
Future Role of the
C_{ost} **A**_{ccounting} **S**_{tandards} **B**_{oard}

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Cost Accounting Standards Board Review Panel
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SUMMARY OF RECOMMENDATIONS

Congress asked the General Accounting Office (GAO) to establish a panel of experts to study and make recommendations regarding the Cost Accounting Standards (CAS) Board and the CAS system against the background of the far-reaching procurement reforms of recent years. This group, the CAS Board Review Panel, believes that there is a continuing need for the CAS and the CAS Board. Cost-based contracts continue to represent the majority of all federal contracting dollars and the original purposes of the CAS--principally, the need for uniformity and consistency to protect the government from certain risks inherent in cost-based contracts and to improve communications between the government and contractors with regard to those contracts--remain.

While there continues to be a need for the CAS, the Panel believes reforms are needed to encourage the participation of new commercial companies in government procurement and to reduce the burden of government unique accounting requirements on smaller companies. The Panel believes that a number of reforms can reduce the burdens and costs of the CAS system without diminishing its benefits. Implementing these reforms will help expand the government's industrial base and provide relief for smaller firms, with no significant reduction in the amount of dollars subject to CAS coverage.

Changes to the Board's Location and Membership. The Panel believes that consideration of changes to the Board's location, membership, and staffing is warranted and will improve the Board's effectiveness. In particular, the Board's placement in the Office of Federal Procurement Policy (OFPP) within the Office of Management and Budget (OMB) has imposed limitations on the Board's work and raised questions regarding its independence. In considering an alternative, the Panel believes that the Board should be an independent organization, although it could be placed within a host agency, either the General Services Administration or the Department of Defense (DOD), as long as the Board's autonomy is ensured. In terms of membership, the Panel recommends that the Board continue to have a majority of government members; the Chair be a government officer; and that other members include a representative of DOD (which continues to be responsible for the majority of CAS-covered contracts), a representative of a civilian agency, an industry representative, and a representative of the accounting profession (not a government employee). The Panel believes that, given the Comptroller General's independence and particular interest in the CAS, there would be value in adding the Comptroller General as a non-voting member.

Changes in CAS Applicability. The Panel recognizes that increases to the applicability thresholds as well as the creation of new exemptions to CAS coverage are controversial areas. Accordingly, the Panel searched for ways to reduce the costs of the CAS system while maintaining its benefits for those contractors with a significant pricing risk to the government. Based on its analysis of the numbers of

contractors and percentages of dollars that would be affected, the Panel concludes that the current \$500,000 contract application threshold should be retained, but that the OFPP Act of 1988 should be amended so that the applicability of the CAS to non-exempt contracts would be triggered only by receipt of a contract of \$7.5 million or more. According to the Panel's analysis, if this change is implemented, about 97 percent of CAS-covered dollars will continue to be subject to the CAS, but the number of contractor segments subject to CAS coverage will significantly decrease. The Panel also recommends that the threshold for full CAS coverage be increased from \$25 million to \$50 million.

In addition, the Panel recommends that firm fixed-price contracts be exempt from the CAS in those cases where the government does not obtain certified cost or pricing data at the time of award. The Panel reached this conclusion because when certified cost or pricing data is not obtained, the safeguards provided by the CAS are not necessary.

Transfer of Administrative Responsibilities to Contracting Agencies. The Panel recommends that Congress provide contracting agencies with responsibility for contract administration related to the CAS, such as the authority to waive CAS requirements. Consistent with recent procurement reforms, which have vested more discretion in contracting agencies in such contract administration matters, the granting of waivers by the concerned agencies would be more efficient and expeditious, and would allow the CAS Board to focus on maintaining a system of cost accounting requirements.

Review of Standards. The Panel believes that an overall review of the CAS and their attendant requirements is warranted to judge whether the standards should be streamlined. In that review, consideration should be given to the experience gained in the twenty years since the standards were initially promulgated; the contentions that procurement policy and funding concerns have inappropriately shaped the standards; the areas in which the CAS and generally accepted accounting principles overlap and differ; and the possibility that the disclosure statement may be unnecessarily burdensome. The Panel also concludes that there is no longer a continuing need to include CAS 405 (accounting for unallowable costs) and CAS 406 (cost accounting period) in the definition of modified coverage in light of other applicable requirements.

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Abbreviations

ABC	Activity Based Costing
AICPA	American Institute of Certified Public Accountants
ASBCA	Armed Services Board of Contract Appeals
ASPR	Armed Services Procurement Regulation
B&P	Bid and Proposal
CAS	Cost Accounting Standards
CBO	Congressional Budget Office
CPA	Certified Public Accountant
DCAA	Defense Contract Audit Agency
DCMC	Defense Contract Management Command
DOD	Department of Defense
DOE	Department of Energy
IDCC	Integrated Dual-use Commercial Companies
FACA	Federal Advisory Committee Act
FAR	Federal Acquisition Regulation
FASA	Federal Acquisition Streamlining Act
FASB	Financial Accounting Standard Board
FERC	Federal Energy Regulatory Commission
FIFO	First-in, First-out
FPDS	Federal Procurement Data System
G&A	General and Administrative Expense
GAAP	Generally Accepted Accounting Principles
GAO	General Accounting Office
GSA	General Services Administration
ICC	Interstate Commerce Commission
IR&D	Independent research and development
JDAMS	Joint Direct Attack Munitions System
JPATS	Joint Primary Aircraft Training System
LIFO	Last-in, First-out
NASA	National Aeronautics and Space Administration
OFPP	Office of Federal Procurement Policy
OPM	Office of Personnel Management
OMB	Office of Management and Budget

Abbreviations

RAPB	Railroad Accounting Principles Board
STB	Surface Transportation Board
T.D.	Treasury Decision
TINA	Truth in Negotiations Act

INTRODUCTION

BACKGROUND

Since the early part of the century, the federal government has had accounting requirements or criteria designed to protect it from the risk of overpaying for goods and services by governing the manner or degree to which contractors apportion costs to their cost-based contracts with the government. A key role in the current rules is played by the 19 standards that were developed in the 1970s by the Cost Accounting Standards (CAS) Board, a body created by Congress for the purpose of developing a set of uniform and consistent standards. The 19 standards and their attendant regulations impose unique and significant accounting requirements on companies that are awarded cost-based contracts by the government.

In recent years, the dominant trend in government contracting has moved toward simplifying the government's acquisition process and eliminating government-unique requirements. While the CAS system has largely remained untouched by these reforms, there have been calls to adjust the standards or exempt more contracts from the burden of compliance with them. The wisdom of doing so turns largely on cost/benefit analyses weighing the benefits of the CAS system against its costs, as well as on judgments about the level of risk the government should tolerate in possible accounting, pricing, and costing techniques that may result in overpayments by the government.

Congress asked that the General Accounting Office (GAO) establish a panel of experts to study issues concerning the CAS system and make recommendations to Congress. Noting that the contracting environment in the federal procurement system has significantly changed since the establishment of the original CAS Board more than 25 years ago, Congress asked that the CAS Board Review Panel focus on such things as the:

- viability of the CAS Board's original mission after major changes in the procurement laws;
- extent to which a board is advisable to regulate contractor cost accounting practices;
- extent to which the cost allocability functions of such a board should be combined with functions related to determinations of cost allowability;

-
- composition, membership, and structure of such a board to ensure its independence and balance; and
 - provision of adequate staff and resources for such a board.

Congress directed that the Panel consist of members from the government's procurement/acquisition offices, private industry, and the private accounting profession (but not CAS Board members or staff). Congress further directed that the Panel's activities should "include opportunities for substantial participation and analysis by industry and the private accounting profession, as well as government representatives."

In accordance with this direction, GAO created a Panel of 10 members with extensive knowledge of accounting and finance and proven track records of concern for the public interest in matters related to the CAS.¹ Five were from the government, four from private industry, and one from the private accounting profession.

In considering the various issues that Congress raised, the Panel received an enormous amount of information and advice from government representatives, industry, and the private accounting profession. For example, as part of the data gathering process for this report, the Panel held public hearings on June 16-18, 1998, at which more than 25 officials from government and industry presented views about the future role of the CAS Board and the standards themselves. The Panel also met with the current members of the CAS Board.

The Panel's work was supported by staff working groups formed under GAO's sponsorship to provide support to the Panel members as well as administrative support to the study. The working groups consisted of staff from GAO, other government agencies (Department of Defense (DOD), National Aeronautics and Space Administration (NASA), and Office of Personnel Management (OPM)), the legal and public accounting community, and industry. The members of these working groups brought substantial expertise on issues relating to contract administration, government requirements, and industry compliance with the CAS requirements.

To review the past and current role of the CAS Board, the working groups researched the events leading to the creation of the standards and the CAS Board as well as the events leading to more recent changes in acquisition laws. The Defense Contract Audit Agency (DCAA) and the Defense Contract Management Command (DCMC) presented data to evaluate contracts to which the CAS apply and analyze potential changes in the CAS thresholds. In addition, to learn about the costs and benefits of the CAS and how contractors manage the CAS requirements, a group of primarily commercial companies and the major DOD contractors was surveyed, and the testimony of government and

¹See appendix I for a list of Panel members.

industry representatives was considered. GAO staff reviewed internal Board documentation and held meetings with the Executive Secretary and other Board staff to analyze recent CAS Board promulgations. A draft report was developed that was then fully reviewed by the Panel members, who brought to bear their individual expertise.

The Panel found a continuing need for the CAS and CAS Board, but it concluded that some changes are appropriate. This report is the result of this extensive effort and presents the Panel's unanimous conclusions and recommendations.

The following sections of this chapter trace the early history of cost allocation rules and the events that led to the development and adoption of the present-day CAS Board. The chapter closes with a summary of some of the more relevant aspects of the recent reforms that have been implemented in the federal procurement process.

EARLY COST ALLOCATION RULES

The federal government has often used contracts in which the price is based upon the contractor's cost of performing (cost-based contracts),² and the government has recognized the need to protect itself from being mischarged by defining the costs that can be recovered under the contracts ("allowability") and establishing some rules for the allocation of indirect costs to the contracts. As early as 1916, the Munitions Manufacturers Tax legislation specified which costs could be recognized when determining profits on government contracts for purposes of determining a tax on munitions contractors' profits.³ Government contracting officers began referring to this legislation to determine which costs would be reimbursed on federal cost-type contracts.

Beginning in 1934, the Department of Treasury issued rules (culminating in Treasury Decision [T.D.] 5000) that were followed by government contracting officers. T.D. 5000 defined various types of costs and identified certain ones as unallowable, and provided principles for allocating indirect costs to federal contracts. In 1942, the War and Navy Departments jointly published a set of cost principles, dubbed the "Green Book," which were also widely used by contracting officers. The Green Book took a cost-by-cost approach to the apportionment of cost categories. For example, the Green Book provided that shop engineering expenses could be allocated by job or project and calculated as percentages of direct labor or production costs.

²Throughout this report, references to cost-based contracts include all cost-type contracts as well as those fixed-priced contracts where the contractor's estimated or actual costs play a role in determining the amount the government pays.

³38 Stat. 781 (1916).

In 1949, the Armed Services Procurement Regulation (ASPR) superseded the Green Book and T.D. 5000 for DOD contracts. The ASPR addressed the allowability of various costs and stated general principles regarding how costs should be allocated. In 1959, the ASPR was amended to introduce more detailed and specific allocation rules, although contractors were still allowed broad latitude in measuring, assigning, and allocating costs. These rules were essentially the same as those contained in the Federal Acquisition Regulation (FAR) today.

While not a cost allocation rule, a significant statute relevant to contractor costs is the Truth in Negotiations Act (TINA).⁴ TINA was first enacted in 1962 after congressional studies found cases of overpricing in negotiated DOD contracts because of inflated or erroneous cost estimates. TINA was intended to protect the government from the risk of overpayment by placing the government on equal footing with contractors in negotiating contract prices and giving the government the right to seek contract price adjustments if contractors breach their duties under TINA.

EVENTS LEADING TO THE DEVELOPMENT OF THE CAS

In 1968, during Congress's consideration of whether the Defense Production Act of 1950 should be extended, Admiral Hyman G. Rickover testified that it was nearly impossible to ascertain the profit on a particular contract because of the lack of control over the definitions and the shifting treatment of contract costs. He proposed that Congress provide for the development of uniform accounting standards for defense contracts so that these costs could be measured and controlled.

As a result, the House Banking and Currency Committee conducted hearings to determine whether a uniform set of cost accounting principles should be developed. At the time, negotiated cost-based contracts represented the overwhelming majority of all military procurements on a dollar-value basis, and various witnesses testified that uniform cost accounting rules were necessary because the lack of such standards substantially increased costs of procurement and difficulties in contract administration. Witnesses testified that without such standards it was difficult for the government to compare competing companies' contract price estimates because various contractors might use different accounting methods to measure and allocate costs. Moreover, witnesses reported that once contracts had been awarded, carrying out accurate audits was difficult because contractors sometimes presented costs in their proposals differently from the way they charged the government during contract performance. It was also argued that the various existing laws that were intended to control contractor

⁴The provisions of TINA are discussed in chapter 2.

costs and excess profits (including the Renegotiation Act of 1951⁵ and TINA) were not sufficient to protect the government's interests.

Other witnesses disagreed with both the need for, and workability of, uniform cost accounting rules. These witnesses argued that uniform standards were unnecessary because federal regulations governing cost allocation (that is, the ASPR) and the Generally Accepted Accounting Principles (GAAP) already contained the necessary cost accounting guidelines. Such standards, they also argued, would unnecessarily interfere with commercial accounting practices.

The House Banking and Currency Committee report issued after the hearings concluded that the absence of uniform cost accounting rules was substantially increasing procurement costs and that there were inadequate safeguards against excess profits.⁶ However, Congress did not then require the development of uniform standards but directed GAO to undertake a study on the feasibility of establishing such standards.⁷

After a year of study, the Comptroller General reported that uniform and consistent standards were feasible and recommended that such standards be developed.⁸ In its report, GAO reported a number of cases of cost misallocation, including cases in which contractors: (1) used one set of generally accepted accounting methods to estimate contract costs and a different set to record actual performance costs; (2) double-counted a cost, once as direct and again as indirect; (3) hid unallowable direct charges in overhead rates; (4) included costs that were exclusively or mostly related to commercial operations in general overhead pools and charged part of these to government contracts; (5) recovered cost overruns on independent research and development by charging the costs under another name; (6) treated capital outlays as current expenditures and charged the entire amount to the government; or (7) failed to credit the government for refunds and discounts they received from subcontractors and suppliers.

The GAO report identified several potential benefits of uniform and consistent standards. The study noted that such standards could (1) facilitate the preparation and reporting of cost information by contractors and its audit and evaluation by the government; (2) provide guidance to ensure that costs would be reported on a consistent basis and be comparable with those proposed, projected, or otherwise reported; (3) improve communications among the government, Congress, industry, and the public; (4) promote a common understanding of the methods of cost determination and minimize controversy in the administration

⁵65 Stat. 7 (1951).

⁶House Report No. 1455, May 23, 1968.

⁷82 Stat. 279 (1968).

⁸Report on the Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts by the Comptroller General of the United States, January 1970.

and settlement of contract disputes; and (5) eliminate differences within the government regarding acceptable accounting practices.⁹

The GAO report did not discuss the potential costs associated with the implementation of standards. Although neither the benefits nor the costs of implementing standards were quantified, the study concluded that for a variety of reasons the “cumulative benefits from the establishment of cost accounting standards should outweigh the cost of implementation.”

In 1970, when the extension of the Defense Production Act was again under consideration, the Senate Banking and Currency Committee was presented with the GAO report. The committee report on the Defense Production Act concluded that accurate measurement of contractors’ costs was needed in negotiated contracts both during price negotiations and during contract performance and noted that financial accounting standards (e.g., GAAP) could not satisfy the government’s requirements because “unlike financial accounting, which concentrates on a company’s total operations for a given period, cost accounting is concerned with allocating a part of a company’s total expenses to a specific product or service.”¹⁰ According to the committee, the essential problem was that contractors could, to a significant degree, control their reported costs on negotiated contracts simply by picking and choosing the accounting methods most advantageous to them.

ESTABLISHMENT AND HISTORY OF THE CAS BOARD

Against this background, Congress in 1970 created the CAS Board as an independent board located within the legislative branch.¹¹ The Board was chaired by the Comptroller General, who appointed four other members. The Board was authorized to promulgate standards designed to achieve uniformity and consistency in cost accounting practices used by federal contractors on national defense contracts in excess of \$100,000.

By the end of the decade, the Board had issued 19 standards that stated principles for the measurement, assignment, and allocation of a variety of cost subjects.¹² During that period, the Board also issued various amendments and interpretations to its standards. The Board exempted some classes of contracts from CAS coverage (for example, contracts with small businesses) and established procedures for waiving the CAS for particular contracts. Two of the more significant actions by the Board were the establishment of a trigger contract and

⁹See appendix II for a complete list of benefits projected in the GAO report.

¹⁰Senate Report No. 91-890, May 21, 1970. See also House Report No. 91-1330, July 27, 1970.

¹¹P.L. 91-379, August 15, 1970, 84 Stat. 796 (1970). Funds were first appropriated for the Board's operation in the 1971 Supplemental Appropriation Act, 84 Stat. 1991 (1971).

¹²The CAS system is discussed in chapter 2.

the use of two tiers of CAS coverage, full and modified. Under the trigger contract approach, a contractor segment was not subject to CAS coverage until that segment received a non-exempt contract in excess of \$500,000. After that, all non-exempt contracts received by that segment in excess of \$100,000 were CAS-covered. Once a segment had a CAS-covered contract, the two tiers of CAS coverage determined whether that contract was subject to modified coverage (compliance with CAS 401 and CAS 402) or full coverage (compliance with all standards). Full coverage was applicable to non-exempt contracts when total contract awards for a contractor segment exceeded a certain dollar threshold; modified coverage applied when total contract awards did not exceed that threshold.

In 1980, Congress considered the CAS Board's task essentially complete and did not renew its funding.¹³ Because it did not receive a fiscal year 1981 appropriation, the CAS Board ceased its operations. Congress, however, did not repeal the law that created the Board, and the standards remained in effect.

In the absence of the Board, DOD took responsibility for maintaining the standards and their accompanying rules and regulations during the 1980s. DOD believed that future revisions to the CAS could be introduced through the normal procedures for revising procurement regulations and that there would be no need for a CAS Board. Industry was strongly opposed to DOD taking over the CAS Board's functions, and several government agencies—NASA, the General Services Administration (GSA), and GAO—also challenged DOD's authority to revise the CAS.

Between 1980 and 1988, disputes emerged over the interpretation of 9 of the 19 standards. For example, shortly after the CAS Board ceased operations, DOD determined that the standard addressing depreciation of tangible capital assets (CAS 409) ran counter to its procurement policies aimed at promoting higher contractor productivity. To avoid that conflict, DOD interpreted and later proposed to amend that standard to provide the flexibility to reach advance agreements with contractors on shorter depreciation periods, allow more rapid capital equipment depreciation, and recognize replacement costs as the basis for depreciation. GAO opposed DOD's proposal to amend this standard and took the position that CAS 409 should not be a vehicle for defense contractors to stimulate cash flow and returns on investment. GAO argued that CAS 409 was based on the most appropriate cost accounting practices, whereas the DOD initiative was "an arbitrary measure which has been devised for other than cost accounting purposes."¹⁴ Later, DOD essentially abandoned its position.

The disputes regarding the various standards caused increasing numbers of government and industry representatives to conclude that the standards needed to

¹³In November 1980, the Comptroller General issued a report, Cumulative Progress Report to the Congress, 1971-1980, which indicated that the Board had substantially completed its assigned task of promulgating the CAS.

¹⁴GAO also warned that this DOD initiative could cost as much as \$2.4 billion.

be reviewed and possibly amended. There were also suggestions that the CAS thresholds might be obsolete and questions as to how the CAS requirements could be waived in the absence of a CAS Board. These were among the factors that drew attention to the need to reestablish an independent board to administer the CAS.

In 1988, in the Office of Federal Procurement Policy (OFPP) Act,¹⁵ Congress reestablished the CAS Board. The new Board was placed in OFPP, which is part of the Office of Management and Budget (OMB). The reestablished Board was given broader authority than its predecessor. For example, the CAS now apply by law to all federal contracts, not just defense contracts. The Board was also given “exclusive” authority to make, promulgate, amend, and rescind the CAS, and the OFPP Administrator was charged with ensuring that no agency regulations were inconsistent with the CAS.

RECENT ACQUISITION REFORMS

A recurring goal of recent statutory and regulatory changes in the government’s purchasing processes has been to adopt practices more like those of the commercial marketplace and to increase the availability of commercial products to meet government needs. These acquisition reforms also vested more discretion in contracting agencies to allow them to better exercise their business judgment in making contracting decisions. It was believed that the implementation of these procurement reform initiatives would result in substantial cost savings.

In the National Defense Authorization Act of 1991, Congress declared that the time had come to start the process of streamlining the hundreds of individual federal laws that formed the underpinnings of the defense acquisition system.¹⁶ To that end, Congress directed DOD to establish a panel of experts (known as the Section 800 Panel) to study acquisition laws and to make specific recommendations for streamlining them.

