UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

25817

NATIONAL SECURITY AND
NTERNATIONAL AFFAIRS DIVISION

B-210991

JULY 26, 1983

The Honorable Caspar W. Weinberger
The Secretary of Defense

Attention: Office of GAO Report Analysis

Dear Mr. Secretary:

Subject: Unresolved Cost Accounting Standard 409 Noncompliance Issues at FMC and Northrop Corporation (GAO/NSIAD-83-13)

This report summarizes our review of certain unresolved issues involving Cost Accounting Standard (CAS) 409, "Depreciation of Tangible Capital Assets," at FMC's Ordnance Division Operations and Northrop Corporation's Aircraft Division. These issues have remained unresolved since 1978, despite considerable Department of Defense (DOD) contract administration, audit, and review activity.

We believe, as discussed in enclosure I, that there is a sufficient basis for the responsible administrative contracting officers (ACOs) to settle these issues. Further, we believe available information suggests a determination that:

--FMC's Ordnance Division is in noncompliance with CAS 409 for (1) using a depreciation method which does not reasonably reflect the expected consumption of services for its buildings and (2) failing to estimate asset service lives as supported by historical records.

--Northrop's Aircraft Division is in noncompliance with CAS 409 for using a depreciation method which does not reasonably reflect the expected consumption of services for its new aircraft and new buildings.

These unresolved issues have negatively affected the contracting processes at these locations since 1978. Over this period, the Government and these two corporations have spent a great deal of administrative time and effort on these issues, and this should be reason enough to expedite a resolution of this matter.

(942074)

026233 / 121951

Furthermore, the ACOs' delay in issuing final determinations at FMC and Northrop causes the Government to reimburse the contractors for excess depreciation charges. At FMC's Ordnance Division, at least six defense contracts have been affected by depreciation charges which were based on disputed depreciation methods.

Although we recognize the complexities associated with evaluating depreciation practices, further delay in making final determinations is not warranted. We recommend that the Secretary of Defense take action to resolve these issues.

DOD reviewed a draft of this report and agreed that FMC's service life estimates for metal working assets are understated. The ACO will negotiate with FMC to resolve this matter. On the issue of depreciation methods used by FMC, DCAA issued two reports. The first report indicated that FMC's depreciation methods were in noncompliance with CAS 409. In the latter report, DCAA reversed its positon on this matter and indicated that FMC was in compliance with the standard. We disagree with DCAA's revised position. In the case of Northrop, DOD stated that it needs a final audit report from DCAA to serve as a basis for resolution. We believe DCAA should issue the required audit report which would allow the ACO to make a final decision on the matter.

- - - -

As you know, 31 U.S.C. § 720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to (1) the Director, Office of Management and Budget, (2) the Chairmen of the above committees, and (3) the Chairman, House Committee on Banking, Finance and Urban Affairs.

Sincerely yours,

Frank C. Conahan

Frank C. Conahan
Director

Enclosures - 2

UNRESOLVED COST ACCOUNTING STANDARD 409 NONCOMPLIANCE ISSUES AT FMC AND NORTHROP CORPORATION

OVERVIEW

CAS 409 was promulgated to achieve more uniformity and consistency in the depreciation practices of defense contractors. It provides criteria and guidance for assigning costs of tangible capital assets to cost accounting periods and for allocating such costs in cost objectives within such periods in an objective and consistent manner. CAS 409 is based on the concept that the depreciation costs identified with cost accounting periods and benefiting cost objectives within periods should be a reasonable measure of the expiration of service potential of the tangible assets subject to depreciation. Adherence to this standard should provide a systematic and rational flow of the costs of tangible capital assets to benefited cost objectives over the expected service lives of assets. CAS 409 became effective on July 1, 1975.

The standard states that the following factors may be considered when depreciating an asset for Government contract costing or financial reporting purposes: quality and quantity of expected output, repair and maintenance expenditures, standby or incidental use, and technical or economic obsolescence of the asset.

