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COMPTROLLER GENERAL OF THE UNITED STATES
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August 13, 1981

The Honorable James J. Blanchard
Chairman, Subcommittee on Economic
Stabilization
Committee on Banking, Finance and
Urban Affairs
House of Representatives

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Dear Mr. Chairman:

This is in response to your June 29, 1981, letter in which you raised two issues related to Cost Accounting Standards (CAS). First, you pointed out that before any attempt was made to amend or repeal CAS 409, "Depreciation of Tangible (Capital) Assets," an independent agency should further examine all of the issues involved. Second, you asked to be apprised of the status of any current GAO reviews dealing with Cost Accounting Standards.

We agree that an examination and review should be made prior to changing any of the Cost Accounting Standards promulgated under Public Law 91-379. As you pointed out CAS 409 underwent extensive research in support of its promulgation. The report of the Defense Industrial Base Panel of the House Committee on Armed Services, dated December 31, 1980, and the Department of Defense (DOD) Memorandum dated April 30, 1981, both include a common element, in that they suggest changes to CAS 409 as a means of offering incentives for industry to invest in tangible capital assets. It should be remembered, however, factors other than CAS 409 which bear directly on this point. CAS 414, for example, is one factor; DOD's profit policy is another.

Before an apparently simple solution, such as amending or repealing CAS 409 is attempted, all of the factors that have been identified as affecting additional capital investment should be examined and a set of recommendations should be developed that would deal with all of the issues. This would include consideration of the current DOD profit policy, CAS 414, and corporate management's orientation toward long-term investment. In particular, the position to avoid is one where corrective action is taken that deals only with some of the factors involved and thus provides no real assurance that the remaining impediments do not negate the attainment of the goal of improving the investment climate. The recommendations dealing with CAS 409 should not be segregated from other issues in this rather complex area dealing with investment incentives.

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The argument in favor of repealing CAS 409 is in essence, an argument for abandoning the rational cost accounting concept for computing depreciation costs in Government contracting. Depreciation will no longer reflect "expected consumption of services;" rather, it will become an arbitrary figure designed to provide economic incentives for higher contractor investment. Such an isolated approach, by dealing with a single factor in an exceedingly complex situation, should be avoided.

We would like to make an additional point regarding the issue of replacement costs raised by the April 30, 1981, DOD Memorandum, in connection with CAS 409. We believe that particular care must be taken in dealing with arguments that favor introduction of replacement costs as a base for depreciation computation. The question of adjustment for the inflationary erosion in invested capital is a longstanding issue and has been considered at some length by authoritative accounting bodies, including the Cost Accounting Standards Board (CASB) and the Financial Accounting Standards Board (FASB). Generally, two approaches to the problem involve: (1) adjusting assets bases so that the inflationary price changes would be reflected in the asset values used for depreciation computation or (2) incorporating a return on invested capital (applied to a historical cost base) at a rate that would include compensation for the inflationary price movements.

The first approach is more commonly advocated for financial accounting purposes, and in fact, FASB, in its statement No. 33, follows this approach, that is the adjustment of asset bases. The CASB proposed a standard along these lines in October 1975. However, after reconsideration, CASB changed its view, proceeded with the second approach, and promulgated CAS 414. By recognizing imputed interest as a cost, CAS 414 provided contractors with return on their invested capital. The two approaches, however, represent alternatives, and therefore, should not be applied concurrently. The introduction of the concept of replacement costs into Government contracting should be accompanied by a modification of CAS 414 to eliminate any inflationary element from the cost of money rate as currently employed in the implementation of that standard.

In response to the second point in your letter, early this year, we began a project to determine whether Cost Accounting Standards are being implemented by Government agencies in accordance with the provisions of Public Law 91-379. We have made onsite inspections of 44 procurement installations of DOD, National Aeronautics Space Administration, and Department of Energy. Over 150 individuals were interviewed. Using the information gathered in these interviews, we are scoping the second phase of our CAS Review Program. In this next phase, we intend to determine how contractors are complying with Cost Accounting Standards.

Although our Review Program emphasizes Government implementation of, and contractor compliance with, the standards, it is anticipated that either toward the end of this review, or as a separate review effort, attention will be paid to the effectiveness of individual standards. CAS 409 will be covered in any such review. Meanwhile, if it would be of benefit to the Committee, we will provide an analysis of the principal arguments on this subject which were considered at the time CAS 409 was being developed. This analysis could be made from data available from CASB files which GAO has in temporary custody.

We expect to issue a report on phase I (Government implementation) and phase II (contractor compliance) in July 1982. We would be pleased to provide you with progress briefings if you so desire.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States