The Section 800 Panel was particularly concerned that government-unique requirements, such as the CAS, were among the reasons why many contractors chose to separate their government and commercial production facilities. The Panel’s report stated that these barriers to civilian-military integration not only added to the costs of doing business with the government, but also “walled off” the rapid advances being made in commercial research and development from easy exploitation and use in military systems.¹⁷

The Section 800 Panel recommended that the CAS be retained but urged the CAS Board to take prompt action to facilitate purchases of commercial items and services.

¹⁵PL. 100-679, 102 Stat. 4059 (1988), codified at 41 U.S.C. 422.

¹⁶PL. 104 Stat. 1587 (1990).

¹⁷Final Report of the Acquisition Law Advisory Panel, January 1993.

The Panel believed that, even without new laws, the Board had the authority to exempt classes of contractors and subcontractors and types of contracts and subcontracts from the CAS. The Panel stated that, "as a priority matter," the CAS Board should use its existing authority "to exempt contracts for commercial items or at least limit the standards that would be applicable to government contracts for commercial items." The Panel believed that prompt action would be "among the most important steps" that could be taken to facilitate the government's purchase of commercial items and services and to allow contractors offering commercial products to the government "to be able to integrate defense and commercial production where economically feasible without being subject to restrictive cost accounting standards." The Panel also stated that the implementation of this recommendation would "result in cost savings by allowing businesses to consolidate the production of commercial and defense related products in a single business unit without altering existing accounting or management practices."

Congress adopted many of the recommendations of the Section 800 Panel in the Federal Acquisition Streamlining Act of 1994 (FASA),¹⁸ which contained sweeping statutory procurement reforms. FASA contained more than 200 sections, changing the laws that govern how federal agencies annually acquire almost \$200 billion in goods and services. The major issues covered by FASA include buying commercial items, using commercial practices, reducing administrative operating costs by eliminating burdensome paperwork, increasing the importance of past performance in selecting contractors, empowering contracting officers to exercise business judgment, and streamlining the entire acquisition process.

FASA established preferences for purchasing commercial end items and components. It also required agencies, to the maximum extent practicable, to specify their needs in terms of functions to be performed, performance required, or essential characteristics; define requirements to allow commercial items to compete; and conduct market research to find commercial products that can meet their needs. FASA also expanded the range of products and services that qualify as commercial items and exempted commercial items from various procurement laws. In FASA, Congress implemented the Section 800 recommendation regarding the CAS, by exempting from the CAS "any other firm-fixed price contract or subcontract (without cost incentives) for commercial items." In 1996, Congress enacted the Clinger-Cohen Act of 1996,¹⁹ to provide further acquisition reform. As part of the Clinger-Cohen Act, Congress amended the OFPP Act to expressly exempt contracts for commercial items from the CAS requirements.

The changes implemented in FASA and the Clinger-Cohen Act were intended to make the government's acquisition policies for procuring commercial items more similar to those of the private sector. For example, FASA provided that no

¹⁸P.L. 103-355, 108 Stat. 3243 (1994).

¹⁹P.L. 104-106, 110 Stat. 656 (1996).

certified cost or pricing data should be required from a contractor for commercial items sold to the government so long as there was adequate price competition. FASA further provided that even without adequate price competition, the agency should attempt to determine price reasonableness without requiring the submission of certified cost or pricing data. Also, the Clinger-Cohen Act removed the requirement that commercial items be sold at “established catalog or market prices” and “in substantial quantities to the public” in order to be exempt from the requirement to submit certified cost or pricing data.

The procurement reform initiatives in FASA and the Clinger-Cohen Act authorized and encouraged the exercise of discretion and business judgment by contracting officials. For example, the provision in FASA authorizing the use of simplified acquisition procedures for procurements under \$100,000 in value was intended to grant agencies greater discretion when making smaller dollar purchases. Another area where FASA granted increased discretion to contracting agencies was in task and delivery order contracts, where agencies were given broad discretion in establishing procedures for the evaluation and award of individual task orders. Moreover, the commercial item acquisition procedures envisioned that contracting officials would have far more flexibility in exercising their business judgment. Finally, Congress authorized various pilot programs that granted DOD discretion to use innovative acquisition procedures—for example, the Joint Direct Attack Munitions System (JDAMS) and the Joint Primary Aircraft Training System (JPATS).

Congress expected this procurement reform legislation to “enable the government to buy goods and services cheaper and faster.”²⁰ The Senate Committee on Governmental Affairs and the Senate Committee on Armed Services, in their reports on FASA, incorporated the views of the Congressional Budget Office (CBO), which stated that FASA would likely reduce the cost that the federal government would incur for goods and services, allowing agencies to make more efficient use of their appropriated funds.²¹ The CBO stated that savings could be achieved by adjusting “policies that require government contractors to supply data that they do not have to collect or provide in ordinary business dealings” by facilitating the purchase of commercial items and by granting agencies greater discretion when making small dollar purchases. The CBO also stated that “there is good reason to expect that [FASA, which] makes accounting simpler, government-specific products less prevalent, and procurement more efficient[,] would yield budgetary savings.”

While there is no consensus on how many billions of dollars in savings have been already realized by the various procurement reform initiatives, there is no doubt that considerable savings have occurred.²² The JDAMS and JPATS programs

²⁰Senate Report No. 103-259, May 12, 1994.

²¹Senate Report No. 103-258, May 11, 1994; Senate Report No. 103-259, May 12, 1994.

have both been reported as acquisition reform success stories that have achieved significant cost savings; for example, DOD states that the JPATS acquisition strategy resulted in original program estimates of \$7 billion being reduced to about \$4 billion upon contract award.

In sum, there has been considerable acquisition reform in recent years to streamline the procurement process and increase the discretion of contracting agencies in making their acquisition decisions. While these reforms have allowed considerable cost savings to be achieved, opportunities for additional savings exist.

In the following chapters, the Panel discusses the various government cost rules, the benefits and costs of the CAS, proposed modifications to the existing CAS applicability thresholds, proposed modifications to the CAS Board administrative functions, a proposed review of the existing standards, and proposed restructuring and relocation of the CAS Board.

²²See, for example, *Acquisition Reform: Effect on Weapon System Funding* (GAO/NSIAD-98-31, Oct. 1997).

THE CAS AND OTHER COST RULES

To reduce the risk of the government being overcharged, as well as for other reasons, government contractors are subject to a variety of statutes and regulations governing the allowance, allocation, and negotiation of costs for federal contracts. The cost review and control systems established by these statutes and regulations include the CAS, the FAR cost principles, and TINA. To ensure compliance with these rules, contractors are required to make available for audit their books, records, accounting procedures and practices, and other data. In this chapter, the Panel briefly describes each of these sets of cost rules and discusses the audit oversight available to ensure compliance with them.

THE CAS

As part of efforts to protect the government from the adverse effects of inconsistent or inaccurate contractor cost accounting, including overpayment, the CAS Board was established more than 25 years ago to achieve greater uniformity and consistency in cost accounting practices used by certain federal contractors. The primary task of the CAS Board is to promulgate and revise standards to achieve (1) an increased degree of uniformity in cost accounting practices among government contractors, and (2) consistency in cost accounting practices by individual government contractors over periods of time.

A CAS is a statement formally issued by the Board with regard to the measurement, assignment, and allocation of costs that enunciates a principle or principles to be followed, establishes practices to be applied, or specifies criteria to be employed in selecting from alternative principles and practices in estimating, accumulating, and reporting costs under contracts subject to the rules of the Board. The standards may be stated in terms as general or as specific as the Board considers necessary to accomplish its purpose, and the existing standards are generally not written in such detail as to precisely prescribe methods of accounting for every kind of cost under all the variety of circumstances involved in government contracting. There are currently 19 standards that can be broadly categorized into three groups: (1) standards dealing with overall cost accounting matters; (2) standards dealing with classes, categories, and elements of cost; and (3) standards dealing with pools of indirect costs.²³

CAS Applicability

In the absence of a specific exemption or waiver, the CAS must be used by all executive agencies and by contractors and subcontractors when estimating,

²³The 19 standards are described in further detail in appendix III.

accumulating, and reporting costs in connection with the pricing and administration of, and settlement of disputes concerning, all negotiated contracts and subcontracts in excess of \$500,000.²⁴ There are a number of statutory and regulatory exemptions to the CAS requirements. Congress has provided by statute that the CAS requirements do not apply to contracts and subcontracts for the acquisition of commercial items and contracts and subcontracts where the price negotiated is based on prices set by law or regulation. In addition, the CAS Board has broad authority to exempt classes or categories of contracts and subcontracts or contractors and subcontractors from CAS coverage. Under this authority, the CAS Board has promulgated a number of other exemptions from the CAS requirements, including contracts and subcontracts with small businesses as well as firm fixed-price contracts and subcontracts awarded without the submission of any cost data.²⁵ There is also a mechanism for the CAS Board to grant waivers for individual contracts or subcontracts.²⁶

CAS Coverage

In 1977, the CAS Board established two levels of compliance—full and modified coverage.²⁷ Full coverage requires that a business unit²⁸ comply with all existing standards at the time of contract award. Currently, full coverage applies to a business unit that receives a single CAS-covered contract of \$25 million or more, or received \$25 million or more in total CAS contracts during the preceding cost accounting period—if at least one of those contracts exceeded \$1 million.²⁹ Once a business unit receives an award subject to full coverage, all of the unit's subsequent non-exempt contracts are also subject to full coverage.

Modified coverage currently requires a business unit to comply only with CAS 401 (consistency in estimating, accumulating, and reporting costs), CAS 402 (consistency in allocating costs incurred for the same purpose), CAS 405 (accounting for unallowable costs), and CAS 406 (cost accounting period).³⁰ Business units that receive CAS-covered contracts, which do not exceed the threshold for full coverage, are subject only to modified coverage. That is, the business units subject to modified coverage include those that received a non-exempt contract of more than \$500,000 but did not receive a single CAS-covered

²⁴Unlike the FAR cost principles and TINA, the CAS generally do not apply to the pricing and costing of modifications of contracts not initially subject to CAS coverage.

²⁵See appendix IV for a list of all the CAS exemptions.

²⁶The waiver process is discussed in detail in chapter 4.

²⁷See appendix V for a CAS applicability and coverage diagram.

²⁸A "business unit" is defined as "any segment of an organization, or an entire business organization which is not divided into segments." A "segment" is defined to be "one of two or more divisions, product departments, plants, or other subdivisions of an organization reporting directly to a home office." 48 C.F.R. 9904.410-30(a)(2), (7).

²⁹A "CAS-covered contract" is defined as any negotiated contract or subcontract in which a CAS clause is required to be included, that is, non-exempt contracts or subcontracts of \$500,000 or more. 48 C.F.R. 9903.301(a).

³⁰Until 1993, modified coverage only required a business unit to comply with CAS 401 and CAS 402.

contract in excess of \$25 million in the current cost accounting period and either (1) received less than \$25 million in net CAS-covered awards³¹ in the immediately preceding cost accounting period or (2) received more than \$25 million in net CAS-covered awards in the immediately preceding cost accounting period, but no single award in excess of \$1 million. Contracts awarded subject to modified coverage remain so throughout the contract life, regardless of changes in the business unit's CAS status in subsequent cost accounting periods. Once a business unit receives an award subject to modified coverage, all CAS-covered contracts awarded to the business unit during that cost accounting period are also subject to modified coverage unless a contract is awarded that triggers full coverage, which then results in the business unit's subsequent CAS-covered contracts being subject to full coverage.

CAS Disclosure Statements

Certain CAS-covered contractors (that is, contractors that have received contracts or subcontracts that are subject to the CAS) are required to disclose their cost accounting practices in writing. The CAS Board has designed a disclosure statement for this purpose. Generally, a disclosure statement must be filed by (1) any business unit receiving a CAS-covered contract or subcontract of \$25 million or more or (2) any company which, together with its segments, received net CAS-covered awards totaling more than \$25 million in its most recent cost accounting period, provided that at least one award exceeded \$1 million.

The disclosure statement, which consists of eight parts, requires a contractor to describe in summary fashion its methods and techniques for measuring, assigning, and allocating costs.³² The more important objectives of the disclosure statement include establishing a clear understanding of the cost accounting practices the contractor intends to follow, defining costs charged directly to contracts and disclosing the methods used to make such charges, and delineating the contractor's methods of distinguishing direct costs from indirect costs as well as the basis for allocating indirect costs to contracts.

Once filed, the disclosure statement may be audited to determine whether it adequately describes the contractor's cost accounting practices and whether those practices are compliant with the CAS.³³ The disclosure statement documents a contractor's established cost accounting practices and is useful in determining if any changes have occurred and, if so, whether the changes comply with the CAS. A contractor that has filed a disclosure statement must amend the statement

³¹"Net awards" is defined in the CAS Board's regulations to be "the total value of negotiated CAS-covered prime contract and subcontract awards, including the potential value of contract options, received during the reporting period minus cancellations, terminations, and other related credit transactions." 48 C.F.R. 9903.301.

³²The CAS Board's general form for disclosure is included in appendix VI. The CAS Board has also designed a specialized disclosure statement for use by educational institutions; this form consists of seven parts and uses terminology specific to colleges and universities.

³³To be considered adequate, according to the Defense Contract Audit Manual, the disclosure statement must be current, accurate, and complete.

whenever it changes any of its disclosed accounting practices, and if it deviates from its disclosure statement, it may be required to submit a cost impact proposal as described below.³⁴

Cost Impact Process

Contractors and subcontractors receiving CAS-covered contracts are required to agree to a contract price adjustment for “any increased costs paid to such contractor or subcontractor” by the government because of a change in the contractor’s or subcontractor’s cost accounting practices or because of the contractor’s or subcontractor’s noncompliance with any applicable standard. In the event of a change in cost accounting practices or noncompliance with a standard, a CAS-covered contractor is generally required to prepare a cost impact proposal to assess any increased costs paid by the government because of the change or noncompliance and to estimate the appropriate adjustments, if any, to contract prices or cost allowances; this is commonly referred to as the cost impact process.

Although the CAS Board’s regulations define the circumstances under which a cost impact proposal is necessary for a contractor’s change in cost accounting practices, the regulations do not specify the form and content of the cost impact proposal.³⁵ Rather, the manner and level of detail of the proposal are left to the discretion of the contracting officer in accordance with the FAR.³⁶

OTHER COST RULES

Government contractors are subject to a variety of laws governing costs on government contracts and to various reviews to ensure compliance with those laws. While these rules have some overlapping requirements, they each have a discrete role in protecting the government.

FAR Cost Principles

The currently applicable cost principles are included in FAR Part 31, which enunciates cost principles and procedures for pricing contracts and subcontracts, as well as modifications to them, whenever a cost analysis is performed, and for determining, negotiating, and allowing costs when required by a contract clause.³⁷ These principles and procedures are broadly applied to government contracts, including CAS-covered contracts. The CAS, however, take precedence over FAR with regard to the measurement, assignment, and allocation of costs for CAS-covered contracts. This primacy is assured by the OFPP Act, which provides that

³⁴Contractors that are not required to file a disclosure statement must also consistently follow their established accounting practices and may be required to submit cost impact proposals if they deviate from these practices.

³⁵As discussed in chapter 4, the CAS Board has proposed a change in its regulations concerning the cost impact process.

³⁶FAR 30.602.

³⁷The FAR also incorporates by reference a number of OMB circulars, which state the principles for cost allowability for other organizations such as educational institutions (Circular A-21), state and local governments (Circular A-87), and nonprofit organizations (Circular A-122).

costs subject to CAS requirements are not subject to other regulations that differ with respect to cost measurement, assignment, and allocation.

As a general rule, the FAR cost principles provide that costs are allowable to the extent that they are (1) reasonable and allocable; (2) in accord with the CAS (if applicable, otherwise GAAP), with the contract terms, and with any limitation specified in the FAR; and (3) are adequately documented by the contractor.³⁸ The definition of and requirements for each of these criteria are set forth in the FAR.

A general allocation rule in the FAR that has not markedly changed since 1959 determines whether or not a cost is allocable.³⁹ That rule states:

A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Subject to the foregoing, a cost is allocable to a Government contract if it--

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

The cost principles also state more specific rules for determining the allowability of 48 selected costs, including, for example, compensation for personal services, cost of money, and insurance and indemnification.

A number of the FAR cost principles incorporate the CAS measurement, assignment, and allocation rules. These principles limit the measurement and assignment, and therefore allocability, of costs to the amounts determined using these criteria. To the extent that these CAS requirements are incorporated into the cost principles, they apply to all government contracts covered by the FAR. The FAR cost principles incorporate by reference 5 of the 19 standards (including standards concerning deferred compensation, pensions, and cost of money) and duplicate provisions of another 4 standards (including standards concerning consistency in direct/indirect cost charging, segregation of unallowable costs, self-insurance, and independent research and development costs and bid and proposal costs excluding allocation provisions).⁴⁰

Non-CAS-covered contracts are subject only to those CAS that have been incorporated into the FAR cost principles. The FAR has not incorporated CAS

³⁸FAR 31.201-2.

³⁹FAR 31.201-4.

⁴⁰See appendix VII for a comparison of the CAS and FAR cost principle requirements.

requirements governing consistency (such as, for example, CAS 401, which requires consistency in estimating, accumulating, and reporting costs), asset capitalization and depreciation,⁴¹ cost accounting periods, standard costs, specific cost allocation requirements, and material costs. In addition, the FAR has not incorporated the CAS requirement for price adjustments for changes in a contractor's cost accounting practices.

TINA

TINA, which is applicable to both military and civilian agencies, generally requires that contractors and subcontractors submit cost or pricing data for contracts or contract pricing actions (such as contract changes or modifications) in excess of \$500,000 and certify that the data is accurate, complete, and current.⁴² There are a number of exceptions to the requirement for the submission of certified cost or pricing data. These include cases where:

- The prices agreed upon are based upon adequate price competition;
- The prices agreed upon are based upon prices set by law or regulation; or
- A commercial item is being acquired.

In addition, contracting officials have the authority to waive the requirement for submission of certified cost or pricing data for "exceptional circumstances."

If a contractor submits defective cost or pricing data that was relied upon by the government in negotiating a contract price, the government may seek a contract price adjustment to recover the overstated amount. TINA also provides for civil penalties (equal to the amount of the overpayment) for the knowing submission of defective cost or pricing data and also provides for the payment of interest on overpayments made to the contractor. In addition, the knowing submission of a false certificate of cost or pricing data is subject to the civil and criminal penalties of the False Claims Act and the False Statements Act.

AUDIT OVERSIGHT

Negotiated government contracts are generally subject to audit oversight throughout the contract cycle, from negotiation to completion and final payment. That is, cost-type contracts are audited during pricing and performance and at final payment, and fixed-priced type contracts are audited during pricing and are subject to post-award audit for defective pricing. An "audit and records" clause included in every negotiated contract provides government auditors, inspector

⁴¹The FAR states that contractors may follow the CAS requirements for capitalization and depreciation but does not require them to do so.

⁴²10 U.S.C. 2306a, 41 U.S.C. 254b.

generals, and GAO with access to a contractor's books, records, accounting procedures and practices, and other data sufficient to assess costs claimed to have been incurred or anticipated to be incurred in the performance of the contract.

Because most CAS-covered contractors are subject to audit by DCAA, the audits it performs are particularly relevant here. DCAA is a component of DOD and is responsible for performing contract audits and providing accounting and financial advisory services to all DOD components. DCAA also provides contract audit services to a number of other government agencies.⁴³ DCAA provides a wide variety of contract-related services, including pre- and post-award contract audits and cyclical system reviews.

As part of a pre-award survey, DCAA may audit the adequacy and suitability of a contractor's accounting system and practices for accumulating costs. DCAA may also be asked to audit a contractor's cost or price proposal. This could include assessing the adequacy of the contractor's cost accounting system and practices, compliance of the actual estimating practices with the CAS requirements, and the reasonableness of material and labor cost estimates. DCAA estimates that 25 percent of its workload involves evaluating whether proposed costs are reasonable in pre-award evaluations. DCAA also performs audit reviews of forward pricing agreements. DCAA's audit services can be as extensive as a full audit of the contractor's cost accounting system and practices or may be limited to providing rate verification information to contracting officials. DCAA also assesses contractors' disclosure statements for adequacy and compliance.

In the post-award area, DCAA audits CAS-covered contractors' compliance with the CAS. It also audits termination settlements and contract change proposals. DCAA provides audit support to determine compliance with TINA. It also performs audits of incurred costs, usually on a contractor-wide basis, to determine whether incurred costs are allowable under the FAR. As part of an incurred cost audit, DCAA will assess the adequacy of the contractor's accounting system for cost determinations that may be required for current or future contracts.

DCAA also performs a number of cyclical reviews such as audits of contractors' internal controls. Periodically, DCAA may audit a contractor's accounting and management systems (internal controls) that have a significant impact on government contract costs. The purpose of these audits is to assess the adequacy of accounting and management systems for compliance with applicable laws, regulations, and contract terms and to assess control risk to determine the degree of reliance that can be placed upon the contractor's internal controls as a basis for planning the scope of other related audits.

⁴³A number of civilian agencies perform their own audit oversight.

CAS APPLICABILITY

A significant benefit of the CAS is to lower the government's risk of accounting, pricing, and costing inaccuracies that may result in the government being mischarged. The government recognizes, however, that the costs of CAS compliance, both to the contractor and the government, may sometimes exceed the benefits the CAS provide, and accordingly not all cost-based contracts are subject to the CAS. That is, the CAS apply only to negotiated contracts in excess of a specified dollar threshold, and certain types of contracts are completely exempt from the CAS requirements.⁴⁴ Judgments as to the level of risk and costs the government is willing to bear have changed over time. In the context of the CAS, the level of risk to the government can be adjusted by limiting the criteria for CAS applicability or coverage—that is, by modifying thresholds and exemptions.