The Defense Contract Audit Agency (DCAA) is designated to determine whether defense contractors are complying with the Cost Accounting Standards. DCAA provides financial information and advice to Government procurement and contract administrative management personnel. DCAA audit services are used also in connection with negotiating, administering, and settling contract payments.

Defense procurement policies require that contracting officers consider DCAA audit recommendations in the pricing actions of defense contracts. However, the ACO has the final responsibility for determining whether a contractor is complying with the Cost Accounting Standards. Upon evaluating a DCAA report of noncompliance, the ACO makes an initial determination. If the ACO agrees with DCAA that a noncompliance situation exists, the contractor has an opportunity to comment and furnish additional information. After evaluating the contractor's response, the ACO should promptly make a final decision on the matter.

OBJECTIVES, SCOPE, AND METHODOLOGY

In July 1982, we completed a review of DCAA audits of contractor compliance with the Cost Accounting Standards. During that review, we became aware of several issues concerning initial determinations of noncompliance with certain provisions of CAS 409 at FMC and Northrop. In addition, we noted disagreement within DOD over the resolution of these issues. Therefore, we evaluated these issues to determine why they have remained unresolved since 1978.

Our review was performed at the FMC Ordnance Division Operations, San Jose, California, and the Northrop Corporation Aircraft Division, Hawthorne, California. We examined procurement files, audit reports, Federal procurement regulations, Cost Accounting Standards, and financial accounting depreciation literature.

Documentation was obtained from DCAA, the Defense Logistics Agency (DLA), the Defense Contract Administration Services, the Air Force Systems Command, the Air Force Contract Management Division, FMC, and Northrop. We talked with officials from these organizations and consulted with former staff members of the Cost Accounting Standards Board, as well as staff members of the Financial Accounting Standards Board, the Logistics Management Institute, and a major accounting firm.

Our audit was made in accordance with generally accepted government audit standards.

UNRESOLVED CAS 409 ISSUES AT FMC'S ORDNANCE DIVISION OPERATIONS

The ACO at FMC made three initial determinations of noncompliance with CAS 409 on October 24, 1978. According to the ACO, FMC's proposals did not provide

--reasonable asset service lives (CAS 409.50(a)),

--estimates of likely patterns of asset consumption (CAS 409.50(a)), and

--asset residual value estimates (CAS 409.50(h)).

The ACO stated that the FMC Ordnance Division's proposed service lives and use of the 150-percent declining balance depreciation method for buildings and land improvements and the sum of-the-years digits depreciation method for other asset classes did "not appear to result in reasonable costs to the

Government when compared to the commercial operation [of FMC] which uses a straight line method of depreciation * * *."

FMC disagreed with the ACO's initial determinations. FMC argued that its depreciation methods had been accepted by the Government prior to the promulgation of CAS 409 and that these methods had not been changed. FMC stated further that since its methods were used for both financial and contract costing purposes and were acceptable for Federal income tax purposes, the Government must substantiate the unreasonableness of FMC's methods vis-a-vis expected consumption of asset services. Also, FMC argued that service lives and residual values based on available historical records were not statistically valid.

The ACO's initial noncompliance determinations concerning service lives and depreciation methods were based on two DCAA audit reports dated 1977 and 1978. In August 1979, DCAA issued two additional reports which concluded that the Ordnance Division was in noncompliance concerning service lives and residual values but that the Division's depreciation method for newly acquired assets complied with CAS 409. The ACO has been reluctant to make a final determination of noncompliance because DCAA changed its position as to whether FMC's depreciation methods violated CAS 409.

In September 1979, DLA analyzed the Division's budget for the period 1979-83 and noted that the Division proposed an almost constant rate of production for this period. Based on this analysis, DLA concluded that a straight-line rather than an accelerated depreciation method was more appropriate for buildings, since expected consumption of these assets was reasonably level and this would match a historical and projected level of production. DLA's analysis measured output over a 5-year period and was based on FMC's data. We reviewed DLA's analysis, and we agree that FMC's buildings should be depreciated on a straight-line basis.

