appropriate members of Congress. To assure that the Board files would be preserved, GAO assumed custody of such files until such time as the function was reactivated. Additionally, a CAS monitoring group was established in the General Accounting Office to carry out its oversight role in this important procurement area.

ISSUES SURROUNDING CAS 409 AND 414

In carrying out GAO's procurement oversight responsibility, GAO is conducting several active reviews involving specific Cost Accounting Standards. One review involves CAS 409, "Depreciation of Tangible Capital Assets" and CAS 414, "Cost of Money as an Element of the Cost of Facilities Capital" as they relate to one of the DOD initiatives for improving the acquisition process. You expressed interest in these two Standards and I would like to discuss briefly some results of our preliminary review.

Over 2 years ago, in April 1981, the DOD set forth a series of 32 initiatives for improving the acquisition process. On October 21, 1981, the Comptroller General testified before your Committee about our plan to monitor the implementation of those initiatives. At that time, he pointed out that GAO had special concerns regarding Initiative 5. The stated intent of Initiative 5 is to encourage contractors performing under defense contracts to invest in capital facilities that will enhance productivity. The Initiative listed 8 action items which were designed to encourage contractor investment in productivity enhancing capital assets. While we support, in principle, the Initiative's intent of enhancing productivity, there was one action item which we believed needed further evaluation before it was implemented.

Action Item 5a, calls for repealing or amending CAS 409 to permit more rapid capital equipment depreciation and to recognize replacement depreciation costs. CAS 409 prescribes methods for allocating depreciation costs to contracts. Because of the concern we had with this action item and because DOD was unable to provide any estimates as to what the cost impact of such an action might be, we sought to develop such information ourselves. The Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs sought GAO's views on this Initiative and on November 17, 1982, we delivered an Executive Summary to that subcommittee which outlined our preliminary observations on that DOD Initiative. Our survey was performed at 7 contractor segments which provided us with their actual asset acquisition and depreciation data for their five most recent years. This information gave us a mixture of real asset acquisitions by different contractors. We obtained from the contractors the value of asset acquisitions by category or class (machinery, buildings, etc.) for the years 1977 through 1981. They also provided their depreciation policies in use during those years.

We ran our data through 6 discrete hypothesis to develop a range of estimates on the possible impact of implementing Initiative 5a. The extreme hypothesis considered rapid depreciation (ACRS), reinvestment, and replacement (inflation) cost depreciation. Based on this hypothesis, we estimate that the added cost to the Government could be as high as $2.4 billion.

Since conditions similar to those we examined at the 7 segments could exist at more than 1000 other defense contractor segments, the potential impact of such a change to the entire defense industry could be much more than $2.4 billion. Furthermore, this is not a one-time cost increase but rather a continuing situation. Should this DOD Initiative be implemented, similar additional costs could continue as long as contractors remain in business, purchase capital assets, and contract with the Federal Government.

We did not conclude that the 7 contractor segments in our study were representative enough to draw an industry-wide conclusion. Because of the magnitude of our findings, it was decided that we should continue our study to assess Initiative 5a's impact under circumstances that will provide a result more nearly predictable for the entire defense industry. Under this continuing study we have expanded the scope of our original survey to gather the same type of data from 75 contractors listed as being in the 100 companies receiving the largest dollar volume of DOD prime contracts. Completion of this review is scheduled for September 1983.

Our Executive Summary was submitted to the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs on November 17, 1982. On December 20, 1982, DOD issued a memorandum for all the Secretaries of the military departments; the Director, Defense Contractor Audit Agency;and the Director, Defense Logistics Agency. The subject of the memorandum was: Encouraging

Capital Investment within Cost Accounting Standard 409 - Depreciation of Tangible Capital Assets. The memo stated in part "..... We have reassessed CAS 409 and find that it may be administered in a manner which is consistent with our need to improve contractor productivity......" In essence, this memo states that a special provision of CAS 409 provides latitude under which DOD can enter into advance agreements with contractors on shorter depreciation periods for certain assets than would otherwise be determined by application of the Standard.

This memorandum encourages DOD procuring activities to treat what is essentially an exception provision of the Standard as the Standard's prime focus. Because of this memo, the Chairman of the House Committee on Government Operations in a February 11, 1983, letter to the Secretary of Defense stated that the memo has the practical effect of repealing CAS 409. The Chairman stated that such a change could have serious budget implications and that DOD should provide any studies on the cost and resulting benefits of "advance agreements".