In this chapter, the Panel addresses (1) the benefits and costs of the CAS, (2) the current CAS applicability and coverage thresholds, and (3) firm fixed-price contracts where certified cost or pricing data is not obtained. The discussion and conclusions reflect the Panel's analysis of the estimated universe of CAS-covered contracts to determine whether opportunities exist for reducing CAS applicability and coverage while still adequately protecting the government's interests.

BENEFITS AND COSTS OF THE CAS

Prior to promulgating standards and interpretations of them, the CAS Board is required to take into account the:

- (i) probable costs of implementation, including inflationary effects, if any, compared to the probable benefits;
- (ii) advantages, disadvantages, and improvements anticipated in the pricing and administration of, and settlement of disputes concerning, contracts; and
- (iii) scope of, and alternatives available, to the action proposed to be taken.⁴⁵

Various studies have shown that it is difficult, and perhaps impossible, to quantify with specificity the benefits and costs of complying with CAS requirements. One study concluded that no objective cost-benefit calculation in aggregate quantitative terms was possible for the CAS as a whole or for any individual standard.⁴⁶ The study stated that because benefits and costs are distributed over time, they are difficult to trace, and any results would be very subjective. Similarly, the CAS Board stated in its 1992 Statement of Objectives, Policies and

⁴⁴As discussed in chapter 2, those cost-based contracts that are not subject to the CAS are still covered by other cost rules that mitigate risk to the government.

⁴⁵41 U.S.C. 422(g)(1).

⁴⁶Report to the Cost Accounting Standards Board by a Special Group of Consultants to Consider Issues Relating to Comparing Costs with Benefits, November 1978. See also *Cost Impact of Cost Accounting Standards*, Logistics Management Institute, November 1977.

Concepts that quantifying the benefits that accrue to the government and contractors alike from the continued use of the standards would be difficult, if not impossible. Notwithstanding the difficulties in quantification, the Panel's review confirms that there are benefits and costs associated with the CAS.

Benefits

The CAS were designed to achieve, among other things, more uniformity and consistency in cost accounting practices and a better understanding by the government of the cost accounting practices that contractors use to estimate costs. Compliance with the CAS was intended to reduce the likelihood of the government being mischarged, reduce misunderstandings between contractors and the government, and increase reliability of contractor cost data.⁴⁷

The Panel found concrete evidence that the CAS produce direct monetary benefits. For example, DCAA reported that it recovered about \$138 million as a result of adjustments to CAS-covered contracts over the 18-month period ending March 1998. The Panel believes that focusing only on the direct monetary benefits substantially understates the benefits produced by the CAS. The existence and enforcement of the standards also generate substantial tangible benefits, even though they cannot be quantified. In fact, the CAS Board reports in its Statement of Objectives, Policies and Concepts that benefits from the CAS include "reductions in the number of time-consuming controversies stemming from unresolved aspects of cost allocability, as well as greater equity to all concerned." Additional benefits identified by the Board are simplified contract administration, audit, and settlement procedures; the prophylactic effect of reduced opportunities for the manipulation of accounting methods that existed prior to the establishment of the CAS; and the availability of better cost data, which permits improved comparability of offers and facilitates better contract negotiation.

At the June 1998 public hearings, many government officials supported the continued use of the CAS and stated that the standards:

- deter the misallocation of costs between government and commercial contracts;
- serve as an effective means of cost recovery if misallocation does occur;
- provide a framework that organizations can use to measure performance;
- place the contracting parties on a more equal basis; and
- keep the government apprised of contractor cost accounting changes.

⁴⁷A list of potential CAS benefits identified in Report on the Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts, by the Comptroller General of the United States, January 1970, is provided in appendix II.

In addition, officials of DCMC, the DOD entity chiefly responsible for the day-to-day administration of the CAS, stated that the standards are an important tool for mitigating risk to the government in a cost-based business environment. These officials contended that the CAS provide the framework and regulatory basis for contracting officers to evaluate contractor cost accounting practices and protect the government against inappropriate measurement, assignment, and allocation of costs. The additional precision and administrative remedies contained in the CAS constitute a valuable tool to ensure equitable allocation of costs under cost-based contracts, the officials contended. A DCAA official testified that the CAS serve both as a deterrent to the misallocation of costs to contracts and an equalizer when costs have been misallocated.

Costs

The CAS generate costs that can be largely borne by the government. At the June 1998 public hearings, industry officials stated that the CAS present significant administrative costs because the requirements to comply with the CAS are complex and labor intensive. Modifying commercial accounting practices to comply with the CAS, maintaining those systems, and complying with other CAS requirements, such as the filing of disclosure statements, require more staff than is required for commercial accounting systems. This is all added to the overhead expense associated with establishing and maintaining CAS-compliance, expenses that are in turn passed on to the government in part or in whole. In addition, these officials stated that they believe the rigidity of the CAS requirements hamper a company's ability to react to changing business conditions in order to remain competitive.

Recent attempts have been made to estimate the costs of complying with the CAS. One study concluded that government contracting involved an 18-percent cost premium over commercial contracting, including a 0.7-percent cost premium attributable to the CAS.⁴⁸ While a subsequent GAO analysis of the study concluded that the premium was overstated,⁴⁹ the Panel notes that, in light of the overall sums involved in cost-based contracting, even a small percentage would be significant in dollar terms. Several commentators believed the premium associated with the CAS to be significant. In this regard, representatives of a number of companies made the following observations:

- The CAS create substantial administrative burdens and require changes to accounting practices and systems, increasing the product costs with no commercial advantage or product improvement, and reduce a company's ability to react to changing market conditions by imposing rigid requirements.

⁴⁸The DOD Regulatory Cost Premium: A Quantitative Assessment, Coopers & Lybrand/The Analytic Science Corporation (TASC), December 1994.

⁴⁹Acquisition Reform: DOD Faces Challenges in Reducing Oversight Costs (GAO/NSIAD-97-48, Jan. 29, 1997).

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- Some commercial companies cannot support the accounting overhead and controls called for by the CAS and still remain competitive.
 - Many smaller companies do not have the resources to deal with the CAS, which can require the maintenance of government-unique accounting practices at considerable cost.

In addition to these observations received at the Panel's public hearings, a survey was sent to a group of the largest government contractors and a select group of predominantly commercial firms in an attempt to estimate the annual costs for creating and maintaining a separate operating segment for government business.⁵⁰ These firms found it difficult to quantify the costs of complying with the CAS. However, this survey indicated that there are costs associated with the CAS that the government incurs in whole or in part because (1) contractors may segregate their commercial and military segments to comply with the CAS and other government-unique requirements, (2) some predominantly commercial companies refuse to seek government business because of the CAS and other government requirements, and (3) some contractors claimed that they cannot make the best use of innovative cost accounting systems. The following paragraphs address these three areas.

As part of acquisition reform, DOD is trying to achieve commercial-military integration—that is, the elimination of the distinction between government and commercial operations such that both commercial and military products are produced on the same production line. According to the Under Secretary of Defense (Acquisition and Technology), this concept is crucial for meeting DOD's future military, economic, and policy objectives.

According to a GAO report,⁵¹ DOD demonstrated that the integration has the potential to produce benefits for the government. The report cited a 1994 Air Force pilot program at TRW where selected military-unique parts, once redesigned, were produced at a lower cost on the company's automated commercial production line than by its segregated military segment. DOD reported that the TRW integration project for the production of military-unique circuit boards for the F-22 aircraft resulted in a 30- to 50-percent savings and produced a product that actually exceeded some of the government's requirements. Although program officials stated that the TRW pilot project saved money on labor, materials, and overhead, GAO noted that the \$21 million cost of the project offset most of the savings. GAO contended that the real "payoff" will come from applying the lessons learned from the pilot to future Air Force electronics procurements.

⁵⁰See appendix VIII for a list of firms surveyed.

⁵¹Acquisition Reform: Military-Commercial Pilot Program Offers Benefits but Faces Challenges (GAO/NSIAD-96-53, Jun. 28, 1996).

As a survey of selected firms indicated, the costs of complying with the CAS and other government regulations can contribute to the practice of some companies establishing separate business units for commercial and government operations. These firms contend that it is more costly to operate a government segment than it is to operate a commercial one, although the companies surveyed do not have systems in place to identify those costs.⁵² They also state that, at the least, separating business units for commercial and government operations deprives the government of savings from integrated commercial/government production processes and products and adds to the cost of complying with the CAS and other government regulations. In addition, the Panel was told that commercial segments at times allocate costs in a manner designed to motivate behavior in a particular accounting period—for example, to achieve cost savings. Such a practice by CAS-covered government segments is hindered by, for example, the submission of cost accounting changes to comply with CAS uniformity and consistency requirements. One panel member pointed out that consistency in accounting is an important principle in both cost and financial accounting and that change should not be made merely to motivate behavior.

There are also costs associated with companies refusing to do business with the government because of the CAS and other unique federal requirements. When firms refuse to seek government business, the available contractor base is reduced, and the government may be denied state-of-the-art technological solutions and pay the higher costs of reduced competition. According to a senior DOD official, Hewlett-Packard has refused government work specifically to avoid the application of the CAS. At the June 1998 public hearings, a General Electric official said that several of that firm's business segments that once did government work now refuse that business because of the costs of complying with the CAS and FAR requirements. That official testified that changing those commercial operating units to become compliant with the CAS and other government-unique requirements was an unjustifiable expenditure of valuable resources.

Some predominantly commercial firms, including members of the Integrated Dual-use Commercial Companies (IDCC) association, refuse or limit business with the government rather than become CAS compliant.⁵³ These companies contend that complying with the CAS and other government regulations is costly and burdensome. Because many of these companies produce leading-edge technologies, the government needs access to their commercial research and development efforts. Examples of these technologies include state-of-the-art semi-conductor chips as well as computers that are faster, smaller, and more powerful, which are needed as critical components in government satellites and defense weapon systems.

⁵²See appendix VIII for a list of firms surveyed.

⁵³IDCC membership consists of companies that have over \$1 billion in annual sales with less than 10 percent of sales from federal government contracts. A list of IDCC members is included in appendix VIII.

A questionnaire was sent to IDCC member companies to gain insight into why some predominantly commercial companies limit or avoid government work. Although the impact of eliminating the CAS alone could not be clearly determined, all IDCC respondents stated that some of their operating segments refused to do government business on a cost basis and some specifically cited the costs of CAS compliance and the submission of cost or pricing data among their reasons. Most respondents also stated that some of their operating segments limited cost-based work with the government to remain below CAS thresholds. Some commercial companies have reported that they established separate segments for government work to isolate the added costs imposed by the CAS and other government regulations and procedures. These companies claimed that they cannot pass these added costs on to their commercial products and services because doing so would decrease their overall competitiveness.

The Panel was told that contractors and subcontractors receiving cost-based government contracts for the first time can find it difficult to cope with the various federal laws, regulations, and procedures. These new entrants in the government marketplace have generally functioned as predominantly commercial companies that sell a very small percentage of goods and services through cost-based federal contracts. Some new entrants contend that compliance with the CAS requirements is burdensome. Some ultimately decide not to seek additional government business, which may limit the government's access to innovative technologies these firms may have. Some are ultimately motivated to create separate operating segments for their government business. As discussed earlier, creating and maintaining segregated segments can be costly to both the government and contractors.

Some subcontractors also refuse to do business with CAS-covered prime contractors. In a survey of some of the largest government contractors, respondents cited examples where subcontractors refused CAS-covered work. This could cause less competition and higher costs for subcontracted work and may inhibit access to necessary technology or services. Some survey respondents joined other companies that reported instances where non-CAS-covered operating segments within their own companies refused to do business with them. One respondent stated that avoidance of costs associated with government-unique requirements, such as the CAS, is the reason its commercial divisions would not accept work from the government business units.

New entrants to federal cost-based contracting, as well as other predominantly commercial companies, contend that the CAS impede the use (or eliminate the advantages) of alternative accounting practices and advanced cost management methods. Some companies are attempting to employ alternative cost accounting systems, such as activity-based costing (ABC),⁵⁴ to reduce product and service costs in today's competitive environment. In this regard, a senior DCAA official stated

⁵⁴ABC management systems analyze the relationships between activities and the resources they consume to determine the costs of those activities.

that contractors, facing strong competition in the global marketplace and a shrinking defense budget, must change not only their production methods but how they conduct their business; this would include embracing advanced cost management systems. DCAA states that it encourages the use of ABC and does not consider the CAS a barrier to the successful implementation of ABC. Some companies believe that the government needs to facilitate the use of alternative accounting practices and advanced cost management methods to reduce costs but that the CAS hinder their use. Encouraging the use of these new methods, however, could ultimately allow both the government and contractors to share the savings associated with reduced costs.

DCAA believes that ABC can be used as an adjunct to a CAS-compliant accounting system. Nevertheless, select industry officials have stated that CAS administrative requirements hamper full implementation of advanced cost management methods such as ABC. Of particular concern are requirements for consistency in estimating, accumulating, and reporting costs and for price adjustments due to changes in cost accounting practices. Advanced cost management methods such as ABC allow companies to make rapid adjustments in their organizational and accounting structures to account for market changes. Such adjustments, however, would have to be assessed under the CAS cost impact process, which may result in implementation delays and/or contract price adjustments for voluntary changes. Thus, it appears that there is an inherent tension between the flexibility presented by the optimal use of ABC and certain CAS requirements. Industry officials say that this is the reason that some CAS-covered contractors are reluctant to adopt advanced cost management methods. DCAA states that surveys conducted in 1990, 1995, and 1997 indicate that government contractor interest in, and actual implementation of, ABC accounting systems is declining. The DCAA survey found that the costs of implementing ABC, incompatibility with existing accounting and/or estimating systems, and loss of key personnel who championed ABC were the primary reasons cited for failure to implement ABC.

CAS APPLICABILITY AND COVERAGE THRESHOLDS

The CAS have never been applied to all contracts and subcontracts. Rather, it has always been recognized that the benefits of CAS compliance must be weighed against its costs. Accordingly, the CAS have been applied only to contracts and subcontracts in excess of a specified dollar threshold. In 1970, Congress, in establishing the CAS Board, provided that the CAS would only be applicable to negotiated contracts and subcontracts that exceeded \$100,000. In 1974, the Board, using its exemption authority, created a "trigger" threshold of \$500,000.⁵⁵ The Board believed that this revised threshold rule would exempt about 70

⁵⁵39 Fed. Reg. 44,389 (Dec. 24, 1974). Under this revised requirement, once a contractor received a CAS-covered contract exceeding \$500,000, all negotiated contracts over \$100,000 that were awarded to that contractor were also CAS-covered.

percent of previously CAS-covered contracts but would still cover 90 percent of the dollar value of the awards. In 1988, Congress, in reestablishing the CAS Board, raised the CAS applicability threshold to \$500,000 for negotiated contracts and subcontracts.⁵⁶

The CAS Board has also recognized a need to balance the costs of CAS compliance against the benefits to the government. In 1977, the Board established two levels of CAS compliance—full and modified coverage. As explained in chapter 2, full coverage requires that a business unit comply with all existing standards at the time of contract award and for subsequent contracts, whereas modified CAS coverage requires compliance with only four of the standards. Modified coverage was intended to address the problem of the application of the CAS to smaller government contractors as well as the application of the CAS to those contractors for whom government business represented only a relatively small share of total sales volume. The Board stated that the impetus for the creation of modified coverage was the concern that “many small companies with less sophisticated accounting systems and small accounting staffs [could not] comply with the [CAS] requirements without experiencing inordinate difficulty and some cost” and that complying with the CAS requirements may cause some companies to avoid government contracts.⁵⁷

As explained in chapter 2, as originally promulgated, modified coverage was generally applied to business segments that received less than \$10 million in CAS-covered contracts in the immediately preceding cost accounting period; modified coverage required compliance only with CAS 401 and CAS 402. In 1993, the CAS Board increased the threshold for full coverage from \$10 million to the current \$25 million. In raising the threshold, the Board stated that it was seeking to adjust the threshold to properly reflect the effects of inflation and to protect the interests of the government, while lessening burdens associated with full coverage on contractors. In addition, the Board required business segments with modified coverage to adhere to two additional standards, CAS 405 (accounting for unallowable costs) and CAS 406 (cost accounting period), because of reports suggesting that the government needed to be protected from overcharging due to contractor abuses in these areas.⁵⁸

While some in government believe that the current applicability and coverage thresholds are needed to protect the government’s interests, others in government as well as in industry expressed a view to the Panel that it is again time to review

⁵⁶Although the CAS applicability threshold was raised to \$500,000, the new CAS Board did not raise the trigger amount; thus, a contractor would be subject to the CAS as soon as it received any CAS-covered contract, regardless of value. In 1993, the CAS Board applied the trigger contract concept to the two tiers of CAS coverage. It increased the threshold for full coverage from \$10 million to the current \$25 million by providing that a contractor would be subject to full coverage (rather than modified) if it received at least one contract valued at \$1 million or more. 58 Fed. Reg. 58,798 (Nov. 4, 1993).

⁵⁷42 Fed. Reg. 45,625 (Mar. 10, 1978).

⁵⁸The Board expanded modified coverage to include CAS 405 in response to information that contractors for some civilian agencies were including unallowable costs in their billings to the government. 57 Fed. Reg. 47,438 (Oct. 16, 1992).

contract applicability and coverage thresholds. They contend that more contracts and contractors are subject to the burden and expense of the CAS than are necessary to adequately protect the government's interests against significant risk in this area. In this regard, there are concerns that modified CAS coverage has not satisfied the CAS Board's stated goal of providing relief to smaller government contractors and contractors for whom government business represents only a relatively small share of total sales volume. They stated that the CAS 401 and CAS 402 requirements for consistency and uniformity, when coupled with the cost impact process, impose a level of rigidity and undue administrative burden that hamper a company's ability to respond to marketplace changes. In addition, they express concern that commercial accounting systems do not ordinarily track unallowable costs as required by CAS 405 and that ensuring that unallowable costs are not allocated to government contracts could be achieved by less onerous methods.

Many believe that the government must be able to enhance its access to commercial items and technologies and do so in a less regulated environment. On this issue, the Panel noted that some government and industry officials believe that the current CAS applicability and full coverage thresholds must be revised to achieve greater commercial sector participation in government procurement. At the public hearings in June 1998, officials from Boeing, General Electric, and 3M testified that consideration should be given to raising the threshold, which now subjects hundreds of business segments to the CAS.⁵⁹ These officials contend that revising the CAS applicability criteria would reduce the burden the CAS place on industry, promote commercial-military integration, and encourage predominantly commercial companies and new entrants to seek government contracts. Those who do not favor major revisions to the current criteria contend that the benefits of such revisions are uncertain, while the risk the changes would entail for the government is significant.

While recognizing these differing views, the Panel found broad agreement that some adjustment in the current CAS applicability criteria was necessary. It was difficult to resolve, since it necessarily involves speculation about how companies will behave and how much risk the government will be exposed to under the changed circumstances of adjusted CAS applicability criteria. Rather than focus on predicting how changes will affect behavior, the Panel searched for solutions that, while excluding a significant percentage of currently CAS-covered contractor segments from the CAS applicability, nonetheless would retain CAS coverage for a very high percentage of contract dollars. Similarly, the Panel focused on the extent to which solutions eliminated the burden associated with the CAS while protecting the government's interest through other controls such as the FAR cost principles.

⁵⁹See appendix IX for a list of individuals who testified.

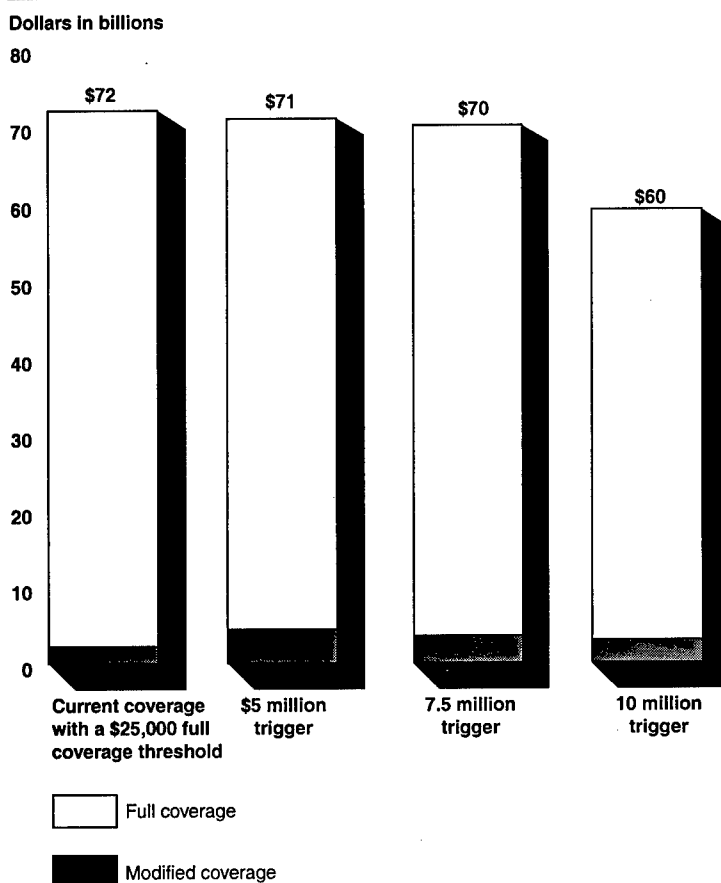
In analyzing the data and conducting its analysis, the Panel searched for solutions that would maximize the benefit of changes while limiting the government's exposure to risk. The Panel considered adjusting the applicability and full coverage thresholds. The Panel also considered the use of a "trigger contract" of at least a certain value as part of the applicability threshold—that is, providing that only non-exempt contracts received after the award of a trigger contract be subject to the CAS.