GAO audit work supports straight-line method for depreciating Ordnance Division buildings

To develop a more complete analysis concerning the CAS 409 noncompliance issue at the FMC Division, we performed additional audit work which sustained the ACO's initial determinations of noncompliance concerning depreciation methods for buildings.

CAS 409.50 states that

"The expected consumption of asset services * * * may be measured by the expected activity or the expected physical output of the assets * * *. An acceptable surrogate for expected activity or output might be a monetary measure of that activity or output generated by use of tangible capital assets, such as * * * total cost incurred or total revenues * * *." [CAS 409.50(f)(3)]

* * * * *

"An accelerated method of depreciation is appropriate where the expected consumption of asset services is significantly greater in the early years of an asset life." [CAS 409.50(f)(3)(i)]

* * * * *

"The straight-line method of depreciation is appropriate where the expected consumption of asset services is reasonably level over the service life of the asset (or group of assets)." [CAS 409.50(f)(3)(ii)]

We believe that a straight-line, rather than an accelerated, method of depreciation most reasonably reflects the expected consumption of services for the Ordnance Division's buildings. This conclusion is based on our review of the Division's building capitalization policies and cost-of-sales history from 1972 to 1981, as well as information disclosed by DCAA and DLA.

CAS 409 provides guidance for measuring the expected output generated by the use of a tangible capital asset. In measuring or estimating the consumption of asset services, reliable data must be obtained which reasonably relates to the usage of the asset. The standard states that an acceptable surrogate for measuring expected activity or output generated by the use of an asset might be a monetary measure of that activity, such as cost of sales. Cost of sales is a recognized measure of physical output for a manufacturing operation. Physical output at the Ordnance Division varied significantly in unit size and type. For example, large and small personnel carriers, kits, and fuel cells were produced in the same facility during overlapping time periods. Therefore, cost of sales rather than production units is a better measure of total physical output generated by the Division's buildings.

To measure the use of an asset, such as a building, we reviewed the Ordnance Division's cost of sales for the period 1972-81. When we adjusted this data for inflation, a trend developed which showed an almost steadily increasing cost-of-sales pattern. This pattern indicated that the straight-line method was appropriate for depreciating the Ordnance Division's buildings. The data did not indicate that the expected utility of the Division's buildings was greater in the earlier years of useful life. To the contrary, the highest annual cost of sales occurred from 1976 to 1981. If, over the 10-year period, the cost of sales had been proportionally greater in the earlier years, FMC would have some support for depreciating its buildings on an accelerated basis. However, the cumulative cost-of-sales did not exceed 50 percent of total cumulative sales for the period until the sixth year, 1977. The Division had not made substantial additions to its building account until 1979, which suggested that the cost-of-sales data up until 1979 was associated with a relatively constant level of investment in buildings.

Asset service lives are not supported by historical records

We believe also that FMC's Ordnance Division is in noncompliance with CAS 409 because FMC's metal working asset service life estimates are not supported by historical records. FMC's records support longer service lives.

CAS 409.50(e) (1) and (2) require asset service life estimates (expected periods of usefulness) to be supported by records of past retirements and withdrawal from active use. These estimates may be shortened by excluding documented past standby or incidental use.

The Division's proposed service lives for metal working assets (metal working--10 years, forklifts--8 years, weld and paint--5 years, and small tools--5 years) are shorter than the average 11-year service life supported by historical records of asset retirements from 1971 to 1976. Additionally, the Division's retirement records for 1976-81 show that conventional and numerically controlled metal working assets had average service lives of 14 years and 12 years, respectively. The Division maintains that these longer service lives include incidental use while its proposed service lives do not provide for such use. However, the Division could not document standby or incidental use as required by CAS 409.