In his response to the Chairman, the Secretary of Defense said that earlier reimbursement of depreciation costs under abnormally short lives would be offset by decreases in the cost of facilities capital. The point being made is that use of abnormally short lives does not cost any more than would otherwise be allowable. We do not concur with DOD's conclusion because it does not go far enough. If the availability of abnormally short lives provides the incentive to invest once, it must be concluded that the continued availability will provide the same incentive again. Since this opportunity to reinvest occurs during the balance of the otherwise normal asset life, we believe DOD should have taken into account subsequent reinvestments. When this is done, significant increased costs must be recognized. For example, one hypothesis of our preliminary study assumed short depreciation lives and reinvestment by contractors when a depreciation cycle was completed. Based on our preliminary survey the full implementation of this hypothesis could result in significant increased cost to the Government.

We believe that DOD should not proceed with Initiative 5a. We believe further that DOD's memorandum of December 20, 1982, should be withdrawn or modified to correct what GAO believes is focusing undue attention and emphasis on what is essentially an exception provision of the Standard. CAS 409 which was promulgated on July 1, 1975, was written to provide criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and to cost objectives within such periods in an objective and consistent manner. CAS 409 was carefully crafted by the Cost Accounting Standards Board. It was founded in the cost accounting concept that depreciation costs "should be a reasonable measure of the expiration of service potential of the tangible assets subject to depreciation." It was published twice in the Federal Register for comment and during its promulgation hearings were held in both the House and the Senate. Congress concurred with the Standard as promulgated.

To suggest that CAS 409 be amended to provide increased cash flow and Return on Investment (ROI) as a incentive to invest in capital assets defeats, we believe, the essential purpose of the Standard. CAS 409 should not become the vehicle for stimulating cashflow and ROI regardless of the purpose for which such stimulation is desired. Mr. Staats, speaking for the Board at the Senate Hearings on CAS 409 identified DOD profit policy as the place to influence contractors investments. We agree with the CAS Board and believe that using the Standard to provide for these investment incentives would disguise as an element of cost what is properly an element of profit.

In the course of our preliminary review of the impact of amending or repealing CAS 409 we made concomitant observations on the impact of CAS 414, "Cost of Money as an Element of the Cost of Capital." The purpose of this Cost Accounting Standard is to establish criteria for the measurement and allocation of the cost of capital committed to facilities as an element of contract cost. Using the actual depreciation data from the 7 contractor segments in our preliminary study, we calculated the cost of money applicable to Government contracts for those 5 years of capital assets. The data from the 7 segments was for the 5 year period 1977 through 1981. This period was after CAS 414 became effective. We estimate that under the conditions that existed at each contractor, those 7 segments were reimbursed $511 million under CAS 414 based on the net book value of the 5 years of assets.

Concurrent with the promulgation of CAS 414, DOD through the Profit '76 study revised its profit policy in the attempt to recognize the fact that cost of money for capital committed to facilities would now be an element of contract cost. Previously, this cost had been considered as covered by the profit awarded on a contract. The revision to the profit policy was an attempt to ensure that this cost element would not be recovered both as a cost and also in profit. Based on its Profit '76 study, DOD structured its weighted guidelines to reduce that profit objective by a factor believed to be representative of the imputed interest allowed as cost. However, in a March 8, 1979, report on DOD's profit policy GAO pointed out that there was insufficient offset to cover the added costs made available to contractors through CAS 414, and thus, average contractor profits increased. Since the GAO report on Profit '76, DOD has increased the range of profit attributable to facilities capital from 6 to 10% to 16 to 20%. We believe this has the probable effect of increasing average contractor profits even further. This emphasizes further the need for considering the combined effects of CAS 409, CAS 414, and DOD profit policy.

One additional point which surfaced during our preliminary study of CAS 409 and CAS 414 has raised questions concerning the extent to which CAS 409 has required contractors to adopt longer asset lives.During the Senate hearings on CAS 409, 10 witnesses gave testimony and 30 additional statements were submitted for the record. Most of the witnesses from industry expressed reservations about the promulgation of CAS 409 because, among other reasons, it would cause asset lives to be lengthened unreasonably thus negatively affecting contractor cash flow. In our survey of the seven contractor segments we became aware of the fact that six of the seven segments indicated to us that they did not change their asset lives as a result of CAS 409's promulgation. In our continuing industry wide review we have specifically requested contractors to identify changes in asset service lives that have occurred subsequent to CAS 409 so that we can speak more directly to this question.

Before any amendment or repeal of CAS 409 is made, we believe that at the very least, the combined effect of CAS 409, CAS 414, and DOD profit policy should be thoroughly evaluated to assess their total impact. We believe that the results of our current industry wide study should provide data to help resolve these issues.