The original CAS Board adopted the trigger contract approach so that a contractor's contracts would not be subject to CAS coverage (even if above the \$100,000 applicability threshold) until the contractor received a "trigger contract" of \$500,000, triggering CAS coverage for future contracts the company received that exceeded the \$100,000 applicability threshold. Under this approach, contractors with only relatively small contracts, albeit in excess of the contract applicability threshold (that is, contracts between \$100,000 and \$500,000), would not be subject to the burden and expense of the CAS until they received a trigger contract.

The Panel analyzed the contract applicability and full coverage thresholds, including the implications of using a trigger contract approach. To help the Panel assess the appropriateness of the current contract applicability threshold (\$500,000) and full coverage threshold (\$25 million), DCAA and DCMC reviewed CAS-covered contracts awarded from April 1997 through March 1998.⁶⁰ Based on this data, DCAA and DCMC found that there were \$72 billion in CAS-covered contracts involving 588 contractor segments during this period. Of that number, 280 are currently subject to full coverage and 308 are subject to modified coverage. Figure 3.1 estimates the number of contractor segments and the amount of contract dollars that would be CAS-covered under various possible trigger thresholds.

⁶⁰See appendix X for the methodology and supporting documentation used to identify the universe of CAS-covered contracts at various threshold levels and a discussion of the data's limitations, including that the number of contractor segments subject to modified coverage may be understated. The Panel also collected and analyzed contract data provided by the Federal Procurement Data System (FPDS) to identify cost-based type contract actions over \$500,000, excluding an estimate of CAS exemptions, totaling almost \$300 billion. The Panel found that the distribution of dollars at various thresholds was similar for the cost-based actions identified using FPDS and for CAS-covered actions identified using DCAA/DCMC data.

Figure 3.1: Comparing Current CAS Coverage With Alternative Trigger Contract Amounts and a Full Coverage Threshold of \$50 million



Type of Coverage	Number of segments	Number of segments	Number of segments	Number of segments
Full	280	189	189	185
Modified	308	173	^a	94
Total	588	362		279

Note a: DCAA and DCMC were the source of the data used to prepare this analysis. The segments that would be subject to modified coverage under a \$7.5 million threshold will be between 173 (those covered with a \$5 million trigger) and 94 (those covered with a \$10 million trigger). DCAA, with the assistance of DCMC, is collecting data to better estimate the actual coverage in order to supplement the record.

In considering an adjustment to the CAS applicability threshold, the Panel found that if the trigger contract approach were reintroduced, a large number of contractor segments could be removed from CAS applicability, but substantially all CAS-covered contract dollars would remain subject to the CAS. In addition to benefiting small contractors already subject to CAS coverage, this could encourage other small firms to enter the government marketplace where those firms have avoided government contracts because of the potential application of the CAS.⁶¹ If, in addition, the full coverage threshold were raised to \$50 million, the number of

⁶¹This approach also recognizes the business reality that contractor segments with CAS-covered contracts will use a single CAS-compliant accounting system for all their government contracts. That is, for these segments, the costs for all government contracts, whether CAS-covered or not, would be accounted for under CAS-compliant systems.

Specifically, the Panel considered the impact of requiring a trigger contract of between \$5 million and \$10 million, while retaining the current \$500,000 contract applicability threshold. If a \$5 million contract were required to trigger the CAS applicability, DCAA and DCMC data shows about 98 percent of CAS-covered dollars included in the survey would continue to be subject to the CAS. The total number of contractor segments with CAS-covered contracts would significantly decrease, as shown in figure 3.1 above. If a \$10 million contract were required to trigger CAS applicability, DCAA and DCMC data shows that about 96 percent of CAS-covered dollars included in the survey would be subject to the CAS, and the total number of contractor segments with CAS-covered contracts would again significantly decrease, as shown in figure 3.1 above.

Although a trigger contract of \$10 million would continue to subject about 96 percent of current CAS-covered dollars to CAS coverage, a number of segments that would have been subject to full coverage (at a \$50 million full coverage threshold) would fall completely from CAS coverage because none of these segments had received a contract of \$10 million or more. Because of this phenomenon, the Panel explored other trigger contract amounts within the range between \$5 million and \$10 million and found that with a trigger contract of \$7.5 million about 97 percent of current CAS-covered dollars would continue to be subject to the CAS and that no segment that would be subject to full coverage (at the \$50 million threshold) would fall completely from CAS coverage.

The use of a trigger contract appears to protect the government's interests better than simply raising the contract applicability threshold, while still relieving a substantial number of contractor segments of the burdens of the CAS. For example, if the individual contract applicability threshold were raised to \$5 million, the number of contractor segments subject to the CAS would again significantly decrease, but only about 88 percent of the CAS-covered dollars would continue to be subject to the CAS. Such an alternative does not account for the fact that contractor segments with some CAS-covered contracts will use a single CAS-compliant accounting system for all of their contracts. Thus, the benefit of a large rise in the CAS applicability threshold would be relatively small for contractors that continue to have contracts subject to the CAS because those contractors would continue to be required to maintain a CAS-compliant accounting system. However, if the applicability threshold were so raised, the number of contracts subject to price adjustments through the cost impact process for CAS noncompliance or for changes in a contractor's disclosed accounting practices would be significantly reduced. Specifically, at a \$5 million applicability threshold level, the government would lose the right to seek price adjustments under the cost impact process for about \$8 billion in contract value (the difference between current coverage and this alternative); this is in contrast to the use of a \$7.5 million trigger contract (while retaining the current \$500,000 CAS applicability threshold), under which the government would lose the right to seek price adjustments under the CAS for about \$2 billion in contract value.

The Panel believes that raising the full coverage threshold and adopting a trigger contract approach, without raising the applicability threshold, would not significantly affect risk to the government. As noted above, not all contracts and subcontracts have been made subject to the CAS. Rather, as it has always been recognized, the benefits of CAS compliance must be weighed against their costs. As a result of its analysis, the Panel concludes that the risk to the government would be low if a \$7.5 million contract were required to trigger CAS applicability and the full coverage threshold were increased to \$50 million. This would result in about 97 percent of surveyed CAS-covered dollars remaining subject to either full or modified CAS coverage, with the overwhelming majority of the dollars (over 90 percent) being subject to full coverage. With regard to the segments that would no longer be subject to the CAS, the Panel also notes that, whether the CAS apply or not, contractors would still be required to adhere to the FAR cost principles and allocation rules and DCAA would continue to perform audits and reviews of non-CAS-covered contracts where necessary to protect the government's interests.

FIRM FIXED-PRICE CONTRACTS

Currently, firm fixed-price contracts and subcontracts that satisfy CAS applicability requirements are subject to CAS coverage if "any cost data" (certified or non-certified) is submitted at the time of award.⁶² Although the CAS Board has not defined the term "any cost data" with respect to this exemption, in Aydin Corporation v. Widnall,⁶³ it was held that the submission of informal cost data was considered to be "any cost data," even if such data was obtained to check for mistakes or major omissions in offers and not to negotiate price.

Many in industry and government oppose the application of the CAS to firm fixed-price contracts and subcontracts where TINA is not applicable. They note that TINA was revised as part of acquisition reform to ensure that certified cost or pricing data is not obtained where pricing risk to the government is considered low, such as where price is based upon adequate price competition.⁶⁴ Exempting firm fixed-price contracts and subcontracts that are not subject to TINA from CAS coverage would also be low risk, in their view, because cost data is not the basis for determining the agreed contract price, and the contract price is not subject to adjustment based upon the contractor's cost experience in performing the contract. In sum, these commentators state that the application of the CAS does not offer sufficient value to the government, for example in the mitigation of risk, to offset the burdens of the CAS.

⁶²The CAS Board has exempted "[f]irm fixed-price contracts and subcontracts awarded without the submission of any cost data."

⁶³61 F.3d 1571 (Fed. Cir. 1995).

⁶⁴Prior to FASA, TINA did not require agencies to exempt procurements from cost or pricing data submission requirements when a statutory exemption was applicable. FASA made mandatory the statutory exceptions to obtaining certified cost or pricing data (for example, where there is adequate price competition).

The Panel believes that firm fixed-price contracts and subcontracts should be exempt from CAS coverage when the government does not obtain certified cost or pricing data at the time of award. When certified cost or pricing data is not obtained for firm fixed-price contracts and subcontracts, the safeguards provided by the CAS are not necessary.

The Panel notes that some of the cost or pricing risks to the government inherent in cost-reimbursement contracts are not present in firm fixed-price contracts and subcontracts. This is so because firm fixed-price contracts do not provide for adjustment of the agreed price based on changes in a contractor's costs during contract performance. Thus, the actual costs incurred during contract performance do not affect what the government pays under a firm fixed-price contract, and changes in a contractor's cost accounting practices during contract performance should not affect the final price.

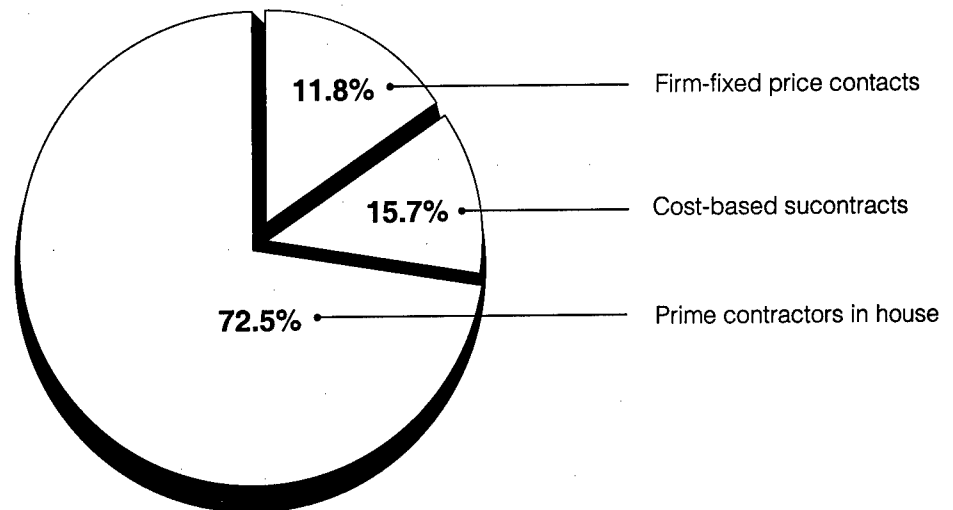
Furthermore, TINA, as implemented, generally does not allow the contracting officer to request the submission of certified cost or pricing data where there is adequate price competition, the prices are set by law or regulation, or the acquisition is for commercial items.⁶⁵ In these situations, the risk to the government in negotiating contract prices is not considered high enough to warrant obtaining certified cost or pricing data. The Panel believes that this risk assessment should be equally applicable to the CAS. That is, where a firm fixed-price can be established without obtaining certified cost or pricing data, the risk to the government of not applying the CAS to these contracts and subcontracts is relatively low.⁶⁶ Conversely, where it is determined that certified cost or pricing data is required for the negotiation of a firm fixed-price contract, this indicates a higher level of risk to the government and should, within the applicable criteria, trigger the application of the CAS requirements.

As discussed above, while the CAS provide significant benefits to the government, they also impose significant burdens on covered contractors and generate costs that are largely borne by the government. For example, contractors may segregate their commercial and military segments to comply with the CAS or refuse to seek government business because of the CAS and other government requirements. The Panel believes that the pricing risks to the government are sufficiently small on firm fixed-priced contracts where no certified cost or pricing data has been obtained. This exemption would seem particularly helpful to firms with fixed-price subcontracts. The survey of 50 DOD prime contractors found, as shown in Figure 3.2, that firm fixed-price subcontracts accounted for 11.8 percent of the total cost-based sales.

⁶⁵Moreover, even if a contract does not fall under one of these three exceptions to certified cost or pricing data requirements, there is provision for a waiver of the requirement for certified cost or pricing data in "exceptional circumstances." 10 U.S.C. 2306a(b)(1)(C), 41 U.S.C. 254b(b)(1)(C). See also House Conference Report No. 105-736, September 22, 1998.

⁶⁶Modifications to non-CAS covered contracts are generally not subject to the CAS. However, contracting officers may rely on various provisions of the FAR and TINA to ensure confidence in the pricing. For example, a contracting officer may request certified (for modifications in excess of \$500,000 for non-commercial items) or non-certified cost or pricing data when negotiating the price of contract modifications.

Figure 3.2: Type of Subcontracts Used by Selected DOD Contractors on Cost-Based Government Contracts



CONCLUSION

Reintroducing the trigger contract approach to the applicability criterion, raising the full coverage threshold, and exempting firm fixed-price contracts from CAS coverage unless certified cost or pricing data is obtained would significantly alleviate the burdens the CAS pose to hundreds of companies, while continuing CAS coverage on the vast majority of current CAS-based dollars. The Panel believes that these changes will (1) promote commercial-military integration, which should provide savings to the government; (2) encourage predominantly commercial companies to seek government business, thus increasing government access to leading edge technologies; and (3) remove an industry perceived obstacle to using advanced cost management methods which could lead to shared cost savings with the government. In addition, these changes will reduce the burden on smaller business segments but will retain coverage for large business segments. Conversely, the Panel's analysis of the potential negative impact of modifying the thresholds shows that requiring the receipt of a trigger contract to activate the application of the CAS and raising the full coverage threshold, as well as exempting firm fixed-price contracts and subcontracts where certified cost or pricing data is not obtained, pose relatively little risk to the government, and that this risk is worth taking in view of the benefits that will be obtained.⁶⁷

⁶⁷As described in chapter 4, the Panel also believes that CAS 405 and CAS 406 should not be included in the definition of modified coverage.

RECOMMENDATIONS

The Panel recommends that Congress amend the OFPP Act of 1988 to provide that the applicability of the CAS to non-exempt contracts be triggered only by receipt of a contract of \$7.5 million or more. The Panel recommends that the current \$500,000 contract application threshold remain unchanged. The Panel also recommends that the threshold for full CAS coverage be increased from \$25 million to \$50 million. The Panel endorses the CAS Board's desire, as reflected in the Board's October 17, 1991 minutes and recently confirmed at the Panel's meeting with the CAS Board, to periodically examine the thresholds for possible adjustment for inflation or marketplace changes. The Panel also recommends that firm fixed-price contracts and subcontracts be exempt from the CAS in those cases where the government does not obtain certified cost or pricing data at the time of award.

THE CAS BOARD'S OPERATIONS AND REVIEW OF THE STANDARDS

As detailed in chapter 1, recent reforms have sought to streamline the acquisition process and facilitate contracting with the government. Statutory and regulatory changes have resulted in the lessening of burdens facing government contractors. Contracting officials have been vested with more discretion to allow them to better exercise their business judgment in making contracting decisions. Underlying these reforms is the belief that reducing hurdles to contracting with the government and expanding contracting agencies' discretion will result in substantial cost savings.

In this chapter, the Panel examines the operations of the CAS Board and the CAS for possible changes in light of acquisition reform and the evolution of GAAP and commercial accounting systems. Specifically, the Panel considered whether (1) the Board should continue to maintain as broad a role in contract administration functions associated with the CAS and (2) a review of the CAS and its attendant requirements should be undertaken for possible streamlining.

ACCOUNTING RULES VERSUS CONTRACT ADMINISTRATION

In establishing and then reestablishing the CAS Board, Congress provided that the Board, in addition to issuing the CAS, would be involved in matters that are traditionally performed by contracting agencies as part of contract administration. For example, the Board was directed to issue regulations for the implementation of the CAS requirements and to require that contractors disclose their cost accounting practices and agree to a contract price adjustment for any increased costs paid to such contractor or subcontractor because of a voluntary change in their cost accounting practices or their failure to comply with the CAS. The legislative history of the original authorizing statute shows that, in setting up the CAS Board, Congress believed that it was important that an independent agency, rather than the contracting agencies, be responsible for establishing and ensuring the implementation of the CAS. This belief was based, in part, upon a lack of confidence that the contracting agencies would properly establish and implement an effective system.

Consistent with its statutory authority, the CAS Board promulgated requirements in a number of contract administration areas that have traditionally been the responsibility of contracting agencies. For example, the CAS Board promulgated a CAS clause that contracting agencies are required to include in covered contracts and retained the authority to determine when a waiver from CAS requirements is appropriate in a particular procurement for a particular contractor or subcontractor. Recently, the Board has proposed a rule that details the cost impact process contracting agencies must follow in negotiating claims associated with CAS coverage with their contractors.

Nevertheless, the Board recognizes the contracting agencies' traditional contract administration responsibilities. The Board states in its Statement of Objectives, Policies and Concepts that it is those agencies' responsibility to receive, review, and approve disclosure statements; to audit covered contractors/subcontractors to ensure compliance with the CAS and their disclosed cost accounting practices; to make appropriate contract price adjustments because of changed accounting practices, failure to follow the existing CAS, or the issuance of new standards; and to ascertain the validity of contractors' and subcontractors' exemption claims.

As described in chapter 1, one theme of recent acquisition reform has been an increase in the discretion accorded agencies and their contracting officials in carrying out procurements. This is materially different from the situation at the time the CAS Board was first established, when Congress felt it had to closely regulate agency procurement activities. In light of this and the contracting agencies' traditional role in administering contracts, consideration should be given to separating the CAS Board's primary responsibility of promulgating and maintaining standards for government contracts from the implementation and administration of those requirements.

As a part of its review, the Panel examined the CAS Board's administration of waiver requests and the proposed regulation governing the cost impact process. These areas were selected because their current administration by the CAS Board has generated controversy.

Waivers

Congress gave the CAS Board specific authority to exempt categories and classes of contractors and subcontractors and to establish procedures for the waiver of the CAS requirements with respect to individual contracts and subcontracts.⁶⁸ Although the law is silent regarding the authority of the Board to delegate its authority, the legislative history indicates that Congress intended that the CAS Board itself could choose to delegate waiver authority to agency heads. Specifically, by consensus amendment, Congress adopted language that simply authorized the CAS Board to establish procedures for the waiver of the CAS requirements. In support of the consensus amendment, the Senate noted that:

The Board itself shall determine appropriate procedures for waiver, including the appropriate officials for granting waivers. Waiver of "classes of contracts" may be granted only by the Board itself.⁶⁹

⁶⁸41 U.S.C. 422(f)(3)(B).

⁶⁹134 Cong. Rec. S16849-52 (October 19, 1988).

The CAS Board rarely delegates its waiver authority. However, in 1995, the Board delegated to executive agencies the authority to waive the application of the CAS to "individual firm fixed-price contracts for the acquisition of commercial items when cost or pricing data is not obtained." Also, the CAS Board has delegated to agency heads the authority to waive the submission of a required disclosure statement before contract award where it was impractical to secure the statement at that time.

In its Statement of Objectives, Policies and Concepts, the Board anticipates that waivers would be granted only in "rare and unusual" cases. This view is confirmed by the stringency of the Board's waiver procedures, which provide that an agency seeking a waiver must describe the contract or subcontract to be waived and provide the following information: (1) a statement that the contractor/subcontractor refuses to accept the contract or subcontract containing all or part of the CAS clause and the reason for the refusal; (2) whether the proposed contractor or subcontractor has in the past accepted a contract or subcontract containing the CAS clause; (3) the amount of the proposed award and the sum of all awards by the agency to the contractor and subcontractor in the preceding 3 years; (4) a statement that no other source will satisfy the agency's needs on a timely basis; (5) the alternative methods considered for filling the agency's needs; and (6) the steps taken to establish other sources of supply for future contracts for the products or services for which a waiver is being requested.

In the 10 years since the CAS Board was reestablished, there have been only 14 requests made to the Board for the waiver of CAS requirements.⁷⁰ While it appears that the CAS Board promptly considers waiver requests, a number of industry officials claim that the stringent criteria for granting waivers discourage firms from seeking them, even if firms believe that a waiver is appropriate.⁷¹ Senior DOD procurement officials also state that the criteria are overly restrictive, thereby greatly inhibiting the waiver process.

DOD believes that the current waiver process does not provide adequate flexibility to meet the agencies' individual procurement needs and that the authority to grant waivers should be delegated to the contracting agencies. For example, DOD states that the CAS requirements hinder efforts to obtain the participation of some advanced technology firms, which will not accept government business that would require compliance with the CAS. Officials from NASA and OPM have agreed with DOD that, with appropriate safeguards, procuring agencies, who are the most knowledgeable about any particular contract or subcontract, could most efficiently and best protect the public interest by being

⁷⁰In contrast, the original CAS Board received more than 50 requests for waiver of CAS requirements. It should be noted that many of those requests predate exemptions that the Board ultimately adopted and that would appear to be applicable today. For example, many of the requests were from United Kingdom or other foreign contractors or subcontractors that apparently would be performing the contract work outside the United States, which fall under an applicable exemption to the CAS.