FMC'S comments and our evaluation

FMC suggested that an asset's future pattern of consumption be considered in determining the reasonableness of the expected period of usefulness. FMC presented an analysis of its projected cost of sales for the period 1983-90. This projection showed a cost-of-sales pattern significantly different from the pattern developed through use of historical data. FMC used this very conservative forecast to support an accelerated depreciation method as matching future revenues. We agree that an asset's future patterns of consumption should be considered in determining the appropriate depreciation method. However, based on its historical cost of sales, we believe that FMC's forecast is unrealistic.

To determine the estimated service lives for metal working equipment, FMC suggested that the most important factor to consider should be the "expected future use" of the asset. In coming to this conclusion, FMC cites CAS 409.50(a) as its basis. In reviewing these circumstances, we considered all aspects of CAS 409. FMC stated that CAS 409.50(a) permits adjustment to historical data for expected technological or economic factors. Too much emphasis on this provision will result in omission of other important elements bearing on this issue (i.e., patterns of consumption). Furthermore, CAS 409.50(e)(2) states that "* * * the burden shall be on the contractor to justify estimated lives which are shorter than such experienced lives." The contractor has not met this burden and has not justified to the contracting officer that the use of shorter depreciation lives is appropriate.

CAS 409 indicates that in unique circumstances, contracting parties may agree on asset lives shorter than historical records would indicate, but this exception provision requires that the parties agree to these shorter lives. In this case, the contracting officer did not agree.

UNRESOLVED CAS 409 ISSUES AT NORTHROP CORPORATION'S AIRCRAFT DIVISION

Based on a December 8, 1978, DCAA audit report of noncompliance, the ACO at Northrop's Aircraft Division made an initial determination of noncompliance on December 20, 1978. DCAA's audit report concluded that Northrop's accelerated depreciation methods did not reflect the actual patterns of consumption for new factory machinery and equipment, scientific test equipment, engineering and photographic equipment, new buildings, furniture,

and fixtures. The report added that Northrop should comply with CAS 409.50(f)(3)(i) by using accelerated depreciation only for those assets where it could demonstrate significantly greater consumption of asset services early in the assets' service lives. Notwithstanding DCAA's position, in January 1980, the ACO decided that Northrop depreciation methods were in compliance with CAS 409.

A DCAA memorandum, dated April 29, 1982, to the ACO reaffirmed DCAA's earlier conclusions that Northrop's use of accelerated depreciation methods did not reasonably reflect the actual patterns of service consumption for aircraft and buildings acquired new. From a review of Northrop's building accounts, DCAA concluded that the expected output of a building (occupancy) remains constant throughout its useful life. Concerning Northrop's aircraft, DCAA's review indicated that aircraft output (flight-hours) had not been significantly greater in the early years of useful life. DCAA noted also that normal aircraft maintenance is scheduled over aircraft life and is not anticipated to be weighted toward the later asset years.

To develop a more complete analysis of the unresolved CAS 409 issues, we performed a comprehensive review of DCAA's audit approach. We agree with DCAA's conclusion that the Northrop Aircraft Division is in noncompliance with CAS 409 by depreciating new aircraft and new buildings under the declining balance method. This method does not reasonably reflect the expected consumption of services for these assets and contradicts CAS 409.50(f)(1) and CAS 409.50(f)(3)(i).

Northrop's secondhand aircraft and secondhand buildings are depreciated under the straight-line method, which we believe reflects the expected patterns of consumption for these assets. Further, since new aircraft and new buildings are employed in similar circumstances as their used counterparts, we believe that the straight-line method should also be used for both new aircraft and new buildings.