GAO VIEWS ON THE COST ACCOUNTING STANDARDS BOARD FUNCTION

You requested our views on (1) the need to reestablish the Board function and (2) the desired location if such a need exist. We have mentioned earlier in this statement there is some controversy surrounding CAS 409. A continuing Board function, we believe, would aid in resolving this type of issue.

Our views on the need for a Board function and its preferred location were addressed in a report we sent you on May 3, 1983. The basic elements of that report are covered below.

The GAO, through its oversight role of government procurement operations, has conducted reviews of the implementation of the Standards and the Defense Contract Audit Agency's (DCAA's) role in monitoring contractor compliance with the Standards. Currently, GAO has several ongoing assignments dealing specifically with selected standards. While GAO's work to date has shown that Federal departments and agencies implementation of the Standards is generally good and DCAA's CAS compliance determinations appear reasonable, GAO believes that, with the passage of time, the need to reactivate some form of a Board function increases. It appears increasingly more difficult for contractors, agency officials, and those charged with resolving CAS-related disputes to continue to operate efficiently without the aid and benefit of a Board. The environment in which the Standards exist continues to change while the Standards themselves remain fixed. Our belief is predicated on numerous problems which would either be resolved or dramatically improved if a Board were in operation. Some examples of these problems which have arisen since the Board ceased to operate are discussed briefly below.

--Without a Board there is no body empowered to grant waivers and exemptions to the Standards; yet it was the apparent intent of the Congress in the authorizing legislation to have a body to consider the need for waivers and exemptions. Recently the National Aeronautics and Space Administration (NASA) used authority under P.L. 85-804 to grant relief from CAS coverage.

--From time to time during the Board's life, it felt the need to provide interpretations of the Standards when there was a widespread and serious question of the Board's intended meaning. As discussed previously, such a question exists around the intended use of a special provision of CAS 409. DOD recently issued a memo to its procurement officials encouraging the use of this special provision. Members of Congress have expressed concern that this memo may focus undue attention and emphasis on what is essentially an exception provision of the Standard. This situation is a question that a continuing CAS Board may well wish to review.

For these reasons and others that will arise in connection with the dynamics of accounting for defense contracts, GAO believes that a body of work exists that is signficant enough to warrant the reactivation of a Board.

2. Appropriate Location for the Board Function

In expressing our views on the appropriate location for a reactivated Board, two features should be discussed:

1. The Standards are founded in well-reasoned accounting theory. The Board and its staff put extensive effort into researching, drafting, soliciting comments, and revising drafts on the Standards. The Board discussed at length the proposed Standards and was not satisfied until it had heard the salient arguments for or against the Standards. As a testament to their work, it should be noted that none of the 19 Standards was rejected during the 60 day period that each was required by law to lie before the Congress. In all their efforts, the Board and its staff strove to maintain and promote good accounting in an effort to increase uniformity and consistency in accounting for costs on defense contracts. This devotion to sound accounting was a paramount consideration to the Board and staff. GAO considers it imperative that any continuing Board function have sufficient accounting expertise and experience to maintain the cost accounting integrity of the promulgated Standards.
2. The second critical feature which must be addressed is independence of this cost accounting activity from the economic and incentive factors which influence Federal procurement policy. This independence was one of the primary features sought by the Congress in authorizing the Board under P.L. 91-379 which provided that the Board be an agent

of the Congress and independent from the executive branch. With the establishment of the Board, determinations as to the proper methods for measurement and allocation of cost were established by accountants who were independent of the Federal procurement process. GAO believes that this independence was intended by the Congress and that the same independence should be maintained in any continuing Board function.

GAO believes, therefore, that any Congressional action on the location of the Board function must ensure the availability of adequate accounting expertise and independence. There are two options for location of a continuing Board function which, if chosen, would in the opinion of GAO satisfy the criteria discussed above.

The option preferred by GAO would be for the Congress to appropriate a limited amount of funds to the original authorizing legislation, P.L. 91-379. The necessary funds would cover the compensation and travel of the Board members appointed from private life as prescribed in P.L. 91-379. GAO, with some augmentation of its staff, would provide the primary staff support for the Board. This action would revitalize the Board and satisfy the criteria of independence and the availability of accounting expertise at reduced costs to the Federal Government.

A secondary option is to issue new authorizing legislation to empower the Comptroller General as the head of GAO to perform all duties and functions that belonged to the Board. Provisions could be made for an Advisory Board similar to the prior Board's make-up which could advise the Comptroller General of the affected parties' views. GAO, with some augmentation of its staff, would perform the support duties. As with the previous option, reactivating the Board function would be accomplished, while ensuring independence and providing accounting expertise at a reduced cost to the Federal Government.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or members of the Committee may have.