⁷¹See appendix XII for information on the waivers granted since 1988.

the ones to decide when and how the CAS requirements should be waived. However, officials from the Department of Transportation and the Environmental Protection Agency believe that the CAS Board should have the sole authority to approve waiver requests because the delegation of such authority to the agencies could result in inconsistent treatment of contractors.

In the Panel's view, the decision to grant or deny a waiver request in a particular procurement is a matter of contract administration and business judgment primarily for consideration by the contracting agency. Although the CAS Board has maintained this authority in the past, procurement rules have evolved in the direction of empowering contracting officials to exercise business judgment. For example, procedures for the acquisition of commercial items and simplified acquisition procedures have streamlined the procurement process and now give contracting officers greater discretion in acquiring products and services. By contrast, the CAS Board's restrictive criteria for granting waivers (e.g., an unequivocal statement that a contractor refuses to accept a contract with the CAS requirements and that no other source will satisfy the government's requirements) have basically remained unchanged since their adoption in 1973.

The Panel thinks that the value of possible increased uniformity gained by having the CAS Board maintain waiver authority is outweighed by the benefits of having contracting agencies exercise control over their own contract administration (with appropriate oversight and reporting requirements). In addition, the Panel believes that the CAS Board would be able to maintain control over uniformity because the authority to issue class deviations is not delegated to the procurement agencies (the delegated waiver authority is limited to particular contracts or particular standards for a particular contractor). Contracting agencies are in the best position to exercise their business judgment regarding their contractors and subcontractors and to determine whether CAS requirements need to be waived (and, if so, which ones) in order to best satisfy the agency's acquisition requirements. The Panel notes that contracting agencies are entrusted to waive procurement regulations in unusual cases, where, in their judgment, the waiver serves the government's interest. For example, under FAR subpart 1.4, deviations from the FAR may be granted by agency heads or their designees when necessary to meet the specific needs of the agency.⁷² Given the enhanced discretion that contracting agencies have gained under recent procurement reform initiatives, the Panel believes that contracting agencies themselves should determine whether CAS waivers are appropriate in accordance with criteria to be provided in the FAR.⁷³

⁷²FAR 1.402 states that "[t]he development and testing of new techniques and methods of acquisition should not be stifled simply because such action would require a FAR waiver."

⁷³While there may be some possibility of inconsistent treatment of contractors by individual agencies in considering waiver requests, such a possibility is inherent in any process in which agencies are expected to exercise their business judgment in a reasonable manner.

Cost Impact Process

The statute establishing the CAS Board directed the Board to issue rules and regulations for the implementation of the CAS promulgated under its authority, including regulations dealing with the cost impact process.⁷⁴ Contractors and subcontractors are required to agree to contract price adjustments for any increased costs resulting from a change in a contractor's or subcontractor's cost accounting practices or because of noncompliance with the CAS. The statute requires that these contract price adjustments be made to the contractor's CAS-covered contracts.

The CAS Board's regulations require contract price adjustments when CAS-covered contracts are materially affected by a cost accounting practice change or by a CAS noncompliance. The current regulations, however, do not specify the form and content which cost impact proposals must take or the method for recovering the costs; these are left to the contracting agencies to determine in accordance with the FAR. In response to both industry and government concerns about the cost impact process, the CAS Board has proposed a new rule governing the cost impact process and defining more specifically what constitutes a change in cost accounting practice.⁷⁵

Among other things, the proposed rule details the methodology for determining required contract price or cost accumulation adjustments due to changes in a contractor's cost accounting practices and specifies the actions to be taken by the contractor and the cognizant federal official (e.g., the contracting officer or other agency official authorized to act in that capacity), including the negotiation of the cost impact settlements on behalf of the government. The proposed rule also provides procedures for handling non-compliance actions.

Although the new cost impact process proposed by the Board is more detailed than the one currently provided, the Board's proposal indicates a belief that the change would result in a more efficient and timely process for the resolution of material cost impacts. Some government and industry commentators, on the other hand, see this proposed rule as intrusive and greatly increasing the expense associated with the cost adjustment process. They believe the CAS Board's proposed rule, if finalized, would encroach on individual contracting agencies' traditional contract administration responsibilities.

⁷⁴41 U.S.C. 422(h)(1)(B).

⁷⁵The CAS Board has stated that, based upon work performed by DCAA, the process for determining and resolving the cost impacts attributable to a contractor's change in a cost accounting practice should be made more explicit in the Board's regulations. As of the date of this report, a final rule had not been issued.

REVIEW OF THE STANDARDS

There has been controversy concerning whether some of the CAS unduly incorporate allowability and procurement policy considerations and unnecessarily deviate from GAAP. The Panel believes that a review of the CAS and their attendant requirements is warranted to ascertain whether improvements or streamlining of the standards can be made in light of these concerns. Also, the Panel believes that there is no longer any need to require compliance with CAS 405 and CAS 406 under modified coverage.

Allowability and Procurement Policy

When it reestablished the CAS Board, Congress made it clear that it intended that the Board limit its authority to cost accounting rules and not expand it to cost "allowability and similar policy issues," which are regulated by the procuring agencies in the FAR.⁷⁶ The CAS Board itself recognized this limitation of its authority when it stated in its Statement of Objectives, Policies and Concepts that it does not determine the allowability of categories or individual items of costs; "allowability is a procurement concept affecting contract price and in most cases is established in regulatory or contractual provisions."

The Panel did not conclude from its review that any of the CAS were in effect cost allowability rules. However, the Panel received testimony and presentations from a number of commentators asserting that provisions of CAS 404, 409, 412, and 413 reflect undue concern with procurement policy and recovery of costs rather than establishing appropriate accounting practices.

The CAS versus GAAP

Generally, the CAS are concerned with cost measurement, assignment, and allocation, while GAAP are concerned with cost measurement and assignment. The Panel found that 6 of the 19 standards govern areas not addressed in GAAP, either in whole or in part. More specifically, GAAP do not have requirements for consistency in allocating costs for the same purpose (CAS 402), allocating direct and indirect costs (including home office and general and administrative costs) (CAS 403, 410, and 418), segregating unallowable costs (CAS 405), or calculating the cost of money for capital assets (CAS 414). In addition, while three of the standards (CAS 401—consistency in bidding and accumulating costs, CAS 407—use of standard costs for direct material and direct labor, and CAS 417—cost of money on constructed assets) have parallel concepts in GAAP, their GAAP counterparts have no practical application to contract costing.

⁷⁶Senate Report No. 100-424 at 17 (1988), reprinted in 1988 U.S.C.A.N. 5687, 5703.

Nevertheless, 10 of the 19 standards have some related GAAP requirements that deal with the measurement and assignment of costs. Two of these standards have requirements similar to GAAP.⁷⁷ While eight of the standards (asset valuation (CAS 404 and 409), restructuring (CAS 406), pensions (CAS 412 and 413), insurance (CAS 416), deferred compensation (CAS 415), and independent research and development and bid proposal costs (CAS 420)) differ from GAAP in the areas of measurement and assignment to cost accounting periods, they include many provisions that follow GAAP as well as certain provisions that do not.⁷⁸

Although most of the areas of difference between the CAS and GAAP have not been the subject of criticism, some areas where they differ have been the subjects of controversy, in particular, CAS 404, 412, and 413. The Panel received testimony at the public hearings that criticized some of the CAS as inappropriately deviating from GAAP.⁷⁹

While it is clear that the CAS cannot be replaced in total by GAAP for the purpose of measuring, assigning, and allocating costs to government contracts, there are significant instances where GAAP principles have requirements similar to a number of the CAS as well as instances where the CAS and GAAP significantly differ. The standards should be reviewed to reflect the knowledge of 20 years of government and industry experience, the evolution of GAAP, and the advent of acquisition reform. Such a review could include revising particular section(s) of a standard, combining section(s) of the same or different standards, eliminating particular section(s) of a standard, or eliminating a particular standard in its entirety, and holds the promise of possibly providing opportunities for streamlining the CAS and allowing for more flexibility for contractors while still ensuring adequate uniformity and consistency.

Modified Coverage

As discussed in chapter 3, in 1993, the CAS Board, while increasing the threshold for full coverage from \$10 million to \$25 million, also expanded the definition of modified coverage by requiring business segments subject to modified coverage to adhere to CAS 405 (accounting for unallowable costs)⁸⁰ and CAS 406 (cost accounting period)⁸¹ in addition to CAS 401 and CAS 402.

⁷⁷CAS 408 (compensated personnel absences) and CAS 411 (acquisition costs of material) duplicate in part GAAP promulgations.

⁷⁸See appendix XIII for a more detailed analysis of the similarities and differences between the CAS and GAAP.

⁷⁹See appendix IX.

⁸⁰CAS 405 provides for the identification of costs that are not allowable for government contracts and establishes guidelines for the cost accounting treatment to be accorded identified unallowable costs.

⁸¹CAS 406 provides that a contractor must use its fiscal year as its cost accounting period and establishes consistent practices for the accumulation and allocation of costs from one accounting period to the next.

In expanding the definition of modified coverage to include adherence to CAS 405, the Board stated that it was concerned that some government contractors, particularly those who work for certain civilian procurement agencies, may be including specifically identifiable unallowable costs in indirect costs pools that are reflected in the billings submitted to, and reimbursements received from, federal government contracting agencies.⁸² The Board believed that conformance with the requirements of CAS 405 would restrict this practice.

The CAS Board added CAS 406 to modified coverage because the Board believed that standard stated a basic requirement with which government contractors engaged in cost-based contracting should be able to comply. Although the Board stated that CAS 406 would provide some protection to the government from the selection of inconsistent cost accounting periods with respect to the costing and pricing of contracts, the Board did not identify this as a particular problem with respect to contractors that were subject to modified coverage. In fact, data provided by DCAA shows that DCAA rarely cites noncompliances under CAS 406.

The FAR cost principles also require the identification and segregation of unallowable costs.⁸³ In addition, the FAR provides that no proposal shall be accepted and no agreement made to establish final indirect cost rates until the costs have been certified by the contractor.⁸⁴ This implements congressional requirements that, since FASA, provide significant penalties for the failure to segregate unallowable indirect costs under government contracts in excess of \$500,000.⁸⁵ Specifically, a contractor that includes unallowable indirect costs in a covered contract may be subject to a penalty of up to two times the amount of the disallowed costs plus interest.⁸⁶ These penalties are in addition to possible penalties under the False Claims Act and False Statements Act for a contractor's falsely certifying its indirect cost rates.

Since requirements for certifications and the imposition of penalties have been extended to civilian agencies, the Panel concludes that there is no longer a need to include CAS 405 and CAS 406 in the definition of modified coverage.⁸⁷ The government's interests in these areas are adequately protected by statute and the FAR. Conversely, not requiring adherence to CAS 405 and CAS 406 as part of modified coverage would greatly benefit new entrants to the government marketplace and smaller commercial concerns that often rely upon commercial

⁸²58 Fed. Reg. 58,798 (November 4, 1993).

⁸³FAR 31.201-6.

⁸⁴FAR 42.703-2.

⁸⁵FASA, Section 2351, October 24, 1994. Prior to FASA, penalties were only provided for the failure to segregate unallowable costs under defense contracts in excess of \$100,000.

⁸⁶10 U.S.C. 2324(b), 41 U.S.C. 256(b); see also FAR 42.709-1.

⁸⁷The Panel acknowledges that GAO supported the addition of these two standards in 1993; however, additional legislative protection, as discussed above, was enacted subsequent to GAO's support for adding these two standards to the definition of modified coverage.

accounting systems that do not ordinarily track unallowable costs. The Panel believes that although contractors that have been subject to full coverage find little difficulty in complying with modified CAS coverage (including CAS 405 and CAS 406), contractors that have not previously been subject to the CAS find even modified CAS coverage to be burdensome and costly.

Disclosure Statement

The original disclosure statement was developed and promulgated in the early 1970s. No revisions to that document were made until after the Board was reestablished. In 1992, some minor revisions were made, and subsequently a project was initiated to revise and update the disclosure statement. The current disclosure statement became effective February 28, 1996.

The CAS Board revised the disclosure statement with the goal of bringing it up to date in light of two decades of experience. The Board believed that the revised disclosure statement would improve the cost accounting practices followed by contractors when estimating, accumulating, and reporting costs deemed allocable to federal contracts. In the Board's view, adequate disclosure of cost accounting practices is essential to ensure consistency in cost measurement, assignment, and allocation. The CAS Board believed that an updated disclosure statement would facilitate interaction between contractors and government representatives when dealing with contract costing matters. The CAS Board also believed that the introduction of the revised statement would not impose any new burden on contractors, as it merely replaced an existing form that required periodic updating of disclosed practices. To further reduce the possibility of increased costs, the extended dates for the submission of the new disclosure statement were designed to provide an opportunity to delay submission until a time when, in most cases, the contractors would have had to file an updated disclosure form, even if a new disclosure statement had not been introduced.

Industry representatives state that the revised disclosure statement is far more burdensome than the previous one and that the additional information requested requires contractors to expend considerable additional time and costs. These representatives question whether the government needs the requested additional information or is obtaining commensurate benefits from this information that offset the costs of completing the revised statement.

In justifying the new disclosure statement, the Executive Secretary for the CAS Board estimated in December 1995 that it would take only about 35 hours for a contractor to prepare and submit the revised form (the previous form was estimated to take 40 hours). The Executive Secretary also estimated that the government's review of the revised statement would take only about 8 hours per statement (review of the previous form took 40 hours). These estimates are disputed, however.

(review of the previous form took 40 hours). These estimates are disputed, however. One company stated that the Board's estimate grossly understates the true burden and estimated that it took 2,437 hours to complete only Part VII of the statement.

While the new CAS Board did extensive theoretical analysis and obtained comments from industry and government representatives before promulgating the revised disclosure statement, it did not conduct any field testing.⁸⁸ This is in contrast to the original CAS Board, which conducted extensive field testing before promulgating the first disclosure statement requirements. If the Board had conducted field tests, it could have more accurately determined the time needed to complete the disclosure statement and assessed the need for, or benefit from, specific data requests. If such an analysis were performed in the future, the Panel believes the CAS Board might identify ways to simplify and streamline the disclosure statement.

CONCLUSION

Although Congress originally directed the CAS Board to involve itself in contract administration matters concerning the CAS, this may no longer be necessary, at least with regard to granting waivers and specifying the cost impact process. Rather, the Panel believes that allowing contracting agencies to handle contract administration functions as part of their traditional role in administering contracts, and thus allowing the CAS Board to focus on maintaining a system of accounting standards, would be more efficient, expeditious, and consistent with the goals of acquisition reform.

The Panel also believes that an overall review of the CAS and their attendant requirements is warranted. There are also a number of standards involving procurement policy and funding considerations that some commentators claim to be inappropriate and should be reviewed. There are also areas in which the CAS and GAAP overlap or differ and should be reviewed for possible streamlining. The Panel also found that adherence to CAS 405 and CAS 406 as part of modified coverage is no longer necessary, and that the recently revised disclosure statement may be unnecessarily burdensome.

RECOMMENDATIONS

The Panel recommends that Congress ensure that contracting agencies, rather than the CAS Board, have primary responsibility for administering individual contracts with respect to applicable CAS requirements. With respect to waiver of

⁸⁸In its final rule, the CAS Board stated that it tried to be responsive to suggestions made by commentators and that it undertook a careful reevaluation of Part VII. For example, the Board pointed out that the instructions were revised to make clear that only relevant cost accounting practices and applicable identifying data need be disclosed and that, therefore, submission of numeric data representing accounting estimates is not required.

that the FAR establish criteria for the waivers. This authority should reside at a senior policy level within the contracting agency and be exercised only when necessary to meet the needs of the agency. The authority to grant waivers should be limited to (1) the waiver of specific requirements or standards in an individual contract or subcontract or (2) the waiver of a particular standard or part of a standard for an individual contractor. The waivers should not serve as class exemptions to circumvent any specific CAS requirement. The Panel recommends that a public report of grants of waivers be made on an annual basis by contracting agencies to the OFPP Administrator or the CAS Board, so that the number and kinds of waivers being granted can be monitored.

The Panel also believes that the current standards and disclosure statement should be reviewed to identify ways to simplify and streamline them in light of acquisition reform and experience. Any such review should consider differences and similarities with GAAP and reevaluate the standards in light of the expressed concerns that the standards might reflect undue consideration of procurement policy issues. The Panel also concludes that there is no longer any need to require compliance with CAS 405 and CAS 406 under modified CAS coverage.

NEED FOR AND ORGANIZATION OF THE CAS BOARD

In this chapter, the Panel responds to the congressional request for its views on the need for the CAS and the CAS Board and on whether changes need to be made to the Board's organization. The Panel strongly believes there is a need for an independent CAS Board to promulgate and amend the CAS as necessary. As discussed below, the Panel recommends changes in the Board's location, structure, and staffing and other support.

CONTINUED NEED FOR A CAS BOARD

As indicated in chapter 1, Congress established the CAS Board in part because negotiated cost-based contracts represented the majority of procurement dollars and were likely to be significant in the foreseeable future and because there was a perceived need to protect the government's interests by establishing accounting rules to uniformly and consistently account for contractors' costs. The Panel's review discloses that negotiated cost-based contracts continue to represent the majority of all federal contracting dollars.⁸⁹ For this reason, the Panel believes that the original purposes of the CAS--principally the need to protect the government from the risk inherent in cost-based contracts and to improve communications between the government and contractors with regard to these contracts--remain. Thus, the Panel reached the firm conclusion that there is a continuing need for standards to govern the measurement, assignment, and allocation of costs.

The Panel believes just as strongly that there is also a continuing need for a CAS Board to promulgate, amend, and maintain the CAS. The standards issued by the Board establish a framework for contractors to measure, assign, and allocate costs, whereas other procurement regulations have much broader applications, such as the establishment or implementation of government procurement policy objectives and the determination of the allowability of particular costs. To achieve the overall objectives of uniformity and consistency in accounting for costs, the CAS must take precedence over other procurement regulations. As discussed in chapter 1, during the period when there was no CAS Board, considerable controversy emerged over the interpretation of 9 of the 19 standards, including alleged attempts by DOD to meet procurement policy objectives through that agency's interpretation and proposed amendment of the CAS. These problems were the primary impetus leading to the reestablishment of the Board, and the Panel believes that similar concerns could reappear in the absence of a Board. Moreover, the CAS Board's accomplishments since 1990, such as revising the full coverage threshold for the CAS, are indications of the continuing need for such an entity.

⁸⁹See appendix XIV.

ORGANIZATION OF THE CAS BOARD

The original CAS Board was located in the legislative branch, whereas the current Board is located in the executive branch in OFPP, and thus within OMB. (See Table 5.1.) There were five members on the original CAS Board, the same number as on the current CAS Board. The original CAS Board was chaired by the Comptroller General, who appointed all other members, whereas the current Board is chaired by the OFPP Administrator, who appoints two of the other members.⁹⁰ The majority of the original Board members were from the private sector (including two from the accounting profession), while the majority of the current Board members are government employees.⁹¹ The original CAS Board received a separate appropriation, whereas the current's Board's funding is supplied in OMB's appropriation. Finally, the present Board has considerably less staffing support than the original Board.

Table 5.1: Structure of Original and Current CAS Boards

	Original	Current
Location	GAO	OFPP/OMB
Funding	Separate appropriation for Board's operation.	No separate appropriation for Board's operation. Part of OMB appropriation.
Board membership	Chair: Comptroller General of the United States. Membership: One member from a federal agency, one from industry, and two from the accounting profession. Total: three non-government and two government members.	Chair: OFPP Administrator. Membership: One member each from DOD, GSA, industry, and the accounting profession. Total: two non-government and three government members.
Staff	Executive Secretary, appointed by Comptroller General, and 25-30 staff members.	Executive Secretary, appointed by OFPP Administrator, and three staff members.

Location

At the June 1998 public hearings, the Panel received several expressions of concern regarding the Board's placement. Some believe the Board's current placement in OFPP has led it into procurement policy considerations that are not appropriate accounting concerns. The Panel heard virtually no support for keeping the Board in OFPP.

While the CAS Board is characterized in its authorizing legislation as an "independent board," it is subordinate to OFPP and OMB. This affects the ability

⁹⁰The Secretary of Defense and the Administrator of GSA appoint the other two members of the current CAS Board.

⁹¹Current members include the OFPP Administrator, the Director of DCAA, the Chief Financial Officer of GSA, an industry representative, and an individual "particularly knowledgeable about cost accounting problems and systems." The original CAS Board consisted of the Comptroller General, the DOD Comptroller, two members from the accounting profession, and one industry representative.

of the Board to operate as an independent entity. The Administrator of OFPP is the Chair of the CAS Board, and with the concurrence of OMB, the Administrator appoints two of the Board members. OFPP/OMB hires, evaluates, and directs the Board employees and provides the Board's funding from OMB's lump sum appropriation. As discussed below, because of the CAS Board's subordination to OFPP/OMB, constitutional concerns have been raised that its placement and structure may not allow the Board to issue binding regulations.

In terms of overall policy considerations, the Panel notes that OMB's and the CAS Board's primary missions are significantly different. While the CAS Board establishes accounting rules for government contractors, OMB provides budgetary and other support to the President, often within the scope of the deliberative process and executive privileges.⁹² To accomplish its primary mission, OMB evaluates the effectiveness of agency programs, policies, and procedures; assesses competing funding demands among agencies; and sets funding priorities. OMB oversees and coordinates the Administration's procurement, financial management, information, and regulatory policies. Thus, OMB has a special relationship with the President that often does not allow for open discussion of preliminary Administration positions on issues until these positions are finalized.