Northrop's comments and our evaluation

Northrop does not believe that its use of accelerated depreciation for new buildings and new aircraft violates CAS 409. Northrop indicated that repairs and maintenance also need to be evaluated when establishing an asset's service life or depreciation method. Northrop stated that its schedule of maintenance for aircraft and buildings is not anticipated to be weighted toward the later asset years, but that "the cost of the maintenance is certainly higher in those years." DCAA noted that

with proper preventive and routine mainenance, accelerated depreciation is not proper for new buildings because expected consumption of asset services is not significantly greater in the early years of the asset's life. Further, DCAA concluded that major overhaul of aircraft is anticipated to occur at the end of the established service life, when the asset is fully depreciated. DCAA noted that the cost of overhaul is capitalized as a betterment to the asset, thereby extending its useful life, and technological or economic obsolescence is not anticipated during the asset life.

We agree with DCAA's conclusions. Northrop states that repairs, maintenance, and obsolescence need to be considered when establishing service life or method of depreciation. However, we do not believe that Northrop has provided sufficient information concerning repairs and maintenance to override all the evidence which supports recommending that new aircraft and new buildings not be depreciated on an accelerated basis.

Finally, Northrop stated that our

> "* * * position on accelerated depreciation seems to be in conflict with the current Administration's policy on industrial investment. There is certainly much evidence which indicates that the Reagan Administration is in favor of industry recouping their investments in plant and equipment much faster than in preceding years. [Northrop] cannot understand why the GAO and the DCAA seem to be going out of their way to thwart the Administration's efforts on this issue."

We support the use of accelerated depreciation where the expected consumption of an asset's services is greater in the early years of an asset's life, pursuant to CAS 409.50(f)(3)(i). However, to suggest that CAS 409 be administered in such a way as to provide increased cash flow and return on investment as an incentive to invest in capital assets defeats the essential purpose of the standard. CAS 409 should not become the vehicle for stimulating cash flow and return on investment. The Cost Accounting Standards Board identified DOD's profit policy as the place to influence contractor investment. We agree with the Board on this point and believe that using CAS 409 to provide for these investment incentives would disguise, as an element of cost, what is properly an element of profit.

DOD AND ADDITIONAL CONTRACTOR COMMENTS AND OUR EVALUATION

Comments on a draft of this report were obtained from DOD, FMC, and Northrop. Most of FMC's and Northrop's comments are contained in enclosure I. However, an additional contractor comment is discussed below.

DOD COMMENTS

DOD agreed with our conclusion that FMC's service life estimates for metal working assets are understated and indicated that the cognizant ACO will negotiate with FMC to reach an agreement on this matter.

DCAA issued two reports concerning FMC's depreciation methods. The first report indicated that FMC's depreciation methods were in noncompliance with CAS 409. In the latter report, DCAA reversed its position on this matter and indicated that FMC was in compliance with the standard. We disagree with DCAA's revised position.

DOD stated that various DOD organizations have not reached an agreement on whether a material noncompliance situation exists at FMC concerning CAS 409. We considered the issue of materiality at FMC, and we believe the benefits of complying with CAS 409 should be of paramount importance to DOD. By requiring contractors to comply with CAS 409, the costs of tangible capital assets will be more consistently assigned to cost accounting periods and uniformly allocated to cost objectives within such periods.

DOD stated that in January 1980, the ACO rejected DCAA's position concerning Northrop's noncompliance with CAS 409 and that this issue had been resolved. However, in April 1982, DCAA issued a memorandum which concluded that Northrop's use of accelerated depreciation for new aircraft and new buildings was not in compliance with CAS 409. DOD officials told us that the information which DCAA had developed was presented in a "memorandum" and not a "report." DOD made the distinction that its procedures prohibit the ACO from taking actions until receipt of a DCAA "report" of noncompliance. The DCAA memorandum indicated that the situation is still unresolved. To help resolve this matter, DCAA should present its position in a report.

ENCLOSURE II

FMC AND NORTHROP COMMENTS

FMC and Northrop informed us that our report should recognize the desirability of a "prospective only" settlement rather than requiring retroactive application of the straight-line depreciation method. We do not have the authority to be dispostive of this issue. However, settlement of these longstanding disagreements on a prospective basis would signficantly benefit all parties in the procurement process.