With respect to OFPP, the Panel views as significant that OFPP's procurement policy mission is much broader than the maintenance of the CAS. OFPP provides high-level direction and leadership of the government procurement system, whereas the CAS Board's primary mission is to establish and maintain appropriate accounting rules for government contractors. The Board's placement within the federal government's primary procurement policy setting organization may have fostered the perception by some observers, discussed in chapter 4, that procurement policy considerations may have unduly influenced certain Board pronouncements.

Current CAS Board's Subordination to OMB/OFPP

Because of the CAS Board's placement within OFPP and OMB, and since OMB subjects the Board to its direction, there are concerns about the Board's independent authority. Though the Panel found no evidence that OMB has materially changed any CAS Board rulings, OMB's review and supervision create at least the appearance of undercutting the Board's independence. While the Board's authorizing legislation characterizes it as an independent board within OFPP to promulgate, amend, and rescind standards, all Board pronouncements and actions, including standards and public hearing announcements, must be approved by OMB, even though the authorizing legislation does not so provide.

⁹²Deliberative process privilege protects pre-decisional opinions, recommendations, and the like from public disclosure before a final decision has been reached. Pre-decisional materials remain privileged even after the decision to which they pertain is made. Executive privilege refers to a judicially recognized privilege flowing from the separation of powers doctrine of the Constitution that permits the President to maintain the confidentiality of official communications with his advisers. The privilege is intended to promote candor in the presidential deliberation and decision-making process.

In addition, the OFPP Administrator must obtain OMB's concurrence to appoint Board members, and conflict of interest waivers for proposed non-government Board members and staff are approved by OMB.⁹³

Since the CAS Board does not have a separate appropriation, OMB controls the CAS Board's funding. As with other OMB components, including OFPP, the Board's salaries and expenses are rolled up into the budget for OMB's lump sum appropriation. This makes the Board's operations subject to OMB's personnel and budgetary constraints.

The requirement for OMB approval of all CAS Board actions is consistent with the position taken by the Department of Justice while the legislation authorizing the CAS Board was pending. At that time, Justice advised Congress that, in order for the Board to promulgate binding rules, the Board must be subject to the OMB Director's, not the OFPP Administrator's, control. In addition, the Section of Public Contract Law of the American Bar Association (ABA) has questioned the CAS Board's ability to issue binding rules and standards on its own in view of its subordination to OMB.⁹⁴ These analyses conclude that the OFPP Administrator, while appointed by the President and confirmed by Congress, may not be a "principal officer" of the government but rather an "inferior officer" under the supervision and direction of the OMB Director, who is a principal officer.⁹⁵ This distinction is significant, according to the Public Contract Law Section of the ABA, because inferior officers or employees may not have the authority to issue binding regulations; it may be that only principal officers can do so under the Appointments Clause of the Constitution.⁹⁶ Thus, it can be argued that neither the Board itself nor its Chair have the requisite authority to issue binding regulations.⁹⁷

OMB Control of the CAS Board's Staffing and Support

Other concerns regarding the CAS Board's placement within OFPP and OMB relate to the control and sufficiency of staff and other support for the CAS Board. The CAS Board's enabling legislation permits the Board an Executive Secretary, two

⁹³Under 18 U.S.C. 208, officers and employees of the United States, including special government employees, are generally prohibited from participating personally and substantially in rendering advice and rulemaking on matters in which the employee or any organization in which the employee is serving as an officer has a financial interest, absent a written determination, referred to as a waiver, by the government official responsible for the appointment that the interest is not so substantial as to be deemed likely to affect the integrity of the services which the government may expect from such officer or employee.

⁹⁴See appendix IX.

⁹⁵The other CAS Board members likewise are not principal officers, but are either inferior officers or employees.

⁹⁶The Appointments Clause, Article II, section 2, clause 2 of the Constitution provides for the appointment of officers and inferior officers of the United States. In *Buckley v. Valeo*, 424 U.S. 1 (1975), the Supreme Court, in considering the constitutionality of the Federal Elections Commission, discussed the distinction between principal and inferior officers under the Appointments Clause and found that the administrative functions of an executive agency which represent the performance of a significant government duty exercised pursuant to a public law, such as rulemaking, can be exercised only by principal officers.

⁹⁷Notwithstanding the arguments regarding the CAS Board's lack of authority to issue binding regulations, OMB's approval of CAS Board promulgations may make the problem moot, even though such approval is not provided for in the CAS Board's enabling legislation. Also, it could be argued that the publication of the rules in the FAR may make them binding. See *Boeing v. United States*, 680 F.2d 132 (Cl.Ct. 1982) (publication of CAS standards in the government's procurement regulations makes them binding whether or not their issuance by the CAS Board, which at that time was located in GAO, was constitutional).

additional senior staff members, and such other staff that the Administrator of OFPP may appoint.⁹⁸ In fact, the CAS Board employs four permanent staff: the Executive Secretary (an attorney with procurement experience); the Director of Research and a Project Director/Accountant, both of whom are certified public accountants (CPA); and a Management Analyst, who acts as the Administrative Officer to the Board. This staff, as well as a fifth staff member (also a CPA), were employed by OFPP/OMB to work for the Board shortly after it was reestablished.⁹⁹ Also, at least two employees of other agencies have at times been detailed to the Board.¹⁰⁰ In 1994, GAO reported that the CAS Board may be understaffed, a problem that did not allow the Board to make progress in resolving important cost accounting issues.¹⁰¹ The GAO report noted that the original CAS Board employed 25 staff members and that when the CAS Board was reestablished, 7 professional staff were contemplated by the Board's staffing plan. The suggestion has been made, which the Panel finds has merit, that the Board's staff would be enhanced by adding individuals with different skills and experience, for example, industry or contract pricing experience.

Also, since 1997, the Board has not allowed its members, including the industry representative, to have individual staff support, even if paid by the member's organization. Instead, the only staff support is that supplied by the permanent CAS Board staff, who are supervised by the OFPP Administrator. Until this change in practice, individual Board members had been allowed to work with their own support staff. Apparently, OMB is unwilling to be subject to possible claims that it has waived its privileges concerning the protection of documents in cases where individuals who are not OMB employees are made privy to the CAS Board's internal information.¹⁰² OMB apparently is also concerned about possible conflicts of interest over the use of non-government staff, and is unwilling to appoint such staff as special government employees, provide funds for them, or accept volunteer staffing support. At least one observer has stated that since actions can be taken to ensure that the deliberative process is protected, OMB's position regarding the staffing and other support issues is too conservative, especially given the value to the system of allowing each Board member to utilize his or her own staff, instead of relying upon the CAS Board's permanent staff.

Moreover, even before 1997, when the Board allowed individual members to have their own staff, the staff were generally barred from attending Board meetings. In contrast, the original CAS Board allowed each member to have one staff person present at Board meetings. Although non-government Board members

⁹⁸41 U.S.C. 422(b), (c).

⁹⁹The fifth staff member no longer works for the CAS Board and has not been replaced.

¹⁰⁰The Panel understands that OMB has not recently authorized such detailees.

¹⁰¹Cost Accounting Standards Board: Little Progress Made in Resolving Important Issues (GAO/AIMD-94-88, May 25, 1994).

¹⁰²OMB reportedly directed this change in the CAS Board's practice after a claimant in an Armed Services Board of Contract Appeals (ASBCA) litigation requested certain documents from the Board, arguing that the requested documents were no longer protected by the deliberative process privilege because the CAS Board or its staff had disclosed the documents to persons outside the government. See Gould Inc., ASBCA No. 46749 (discovery motion to obtain CAS Board records in a claim dispute involving the interpretation of a standard).

have expressed a preference for having staff assist them during meetings and feel that their representation could be enhanced with such assistance, the Board has barred all staff, except the permanent CAS Board staff, from attending meetings, apparently again because OMB believes that the presence of other individuals from outside government may create a potential conflict of interest or may constitute a waiver of the deliberative process privilege.

The Panel finds merit in the contention that the Board process would be enhanced if members were allowed to have their own staff to assist them. Given the restraints that OMB has imposed on Board members in discussing pending Board actions with persons not employed by OMB, the Panel believes that, because of the absence of staff for individual members, legitimate questions have been raised regarding the fairness and extent of consideration given to the viewpoint of industry or represented agencies in Board determinations.

Finally, although the CAS Board's authorizing legislation expressly allows the use of advisory committees and task forces, the Board has not used advisory committees, reportedly because such committees would be subject to the Federal Advisory Committee Act (FACA), which generally requires open access by the public.¹⁰³ Apparently, this position flows, in part, from OMB's concern about allowing public access. The CAS Board has employed informal working groups (not subject to FACA) to assist on Board projects for the revised disclosure statement and for the pending cost accounting changes rule; however, one industry participant stated that because they were prohibited from sharing their work with the rest of the industry, the industry participants were unable to ensure that the industry's viewpoint was adequately presented. In 1994, a GAO report concluded that restricting the use of advisory committees or task forces when staffing needs exist is likely to further limit progress in resolving pressing cost accounting issues.¹⁰⁴ The report stated that with clearly defined safeguards concerning conflicts of interest and with limits on the duration of assignments, detailees, advisory committees, and task forces could be used to provide the Board with needed assistance.

In light of all of the reasons set out above, the Panel concludes that it would be best to move the CAS Board out of OFPP/OMB. Although there is logic in placing the Board within the office handling overall procurement policy, the Panel finds persuasive the concerns that placement in OFPP/OMB has unduly constrained the Board's work and lent some credence to the contention that the Board's pronouncements have been unduly affected by procurement policy considerations. The Panel acknowledges that although several commentators stated that they believe the reestablished CAS Board has functioned well and that its pronouncements have been fair and soundly based,

¹⁰³5 U.S.C. App. 2 § 1. FACA provides that meetings of advisory committees shall be open to the public, that timely notice of each meeting must be published in the Federal Register, that documents prepared for or by an advisory committee must be accessible for public inspection, and that minutes of each meeting shall be kept and made available to the public.

¹⁰⁴Cost Accounting Standards Board: Little Progress Made in Resolving Important Issues (GAO/AIMD-94-88, May 25, 1994).

and while recognizing the legitimacy of OMB's general concerns about protecting internal discussions and documents, the Panel believes that shifting the Board out of OFPP/OMB could reinforce its independence. This removal should facilitate the use of advisory committees, task forces, and staff for individual members, which would improve the CAS Board process and allow for greater acceptance of its pronouncements.

Analysis of Alternative CAS Board Structures

Before analyzing possible options for the location, structure, and membership of a future CAS Board, the Panel believes that it is important to identify the desirable characteristics of such a Board, irrespective of its placement and membership. The Panel has identified the following characteristics as necessary:

- (1) The CAS Board should be an independent organization not subject to the control of another agency. In particular, the Board should not be subject to the control of any other government agency that may have conflicting procurement policy/funding concerns which could inhibit the Board's ability to promulgate standards representing the most appropriate cost accounting practices.
- (2) The Board's members should represent both the government and the private sector, but government members should remain the majority because the Board's underlying purpose is to protect the government's interests through the establishment and maintenance of cost accounting standards.
- (3) The Board members should serve on a part-time basis. The Board's workload has demanded only part-time participation by its members, and the Panel envisions similar circumstances in the future. Alternatively, the Chair of the Board could be a full-time employee and perform many of the functions currently performed by the Executive Secretary.
- (4) The Board's regulations should be binding and take precedence over other regulations regarding the allocation, measurement, and assignment of costs. In order to achieve uniformity and consistency in accounting for the costs of CAS-covered contracts, the accounting rules promulgated by the CAS Board to establish a framework for contractors to allocate, measure, and assign costs logically should be given precedence over any other procurement rules in this area.

With these characteristics in mind, the Panel reviewed alternative Board structures, considering the characteristics of other selected boards and commissions in an effort to determine a desired structure of the future CAS Board.¹⁰⁵ The requirements for a permanent, independent, and balanced Board comprised of government and non-government part-time members authorized to issue binding regulations are rather unique, and the Panel was unable to identify a comparable structure. However, certain characteristics of the statutory authority of the Federal Energy Regulatory Commission (FERC), including one that establishes it as an independent agency, could be adopted to ensure the CAS Board's independence if it were placed within a host agency as well as to address in part the constitutional concerns raised about the present structure.¹⁰⁶ These provisions state:

The Secretary [of Energy] shall provide to the Commission such support and facilities as the Commission determines it needs to carry out its functions.¹⁰⁷

In the performance of their functions, the members, employees, or other personnel of the Commission shall not be responsible to or subject to the supervision or direction of any officer, employee, or agent of any other part of the Department.¹⁰⁸

The Panel reviewed the possibility of placing the Board in GAO or making the Board an advisory committee within a government agency. These options are not recommended because they would not allow the Board to issue binding regulations, a characteristic which the Panel has determined necessary. If the CAS Board were to become an advisory committee, subject to the provisions of FACA (unless exempted), in order for the Board's rules and standards to become legally binding, they would have to be adopted by an individual or organization authorized to issue binding regulations (such as the OMB Director or the FAR Secretariat), and such other organizations would have the option of not accepting the recommendations of an advisory board. The necessity of approval by another agency would also inhibit the Board's independence. Moreover, additional concerns would be raised if the CAS Board were to reside within GAO as an independent agency because of GAO's placement within the legislative branch.¹⁰⁹

¹⁰⁵Appendix XV provides summary information on a number of boards and commissions reviewed by the Panel.

¹⁰⁶The presidentially appointed FERC Commissioners are all considered principal officers, in part because FERC's authorizing legislation does not subordinate FERC to the Department of Energy.

¹⁰⁷42 U.S.C. 7171(c).

¹⁰⁸42 U.S.C. 7171(d).

¹⁰⁹See *Bowsher v. Synar*, 478 U.S. 714 (1986) (GAO's role under the Gramm-Rudman-Hollings Act held to be an executive function, and given GAO's placement in the legislative branch, GAO's role under the Act held to violate the doctrine of separation of powers).

RECOMMENDED CHANGES

Recommended CAS Board Locations and Structure

To ensure the CAS Board's independence and to address the questions raised regarding its rulemaking authority, changes need to be made to the CAS Board's enabling statute. For the reasons addressed above, the Panel recommends that the CAS Board be removed from OFPP and OMB, and be established as an independent agency (either within or independent of another executive branch agency), operating with autonomy.

The Board's placement must take into consideration its independence and ability to continue to effectively regulate the standards. Maintaining the Board as a separate entity independent of any other government agency is key. If the CAS Board were placed in a host agency, FERC's enabling legislation would provide a model to follow to ensure that any agency providing administrative support would not control or influence the CAS Board's process or its members and staff, and to ensure that the regulations issued by the Board would be binding and not subject to constitutional challenge. The CAS Board should employ its own permanent staff, who should not be subject to the direction of any other agency, and should receive a separate appropriation for its operations. Any of the three alternatives discussed below can, in the Panel's view, achieve these goals.

GSA: The first option would place the CAS Board within GSA as an independent agency with separately appropriated funding. As such, the Board would receive administrative support from GSA, including payroll, personnel, legal, and accounting functions, and, with an appropriate structure as discussed above, would not be subject to the control of the host agency. GSA currently provides government-wide support, including administrative support, to various committees, boards, and advisory committees.

DOD: The second option would place the CAS Board within DOD as an independent agency with separately appropriated funding. As with the GSA option, the advantages of this option would be that it would maximize Board independence while maintaining a relationship to the host agency (DOD). In addition, it would place the Board in the agency with the majority of all CAS-covered contracts. Placement of the CAS Board in DOD would have some drawbacks, however, including the possible perception that the agency with the most at stake in the CAS could unduly influence the promulgation of the CAS for procurement policy reasons. In this regard, as discussed in chapter 1, DOD absorbed some of the CAS Board functions between 1980-88, and during that time a number of conflicts over the standards emerged. On the other hand, the Panel notes that the ASBCA, which is in DOD, operates with independence.

Independent Agency: This option would structure the Board as a totally independent agency. Given the Board's relatively small size, and to minimize costs, support could be provided under a memorandum of understanding with another agency (such as GSA). The advantages of this model include total independence in appearance and in reality, whereas disadvantages include potentially higher costs to the government due to the location of the CAS Board outside of a host agency.

Recommended Board Membership

The Panel believes that the current qualification criterion for membership should be retained for the Board members—that is, all members “shall have experience in government contract cost accounting.” In addition, the Panel believes that the Chair should be a government officer of high standing appointed by the President. Other members should include a representative of DOD, which continues to be responsible for the majority of CAS-covered contracts, and a representative of a civilian agency. Consistent with the present make-up, there should also be an industry representative on the CAS Board as well as a member of the accounting profession (not a government employee) particularly knowledgeable about cost accounting problems and systems. Moreover, given the Comptroller General's independence and particular interest in the CAS, the Panel believes that there is value in adding the Comptroller General as an *ex officio*, non-voting member of the CAS Board. To address the constitutional concerns regarding the Board's structure, and because the Panel believes that the CAS Board should be established in a manner that allows a majority of the Board to promulgate binding regulations, the Panel also recommends that all members be the subject of Presidential appointment.¹¹⁰

Recommended Board Staffing

The CAS Board and its Chair should employ permanent staff who would not be subject to the direction of any other agency. Alternatively, the Chair could be a full-time employee of the CAS Board, and take on the functions currently performed by the Executive Secretary and hire and supervise the other Board staff. The Panel also believes that the Board's staff would be enhanced by including individuals with different skill mixes (e.g., individuals with industry or contract pricing experience). The staff could be augmented when necessary by the use of detailees from other government agencies. The Board members should also be permitted their own staff, subject to appropriate safeguards concerning conflicts of interest. In addition, the Board should employ advisory committees and task forces to ensure that all necessary and relevant facts and opinions are

¹¹⁰ Another possible solution would be for the President to appoint only the Chair of the CAS Board to a non-subordinate position to ensure principal officer status, and for the other members to be appointed as they are presently. However, if the Chair were the only principal officer on the Board and were to be outvoted by the other Board members, under the analysis of the Public Contracts Section of the ABA, any resulting rule may be susceptible to challenge on the basis that it was not issued by a principal officer of the United States—unless the Chair could be required to carry out the will of the majority of the Board in issuing rules.

fairly and reasonably considered in promulgating or amending standards or other CAS requirements. Moreover, there should be a mechanism that is not subject to the control of another agency for reviewing and approving conflict of interest waivers for individuals employed by the Board—for example, a requirement for financial disclosure or a process for waiving possible conflicts of interest by the Chair of the CAS Board.

**THE CAS BOARD REVIEW PANEL
LIST OF PANEL MEMBERS**

Co-Chairs

Dr. Jacques S. Gansler, Under Secretary of Defense for Acquisition and Technology. Dr. Gansler graduated from Yale University (BE), Northwestern University (MSIEE), New School for Social Research (MA/Political Economy) and American University (Ph.D./Economics). He is the author of several books on the defense industry as well as numerous journal papers, articles, and congressional testimony.

Mr. Nelson F. Gibbs, Vice President and Controller, Northrop Grumman Corporation. Mr. Gibbs received a BCE from Clarkson University and an MS in industrial management from Purdue. He is a certified public accountant and a member of the California Society of Certified Public Accountants and the Financial Executives Institute.

Mr. James F. Hinchman, Principal Assistant Comptroller General, U. S. General Accounting Office. Mr. Hinchman received his AB degree from Harvard College and his JD degree from Harvard Law School. Prior to joining GAO, Mr. Hinchman worked for 15 years in the executive branch in positions of increasing responsibility.

Panel Members

Mr. Larry L. Grow, Corporate Vice President and Director of Finance, Motorola Systems Solutions Group. Mr. Grow is a graduate of Arizona State University (Accounting) and holds an MBA from the University of Chicago.

Mr. Jack M. Hughes. Mr. Hughes has a degree in Economics and Business from Frostburg State University and completed graduate studies in contract/procurement law. At BTG, Mr. Hughes provided financial management and strategic direction and was responsible for contracting and pricing strategies.

Major General Timothy P. Malishenko, USAF, Commander, Defense Contract Management Command, Defense Logistics Agency (DLA). General Malishenko earned a bachelor's degree in business administration from Ohio State University, a master's in business from Michigan State University, and a master's in systems management from the University of Southern California. At DLA, General Malishenko oversees the agency's procurement operations and worldwide contract administration.

Dr. Louis I. Rosen, National Director for Government Contract Services, Ernst & Young LLP. Mr. Rosen earned a BS in Accounting, an MBA in Management, and a DBA in Accounting at the University of Maryland. In addition, he received a JD from that university's School of Law. He is a CPA and a member of the Bar of the State of Maryland. At Ernst & Young, Dr. Rosen interprets, evaluates, and applies

government regulations to specific contract institutions, including claims preparation and resolution of disputes.

Mr. Michael J. Thibault, Deputy Director, Defense Contract Audit Agency. Mr. Thibault has a BA in Accounting from Southern Oregon State College and a Master's Degree in Management and Supervision from Central Michigan University. He is a CPA and an active speaker and panel member of various professional organizations.

Rear Admiral Leonard Vincent, USN, Commandant, Defense Systems Management College. Admiral Vincent is a graduate of Southeastern State Teachers College in Oklahoma and received an MBA from the George Washington University. He is the former Commander of the Defense Contract Administration Services Region and the Defense Contract Management Command International.

Ms. Karen L. Wilson, Vice President, Government Finance and Process Excellence, AlliedSignal, Inc. Ms. Wilson earned a BS in Philosophy from College of William and Mary and a JD in Corporate Law from the American University. In addition, she received a LLM in Government Contracts from George Washington University. Ms. Wilson has responsibility for acquisition reform, government financial management, and business practices. She leads several joint government/Allied Signal teams to streamline government oversight in various government accounting, contracting, and procurement areas.

**POTENTIAL BENEFITS OF THE CAS AS
IDENTIFIED BY THE COMPTROLLER GENERAL IN 1970¹¹¹**

1. Uniform standards supply the guidance, support, and coordination required to better understand cost estimates and subsequent reports of actual costs.
2. Standards facilitate the preparation and reporting of cost information by contractors and its audit and evaluation by the government.
3. Standards provide guidance in helping to ensure that items of costs on a given contract are reported on a consistent basis and are comparable with costs originally proposed or projected.
4. Standards provide guidance in helping to ensure that items of cost on a given contract are reported on a consistent basis with costs in claims for change orders, reimbursement, price redeterminations, and terminations.
5. Standards require that the basis upon which forecasts of costs are predicated be disclosed.
6. Standards for use in government procurement operations improve communications between the government, Congress, industry and the general public.
7. Standards 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.
8. Standards establish criteria for the use of alternative methods of cost accounting or narrow the use of alternatives where criteria for their use cannot be established.
9. Standards, together with disclosure by the contractor of its cost accounting practices, 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.
10. Standards provide underlying criteria for determining when certain overhead cost allocation methods are appropriate and when they are not.

¹¹¹Report on the Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts, January 1970.

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11. Standards eliminate, to a considerable extent, differences within the government as to interpretations of acceptable cost accounting practices.
 12. Standards increase uniformity between contractors, which provides increased comparability between bidders on the same contract.
 13. Standards increase consistency, thereby providing comparability between estimated and accumulated costs and safeguards against windfall or increased profits due to changes in cost accounting practices.

THE CAS

The Standards are divided into three categories. Those dealing with (1) overall cost accounting matters, (2) classes, categories, or elements of cost, and (3) pools of indirect costs.

Overall cost accounting matters:

CAS 401 - Consistency in Estimating, Accumulating, and Reporting Costs.

Requires that costs estimated in proposals be developed consistently with the practices used by the contractor in accumulating and reporting costs.

CAS 402 - Consistency in Allocating Costs Incurred for Same Purpose. Requires that each type of cost be allocated only once and on one basis to any contract.

CAS 405 - Accounting for Unallowable Costs. Requires the identification of specific costs at the time such costs are determined to be unallowable.

CAS 406 - Cost Accounting Period. Contract costing will be on the basis of the same fiscal periods for which annual financial statements are prepared.

Classes, categories, or elements of cost:

CAS 404 - Capitalization of Tangible Assets. Establishes the beginning point for fixed assets accounting.

CAS 407 - Use of Standard Costs for Direct Material and Direct Labor. Provides guidance for establishment of direct labor and direct material in standard cost systems.

CAS 408 - Accounting for Costs of Compensated Personal Absence. Provides for the assignment of costs to the proper cost accounting period.

CAS 409 - Depreciation of Tangible Capital Assets. Provides for consistent use of current methods of depreciation and for reasonable estimates of asset service lives.

CAS 411 - Accounting for Acquisition Costs of Material. Provides criteria for allocation of cost of a category of material directly to a cost objective and for the use of inventory costing methods.

CAS 412 - Composition and Measurement of Pension Cost. Guidance for determining and measuring the components of pension costs and establishing which costs are to be assigned to a cost accounting period.

CAS 413 - Adjustment and Allocation of Pension Cost. Provides guidance for assignment of pension costs to the cost accounting period and criteria for allocation among the segments of the organization.

CAS 414 - Cost of Money as an Element of the Cost of Facilities Capital. Provides technique for measuring and allocating to contracts costs based on investment in facilities capital.

CAS 415 - Accounting for the Cost of Deferred Compensation. Guidance for the measurement of the cost of deferred compensation and for the assignment of such cost to cost accounting periods.

CAS 416 - Accounting for Insurance Costs. Provides criteria for distinguishing between deposits and earned premiums.

CAS 417 - Cost of Money as an Element of the Cost of Capital Assets Under Construction. Extension of CAS 414, provides that imputed cost of money be included in the cost of capital assets.

Pools of Indirect Costs:

CAS 403 - Allocation of Home Office Expenses to Segments. Establishes criteria for allocation of home office expenses directly to the segments of the organization to the maximum extent practical.

CAS 410 - Allocation of Business Unit General and Administrative Expenses to Final Cost Objectives. Provides criteria for the allocation of business unit general and administrative expenses to contracts and other work.

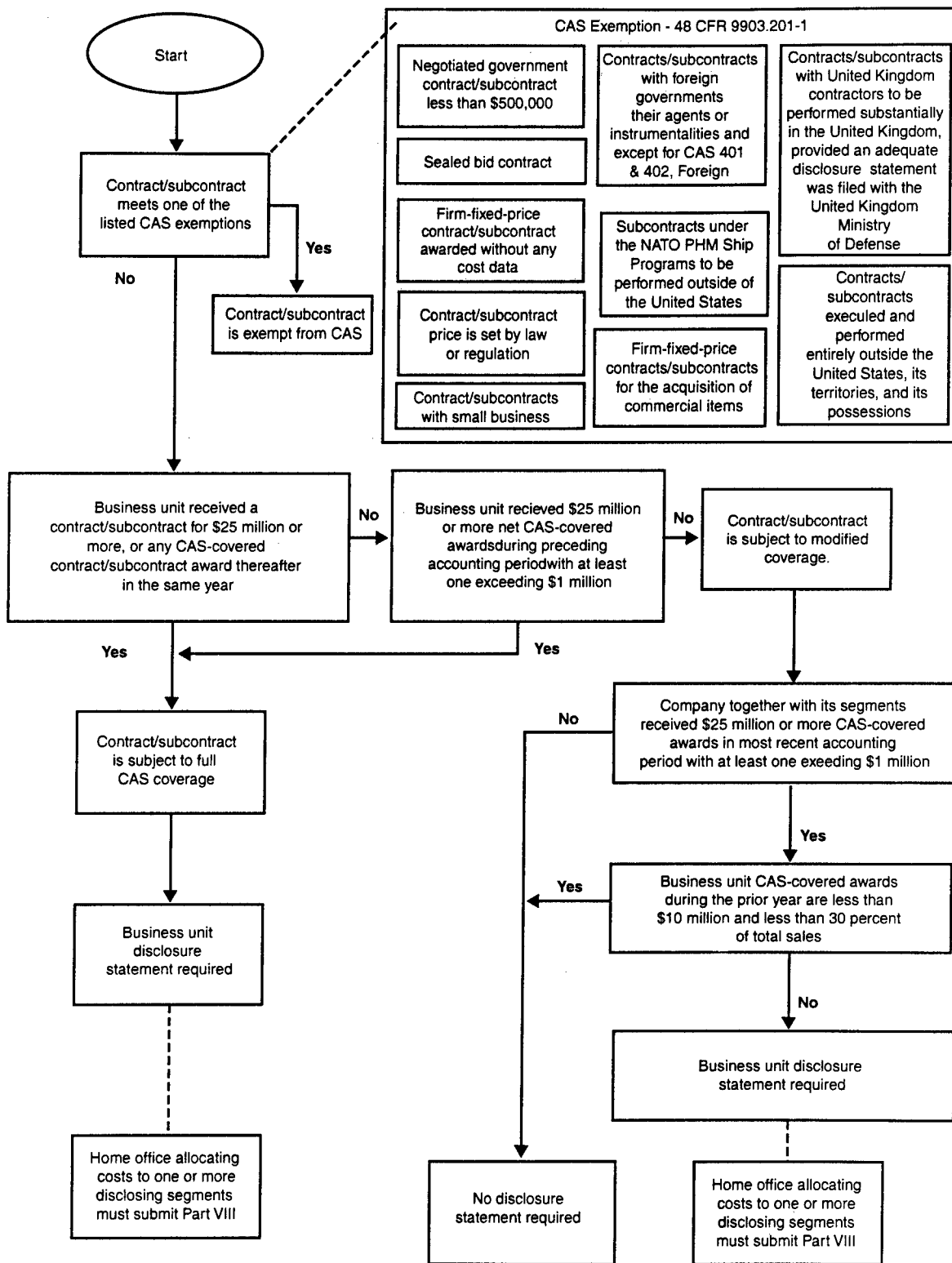
CAS 418 - Allocation of Direct and Indirect Costs. Requires that costs be consistently classified as direct or indirect and provides criteria for accumulating indirect costs into homogeneous indirect cost pools.

CAS 420 - Accounting for Independent Research and Development Costs (IR&D) and Bid and Proposal (B&P) Costs. Provides criteria for the accumulation and allocation of IR&D and B&P costs among defense contractor segments.

THE CAS EXEMPTIONS

The following categories of contracts and subcontracts are exempt from all the CAS requirements:

1. Sealed bid contracts.
2. Negotiated contracts and subcontracts not in excess of \$500,000.
3. Contracts and subcontracts with small businesses.
4. Contracts and subcontracts with foreign governments or their agents.
5. Contracts and subcontracts in which the price is set by law or regulation.
6. Firm fixed-price and fixed-price with economic price adjustment (provided that price adjustment is not based on actual costs incurred) contracts and subcontracts for the acquisition of commercial items.
7. Contracts and subcontracts awarded to a United Kingdom contractor for performance substantially in the United Kingdom, provided that the contractor has filed with the United Kingdom Ministry of Defense a completed Disclosure Statement that adequately describes the contractor's cost accounting practices.
8. Subcontracts under the NATO PHM Ship program to be performed outside the United States by a foreign concern.
9. Contracts and subcontracts to be executed and performed entirely outside the United States, its territories, and possessions.
10. Firm-fixed-price contracts and subcontracts awarded without submission of any cost data.

THE CAS APPLICABILITY AND COVERAGE DIAGRAM¹¹²¹¹²Defense Contract Audit Manual, January 1999.

Sample Disclosure Statement Form

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		INDEX
		<u>Page</u>
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**COST ACCOUNTING STANDARDS BOARD
DISCLOSURE STATEMENT
REQUIRED BY PUBLIC LAW 100-679**

GENERAL INSTRUCTIONS

1. This Disclosure Statement has been designed to meet the requirements of Public Law 100-679, and persons completing it are to describe the contractor and its contract cost accounting practices. For complete regulations, instructions and timing requirements concerning submission of the Disclosure Statement, refer to Section 9903.202 of Chapter 99 Of Title 48 CFR (48 CFR 9903.202).

2. Part I of the Statement provides general information concerning each reporting unit (e.g., segment, Corporate or other intermediate level home office, or a business unit). Parts II through VII pertain to the types of costs generally incurred by the segment or business unit directly performing Federal contracts or similar cost objectives. Part VIII pertains to the types of costs that are generally incurred by a Home office and are allocated to one or more segments performing Federal contracts. For a definition of the term "home office", see 48 CFR 9904.403.

3. Each segment or business unit required to disclose its cost accounting practices should complete the Cover Sheet, the Certification, and Parts I through VII.

4. Each home office required to disclose its cost accounting practices for measuring, assigning and allocating its costs to segments performing Federal contracts or similar cost objectives shall complete the Cover Sheet, the Certification, Part I and Part VIII of the Disclosure Statement. Where a home office either establishes practices or procedures for the types of costs covered by Parts V, VI and VII, or incurs and then allocates these types of cost to its segments, the home office may complete Parts V, VI and VII to be included in the Disclosure Statement submitted by its segments. While a home office may have more than one segment submitting Disclosure Statements, only one Statement needs to be submitted to cover the home office operations.

5. The Statement must be signed by an authorized signatory of the reporting unit.

6. The Disclosure Statement should be answered by marking the appropriate line or inserting the applicable letter code which describes the segment's (reporting unit's) cost accounting practices.

7. A number of questions in this Statement may need narrative answers requiring more space than is provided. In such instances, the reporting unit should use the attached continuation sheet provided. The continuation sheet may be reproduced locally as needed. The number of the question involved should be indicated and the same coding required to answer the questions in the Statement should be used in presenting the answer on the continuation sheet. Continuation sheets should be inserted at the end of the pertinent Part of the Statement. On each continuation sheet, the reporting unit should enter the next sequential page number for that Part and, on the last continuation sheet used, the words "End of Part" should be inserted after the last entry.

8. Where the cost accounting practice being disclosed is clearly set forth in the contractor's existing written accounting policies and procedures, such documents may be cited on a continuation sheet and incorporated by reference at the option of the contractor. In such cases, the contractor should provide the date of issuance and effective date for each accounting policy and/or procedures document cited. Alternatively, copies of the relevant parts of such documents may be attached as appendices to the pertinent Disclosure Statement Part. Such continuation sheets and appendices should be labeled and cross-referenced with the applicable Disclosure Statement number and follow the page number specified in paragraph 7. Any supplementary comments needed to adequately describe the cost accounting practice being disclosed should also be provided.

9. Disclosure Statements must be amended when cost accounting practices are changed to comply with a new CAS or when practices are changed with or without knowledge of the Government (Also see 48 CFR 9903.202-3).

**COST ACCOUNTING STANDARDS BOARD
DISCLOSURE STATEMENT
REQUIRED BY PUBLIC LAW 100-679**

GENERAL INSTRUCTIONS

10. Amendments shall be submitted to the same offices to which submission would have been made were an original Disclosure Statement filed.

11. Each amendment, or set of amendments should be accompanied by an amended cover sheet (indicating revision number and effective date of the change) and a signed certification. For all resubmissions, on each page, insert "Revision Number ____" and "Effective Date ____" in the Item Description block; and, insert a revision mark (e.g., "R") in the right hand margin of any line that is revised. Completely resubmitted Disclosure Statements must be accompanied by similar notations identifying the items which have been changed.

12. Use of this Disclosure Statement, amended February 1996, shall be phased in as follows:

A. New Contractors. This form shall be used by new contractors when they are initially required to disclose their cost accounting practices pursuant to 9903.202-1.

B. Existing Contractors. If a contractor has disclosed its cost accounting practices on a prior edition of the Disclosure Statement (CASB DS-1), such disclosure shall remain in effect until the contractor amends or revises a significant portion of the Disclosure Statement in accordance with CAS 9903.202-3. Minor amendments to an existing DS-1 may continue to be made using the prior form. However, when a substantive change is made, a complete Disclosure Statement must be filed using this form. In any event, all contractors and subcontractors must submit a new Disclosure Statement (this version of the CASB DS-1) not later than the beginning of the contractor's next full fiscal year after December 31, 1998.

ATTACHMENT - Blank Continuation Sheet

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		CONTINUATION SHEET
		NAME OF REPORTING UNIT
Item No.	Item description	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679	COVER SHEET AND CERTIFICATION
0.1	<u>Company or Reporting Unit.</u> Name Street Address City, State, & Zip Code Division or Subsidiary of (if applicable)
0.2	<u>Reporting Unit:</u> (Mark one.) A. ☐ Business Unit comprising an entire business organization which is not divided into segments. B.1. ☐ Corporate Home Office 2. ☐ Intermediate Level Home Office 3. ☐ Segment or business unit reporting directly to a home office.
0.3	<u>Official to Contact Concerning this Statement.</u> Name and Title Phone number (including area code and extension)
0.4	<u>Statement Type and Effective Date:</u> A. (Mark type of submission. If a revision, enter number) (a) ☐ Original Statement (b) ☐ Revised Statement; Revision No. _____ B. Effective Date of this Statement/Revision: _____
0.5	<u>Statement Submitted To</u> (Provide office name, location and telephone number, include area code and extension): (a) Cognizant Federal Agency: _____ (b) Cognizant Federal Auditor: _____
CERTIFICATION I certify that to the best of my knowledge and belief this Statement, as amended in the case of a revision, is the complete and accurate disclosure as of the above date by the above-named organization of its cost accounting practices, as required by the Disclosure Regulation (48 CFR 9903.202) of the Cost Accounting Standards Board under P.L. 100-679. _____ (Name) _____ (Title)	
THE PENALTY FOR MAKING A FALSE STATEMENT IN THIS DISCLOSURE IS PRESCRIBED IN 18 U.S.C. § 1001	

**COST ACCOUNTING STANDARDS BOARD
DISCLOSURE STATEMENT
REQUIRED BY PUBLIC LAW 100-679**

PART I - GENERAL INFORMATION

NAME OF REPORTING UNIT

**Item
No.**

Item description

Part I Instructions

Sales data for this part should cover the most recently completed fiscal year of the reporting unit. "Government CAS Covered Sales" includes sales under both prime contracts and subcontracts. "Annual CAS Covered Sales" includes intracorporate transactions.

1.1.0 **Type of Business Entity of Which the Reporting Unit is a Part.** (Mark one.)

- A. ☐ Corporation
- B. ☐ Partnership
- C. ☐ Proprietorship
- D. ☐ Not-for-profit organization
- E. ☐ Joint Venture
- F. ☐ Federally Funded Research and Development Center (FFRDC)
- Y. ☐ Other (Specify) _____

1.2.0 **Predominant Type of Government Sales.** (Mark one.) 1/

- A. ☐ Manufacturing
- B. ☐ Research and Development
- C. ☐ Construction
- D. ☐ Services
- Y. ☐ Other (Specify) _____

1.3.0 **Annual CAS Covered Government Sales as Percentage of Total Sales (Government and Commercial).** (Mark one. An estimate is permitted for this section.) 1/

- A. ☐ Less than 10%
- B. ☐ 10%-50%
- C. ☐ 51%-80%
- D. ☐ 81% - 95%
- E. ☐ Over 95%

1.4.0 **Description of Your Cost Accounting System for Government Contracts and Subcontracts.** (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) 1/

- A. ☐ Standard costs - Job order
- B. ☐ Standard costs - Process
- C. ☐ Actual costs - Job order
- D. ☐ Actual costs - Process
- Y. ☐ Other(s) 2/

1/ Do not complete when Part I is filed in conjunction with Part VIII.

2/ Describe on a Continuation Sheet.

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART I - GENERAL INFORMATION
		NAME OF REPORTING UNIT
Item No.	Item description	
1.5.0	<u>Identification of Differences Between Contract Cost Accounting and Financial Accounting Records.</u> List on a continuation sheet, the types of costs charged to Federal contracts that are supported by memorandum records and identify the method used to reconcile with the entity's financial accounting records.	
1.6.0	<u>Unallowable Costs.</u> Costs that are not reimbursable as allowable costs under the terms and conditions of Federal awards are identified as follows: (Mark all that apply and if more than one is marked, describe on a continuation sheet the major cost groupings, organizations, or other criteria for using each marked technique.)	
1.6.1	Incurred costs. A. ☐ Specifically identified and recorded separately in the formal financial accounting records. B. ☐ Identified in separately maintained accounting records or workpapers. C. ☐ Identifiable through use of less formal accounting techniques that permit audit verification. D. ☐ Determinable by other means. <u>1/</u>	
1.6.2	Estimated costs. A. ☐ By designation and description (in backup data, workpapers, etc) which have specifically been identified and recognized in making estimates. B. ☐ By description of any other estimating technique employed to provide appropriate recognition of any unallowable amounts pertinent to the estimates. C. ☐ Other. <u>1/</u>	
1.7.0	<u>Fiscal Year:</u> _____ (Specify twelve month period used for financial accounting and reporting purposes, e.g., 1/1 to 12/31.)	
1.7.1	<u>Cost Accounting Period:</u> _____ (Specify period. If the cost accounting period used for the accumulation and reporting of costs under Federal contracts is other than the fiscal year identified in Item 1.7.0, explain circumstances on a continuation sheet.)	
<u>1/</u> Describe on a Continuation Sheet.		

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART II - DIRECT COSTS
		NAME OF REPORTING UNIT
Item No.	Item description	
	Part II Instructions This part covers the three major categories of direct costs, i.e., Direct Material, Direct Labor, and Other Direct Costs. It is not the intent here to spell out or define the three elements of direct costs. Rather, each contractor should disclose practices based on its own definitions of what costs are, or will be, charged directly to Federal contracts or similar cost objectives as Direct Material, Direct Labor, or Other Direct Costs. For example, a contractor may charge or classify purchased labor of a direct nature as "Direct Material" for purposes of pricing proposals, requests for progress payments, claims for cost reimbursement, etc.; some other contractor may classify the same cost as "Direct Labor," and still another as "Other Direct Costs." In these circumstances, it is expected that each contractor will disclose practices consistent with its own classifications of Direct Material, Direct Labor, and Other Direct Costs.	
2.1.0	Description of Direct Material. Direct material as used here is <u>not</u> limited to those items of material actually incorporated into the end product; they also include material, consumable supplies, and other costs when charged to Federal contracts or similar cost objectives as Direct Material. (Describe on a continuation sheet the principal classes or types of material and services which are charged as direct material; group the material and service costs by those which are incorporated in an end product and those which are not.)	
2.2.0	Method of Charging Direct Material.	
2.2.1	Direct Charge Not Through an Inventory Account at: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. ☐ Standard costs (Describe the type of standards used.) 1/ B. ☐ Actual Costs Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
2.2.2	Charged Direct from a Contractor-owned Inventory Account at: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. ☐ Standard costs 1/ B. ☐ Average Costs 1/ C. ☐ First in, first out D. ☐ Last in, first out Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
	1/ Describe on a Continuation Sheet.	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART II - DIRECT COSTS
		NAME OF REPORTING UNIT
Item No.	Item description	
2.3.0	<u>Timing of Charging Direct Material.</u> (Mark the appropriate line(s) to indicate the point in time at which direct material are charged to Federal contracts or similar cost objectives, and if more than one line is marked, explain on a continuation sheet.) A. ☐ When orders are placed B. ☐ When both the material and invoice are received C. ☐ When material is issued or released to a process, batch, or similar intermediate cost objective D. ☐ When material is issued or released to a final cost objective E. ☐ When invoices are paid Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
2.4.0	<u>Variances from Standard Costs for Direct Material.</u> (Do not complete this item unless you use a standard cost method, i.e., you have marked Line A of Item 2.2.1, or 2.2.2. Mark the appropriate line(s) in Items 2.4.1, 2.4.2, and 2.4.4, and if more than one line is marked, explain on a continuation sheet.)	
2.4.1	<u>Type of Variance.</u> A. ☐ Price B. ☐ Usage C. ☐ Combined (A and B) Y. ☐ Other(s) 1/	
2.4.2	<u>Level of Production Unit used to Accumulate Variance.</u> Indicate which level of production unit is used as a basis for accumulating material variances. A. ☐ Plant-wide Basis B. ☐ By Department C. ☐ By Product or Product Line Y. ☐ Other(s) 1/	
2.4.3	<u>Method of Disposing of Variance.</u> Describe on a continuation sheet the basis for, and the frequency of, the disposition of the variance.	
2.4.4	<u>Revisions.</u> Standard costs for direct materials are revised: A. ☐ Semiannually B. ☐ Annually C. ☐ Revised as needed, but at least once annually Y. ☐ Other(s) 1/	
1/ Describe on a Continuation Sheet.		

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART II - DIRECT COSTS																																	
		NAME OF REPORTING UNIT																																	
Item No.	Item description																																		
2.5.0	Method of Charging Direct Labor: (Mark the appropriate line(s) for each Direct Labor Category to show how such labor is charged to Federal contracts or similar cost objectives, and if more than one line is marked, explain on a continuation sheet. Also describe on a continuation sheet the principal classes of labor rates that are, or will be applied to Manufacturing Labor, Engineering Labor, and Other Direct Labor, in order to develop direct labor costs. <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th></th> <th colspan="3" style="text-align: center; border-bottom: 1px solid black;">Direct Labor Category</th> </tr> <tr> <th></th> <th style="text-align: center; border-bottom: 1px solid black;">Manufacturing</th> <th style="text-align: center; border-bottom: 1px solid black;">Engineering</th> <th style="text-align: center; border-bottom: 1px solid black;">Other Direct</th> </tr> </thead> <tbody> <tr> <td>A. Individual/actual rates</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>B. Average rates -- uncompensated overtime hours included in computation ^{1/}</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>C. Average rates -- uncompensated overtime hours excluded from computation</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>D. Standard costs/rates ^{1/}</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Y. Other(s) ^{1/}</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Z. Labor category is not applicable</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> </tbody> </table>				Direct Labor Category				Manufacturing	Engineering	Other Direct	A. Individual/actual rates	_____	_____	_____	B. Average rates -- uncompensated overtime hours included in computation ^{1/}	_____	_____	_____	C. Average rates -- uncompensated overtime hours excluded from computation	_____	_____	_____	D. Standard costs/rates ^{1/}	_____	_____	_____	Y. Other(s) ^{1/}	_____	_____	_____	Z. Labor category is not applicable	_____	_____	_____
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Y. Other(s) ^{1/}	_____	_____	_____																																
Z. Labor category is not applicable	_____	_____	_____																																
2.6.0	Variances from Standard Costs for Direct Labor: (Do not complete this item unless you use a standard costs/rate method, i.e., you have marked Line D of Item 2.5.0 for any direct labor category. Mark the appropriate line(s) in each column of Items 2.6.1, 2.6.2, and 2.6.4. If more than one is marked, explain on a continuation sheet.)																																		
2.6.1	Type of Variance. <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th></th> <th colspan="3" style="text-align: center; border-bottom: 1px solid black;">Direct Labor Category</th> </tr> <tr> <th></th> <th style="text-align: center; border-bottom: 1px solid black;">Manufacturing</th> <th style="text-align: center; border-bottom: 1px solid black;">Engineering</th> <th style="text-align: center; border-bottom: 1px solid black;">Other Direct</th> </tr> </thead> <tbody> <tr> <td>A. Rate</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>B. Efficiency</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>C. Combined (A and B)</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Y. Other(s) ^{1/}</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Z. Labor category is not applicable</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> </tbody> </table>				Direct Labor Category				Manufacturing	Engineering	Other Direct	A. Rate	_____	_____	_____	B. Efficiency	_____	_____	_____	C. Combined (A and B)	_____	_____	_____	Y. Other(s) ^{1/}	_____	_____	_____	Z. Labor category is not applicable	_____	_____	_____				
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^{1/} Describe on a Continuation Sheet.																																			

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART II - DIRECT COSTS																													
		NAME OF REPORTING UNIT																													
Item No.	Item description																														
2.6.2	<u>Level of Production Unit used to Accumulate Variance.</u> Indicate which level of production unit is used as a basis for accumulating the labor variances. <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th></th> <th colspan="3" style="text-align: center; border-bottom: 1px solid black;">Direct Labor Category</th> </tr> <tr> <th></th> <th style="text-align: center; border-bottom: 1px solid black;">Manufacturing</th> <th style="text-align: center; border-bottom: 1px solid black;">Engineering</th> <th style="text-align: center; border-bottom: 1px solid black;">Other Direct</th> </tr> </thead> <tbody> <tr> <td>A. Plant-wide basis</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>B. By department</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>C. By product or product line</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Y. Other(s) <u>1/</u></td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>Z. Labor category is not applicable</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> </tbody> </table>				Direct Labor Category				Manufacturing	Engineering	Other Direct	A. Plant-wide basis	_____	_____	_____	B. By department	_____	_____	_____	C. By product or product line	_____	_____	_____	Y. Other(s) <u>1/</u>	_____	_____	_____	Z. Labor category is not applicable	_____	_____	_____
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2.6.3	<u>Method of Disposing of Variance.</u> Describe on a continuation sheet the basis for, and the frequency of, the disposition of the variance.																														
2.6.4	<u>Revisions.</u> Standard costs for direct labor are revised: A. _____ Semiannually B. _____ Annually C. _____ Revised as needed, but at least once annually Y. _____ Other(s) <u>1/</u>																														
2.7.0	<u>Description of Other Direct Costs.</u> Other significant items of cost directly identified with Federal contracts or other final cost objectives. Describe on a continuation sheet the principal classes of other costs that are always charged directly, that is, identified specifically with final cost objectives, e.g., fringe benefits, travel costs, services, subcontracts, etc.																														
2.7.1	When Employee Travel Expenses for lodging and subsistence are charged direct to Federal contracts or similar cost objectives the charge is based on: A. _____ Actual Costs B. _____ Per Diem Rates C. _____ Lodging at actual costs and subsistence at per diem Y. _____ Other Method <u>1/</u> Z. _____ Not Applicable																														
2.8.0	<u>Credits to Contract Costs.</u> When Federal contracts or similar cost objectives are credited for the following circumstances, are the rates of direct labor, direct materials, other direct costs and applicable indirect costs always the same as those for the original charges? (Mark one line for each circumstance, and for each "No" answer, explain on a continuation sheet how the credit differs from the original charge.) <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th style="text-align: left; border-bottom: 1px solid black;">Circumstances</th> <th style="text-align: center; border-bottom: 1px solid black;">A. Yes</th> <th style="text-align: center; border-bottom: 1px solid black;">B. No</th> <th style="text-align: center; border-bottom: 1px solid black;">Z. Not Applicable</th> </tr> </thead> <tbody> <tr> <td>(a) Transfers to other jobs/contracts</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td>(b) Unused or excess materials remaining upon completion of contract</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> </tbody> </table>			Circumstances	A. Yes	B. No	Z. Not Applicable	(a) Transfers to other jobs/contracts	_____	_____	_____	(b) Unused or excess materials remaining upon completion of contract	_____	_____	_____																
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COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART III - DIRECT VS. INDIRECT COSTS	
		NAME OF REPORTING UNIT	
Item No.	Item description		
3.1.0	<u>Criteria for Determining How Costs are Charged to Federal Contracts Or Similar Cost Objectives.</u> Describe on a continuation sheet your criteria for determining when costs incurred for the same purpose, in like circumstances, are treated either as direct costs only or as indirect costs only with respect to final cost objectives.		
3.2.0	<u>Treatment of Costs of Specified Functions, Elements of Cost, or Transactions.</u> (For each of the functions, elements of cost or transactions listed in Items 3.2.1, 3.2.2, and 3.2.3, enter one of the Codes A through F, or Y, to indicate how the item is treated. Enter Code Z in those lines that are not applicable to you. Also, specify the name(s) of the indirect pool(s) (as listed in 4.1.0, 4.2.0 and 4.3.0) for each function, element of cost, or transaction coded E or F. If Code E, Sometimes direct/Sometimes indirect, is used, explain on a continuation sheet the circumstances under which both direct and indirect allocations are made.)		
	<u>Treatment Code</u>		
	A. Direct material B. Direct labor C. Direct material and labor D. Other direct costs E. Sometimes direct/Sometimes indirect F. Indirect only Y. Other(s) 1/ Z. Not applicable		
3.2.1	<u>Functions, Elements of Cost, or Transactions Related to Direct Material</u>		
	<u>Treatment Code</u>	<u>Name of Pool(s)</u>	
	(a)	Cash Discounts on Purchases	—
	(b)	Freight in	—
	(c)	Income from Sale of Scrap	—
	(d)	Income from Sale of Salvage	—
	(e)	Incoming Material Inspection (receiving)	—
	(f)	Inventory adjustment	—
	(g)	Purchasing	—
	(h)	Trade Discounts, Refunds, Rebates, and Allowances on Purchases	—
1/ Describe on a Continuation Sheet.			

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART III - DIRECT VS. INDIRECT COSTS	
		NAME OF REPORTING UNIT	
Item No.	Item description		
3.2.2	<u>Functions, Elements of Cost, or Transactions Related to Direct Labor</u>		
		<u>Treatment Code</u>	<u>Name of Pool(s)</u>
	(a) Incentive Compensation	—	—
	(b) Holiday Differential (Premium Pay)	—	—
	(c) Vacation Pay	—	—
	(d) Overtime Premium Pay	—	—
	(e) Shift Premium Pay	—	—
	(f) Pension Costs	—	—
	(g) Post Retirement Benefits Other Than Pensions	—	—
	(h) Health Insurance	—	—
	(i) Life Insurance	—	—
	(j) Other Deferred Compensation 1/	—	—
	(k) Training	—	—
	(l) Sick Leave	—	—
1/ Describe on a Continuation Sheet.			

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART III - DIRECT VS. INDIRECT COSTS	
		NAME OF REPORTING UNIT	
Item No.	Item description		
3.2.3	<u>Functions, Elements of Cost, or Transactions - Miscellaneous</u>	<u>Treatment Code</u>	<u>Name of Pool(s)</u>
	(a) Design Engineering (in-house)	_____	_____
	(b) Drafting (in-house)	_____	_____
	(c) Computer Operations (in-house)	_____	_____
	(d) Contract Administration	_____	_____
	(e) Subcontract Administration Costs	_____	_____
	(f) Freight Out (finished product)	_____	_____
	(g) Line (or production) Inspection	_____	_____
	(h) Packaging and Preservation	_____	_____
	(i) Preproduction Costs and Start-up Costs	_____	_____
	(j) Departmental Supervision	_____	_____
	(k) Professional Services (consultant fees)	_____	_____
	(l) Purchased Labor of Direct Nature (on premises)	_____	_____
	(m) Purchased Labor of Direct Nature (off premises)	_____	_____
	(n) Rearrangement Costs	_____	_____
	(o) Rework Costs	_____	_____
	(p) Royalties	_____	_____
	(q) Scrap Work	_____	_____
	(r) Special Test Equipment	_____	_____
	(s) Special Tooling	_____	_____
	(t) Warranty Costs	_____	_____
	(u) Rental Costs	_____	_____
	(v) Travel and Subsistence	_____	_____
	(w) Employee Severance Pay	_____	_____
	(x) Security Guards	_____	_____

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS
		NAME OF REPORTING UNIT

Item No.	Item description		
4.10	<u>Part IV Instructions</u> For the purpose of this part, indirect costs have been divided into three categories: (i) manufacturing, engineering, and comparable indirect costs, (ii) general and administrative (G&A) expenses, and (iii) service center and expense pool costs, as defined in Item 4.3.0. The term "overhead," as used in this part, refers only to the first category of indirect costs. The following Allocation Base Codes are provided for use in connection with Items 4.1.0, 4.2.0 and 4.3.0. <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> A. Sales B. Cost of sales C. Total Cost Input (direct material, direct labor, other direct costs and applicable overhead) D. Value-added cost input (total cost input less direct material and subcontract costs) E. Total cost incurred (total cost input plus G&A expenses) F. Prime cost (direct material, direct labor and other direct cost) G. Processing or conversion cost (direct labor and applicable overhead) </td> <td style="width: 50%; vertical-align: top;"> H. Direct labor dollars I. Direct labor hours J. Machine hours K. Usage L. Unit of production M. Direct material cost N. Total payroll dollars (direct and indirect employees) O. Headcount or number of employees (direct and indirect employees) P. Square feet Y. Other(s), or more than one basis (Describe on a continuation sheet.) Z. Pool not applicable </td> </tr> </table> 4.10 Overhead Pools. List all the overhead pools, i.e., pools of indirect costs, other than general and administrative (G&A) expenses, that are allocated to final cost objectives without any intermediate allocations. A segment or business unit may have only a single pool encompassing all of its overhead costs or alternatively it may have several pools such as manufacturing overhead, engineering overhead, material handling overhead, etc. For each pool listed indicate the base used for allocating such pooled expenses to Federal contracts or similar cost objectives. Also, for each of the pools indicate (a) the major functions, activities, and elements of cost included, and (b) the make up of the allocation base. Use a continuation sheet if additional space is required. <u>Allocation Base Code</u> 1. _____ (a) Major functions, activities, and elements of cost included: _____ _____ (b) Description/Make up of the allocation base: _____ _____	A. Sales B. Cost of sales C. Total Cost Input (direct material, direct labor, other direct costs and applicable overhead) D. Value-added cost input (total cost input less direct material and subcontract costs) E. Total cost incurred (total cost input plus G&A expenses) F. Prime cost (direct material, direct labor and other direct cost) G. Processing or conversion cost (direct labor and applicable overhead)	H. Direct labor dollars I. Direct labor hours J. Machine hours K. Usage L. Unit of production M. Direct material cost N. Total payroll dollars (direct and indirect employees) O. Headcount or number of employees (direct and indirect employees) P. Square feet Y. Other(s), or more than one basis (Describe on a continuation sheet.) Z. Pool not applicable
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COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS
		NAME OF REPORTING UNIT
Item No.	Item description	
4.1.0	Continued. Allocation Base Code 2. _____ (a) Major functions, activities, and elements of cost included: _____ _____ (b) Description/Make up of the allocation base: _____ _____	
4.2.0	General and Administrative (G&A) Expense Pool(s). Select among the three categories of pools below that describe(s) the manner in which G&A expenses are allocated. For each category of pool(s) selected indicate the base(s) used for allocating such pooled expenses to Federal contracts or similar cost objectives. Also, for each category of pool(s) selected, indicate (a) the major functions, activities, and elements of cost included, and (b) the make up of the allocation base(s). For example, if direct labor dollars are used, are fringe benefits included? If a total cost input base is used, is the imputed cost of capital included? Use a continuation sheet if additional space is required. Allocation Base Code <u>Single Pool Containing G&A Expenses Only</u> _____ (a) Major functions, activities, and elements of cost included: _____ _____ (b) Description/Make up of the allocation base: _____ _____	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS
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Item No.	Item description	
4.2.0	Continued.	
	<u>Single Pool Containing Both G&A and Non-G&A Expenses</u>	<u>Allocation Base Code</u>
	(a) Major functions, activities, and elements of cost included:	
	(b) Description/Make up of the allocation base:	
	<u>Special Allocations</u>	<u>Allocation Base Code</u>
	1.	
	(a) Major functions, activities, and elements of cost included:	
	(b) Description/Make up of the allocation base:	
	2.	
	(a) Major functions, activities, and elements of cost included:	
	(b) Description/Make up of the allocation base:	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS	
		NAME OF REPORTING UNIT	

Item No.	Item description																																																																
4.3.0	<u>Service Center and Expense Pool Allocation Bases.</u> Service centers are departments or other functional units which perform specific technical and/or administrative services primarily for the benefit of other units within a reporting unit. Expense pools are pools of indirect costs that are allocated primarily to other units within a reporting unit. Examples of service centers are data processing centers, reproduction services and communications services. Examples of expense pools are use and occupancy pools and fringe benefit pools. <u>Category Code</u> Generally, costs incurred by such centers or pools are, or can be, charged or allocated (i) partially to specific final cost objectives as direct costs and partially to other indirect cost pools (such as a manufacturing overhead pool) for subsequent reallocation to several final cost objectives, referred to herein as Category "A", and (ii) only to several other indirect cost pools (such as a manufacturing overhead pool, engineering overhead pool and G&A expense pool) for subsequent reallocation to several final cost objectives, referred to herein as Category "B". <u>Rate Code</u> Some service centers or expense pools may use predetermined billing or costing rates to charge or allocate the costs (Rate Code A) while others may charge or allocate on an actual basis (Rate Code B). List all the service centers and expense pools and enter in column (1) Code A or B to indicate the category of pool. Enter in Column (2) one of the Allocation Base Codes A through P, or Y, listed on Page ____, to indicate the base used for charging or allocating service center or expense pool costs. Enter in Column (3) Rate Code A or B to describe the costing method used. Also, for each of the centers and pools indicate (a) the major functions, activities, and elements of cost included, and (b) the make up of the allocation base. Use a continuation sheet if additional space is required. <table style="width: 100%; margin-top: 20px;"> <thead> <tr> <th style="width: 70%;"></th> <th style="width: 10%; text-align: center;">Category Code</th> <th style="width: 10%; text-align: center;">Allocation Base Code</th> <th style="width: 10%; text-align: center;">Rate Code</th> </tr> <tr> <th style="text-align: center;"><u>Service Center or Expense Pool</u></th> <th style="text-align: center;"><u>(1)</u></th> <th style="text-align: center;"><u>(2)</u></th> <th style="text-align: center;"><u>(3)</u></th> </tr> </thead> <tbody> <tr> <td style="padding-top: 10px;">1. _____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td style="padding-left: 20px;">(a) Major functions, activities, and elements of cost included:</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">(b) Description/Make up of the allocation base:</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-top: 10px;">2. _____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> <td style="text-align: center;">_____</td> </tr> <tr> <td style="padding-left: 20px;">(a) Major functions, activities, and elements of cost included:</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 20px;">(b) Description/Make up of the allocation base:</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> <tr> <td style="padding-left: 40px;">_____</td> <td></td> <td></td> <td></td> </tr> </tbody> </table>		Category Code	Allocation Base Code	Rate Code	<u>Service Center or Expense Pool</u>	<u>(1)</u>	<u>(2)</u>	<u>(3)</u>	1. _____	_____	_____	_____	(a) Major functions, activities, and elements of cost included:				_____				_____				(b) Description/Make up of the allocation base:				_____				_____				2. _____	_____	_____	_____	(a) Major functions, activities, and elements of cost included:				_____				_____				(b) Description/Make up of the allocation base:				_____				_____			
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COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS																										
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Item No.	Item description																											
4.4.0	<u>Treatment of Variances from Actual Cost (Underabsorption or Overabsorption).</u> Where predetermined billing or costing rates are used to charge costs of service centers and expense pools to Federal contracts or other indirect cost pools (Rate Code A in Column (3) of item 4.3.0), variances from actual costs are: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. _____ Prorated to users on the basis of charges made, at least once annually B. _____ All charged or credited to indirect cost pool(s) at least once annually Y. _____ Other(s) <u>1/</u> Z. _____ Service center is not applicable to reporting unit																											
4.5.0	<u>Application of Overhead and G&A Rates to Specified Transactions or Costs.</u> This item is directed to ascertaining your practice in special situations where, in lieu of establishing a separate indirect cost pool, allocation is made from an established overhead or G&A pool at a rate other than the normal full rate for that pool. In the case of such a special allocation, the terms "less than full rate" or "more than full rate" should be used to describe the practice. The terms do <u>not</u> apply to situations where, as in some cases of off-site activities, etc., a separate indirect cost pool and base are used and the rate for such activities is lower than the "in-house" rate. For each of the transactions or costs listed below, enter one of the following codes to indicate your indirect cost allocation practice with respect to that transaction or cost. If Code A, full rate, is entered, identify on a continuation sheet the pool(s) reported under items 4.1.0, 4.2.0, and 4.3.0, which are applicable. If Codes B or C, less than or more than the full rate, is entered, describe on a continuation sheet the major types of expenses that are covered by such a rate. <u>Rate Code</u> <table style="width: 100%; margin-left: 40px;"> <tr> <td style="width: 50%;">A. Full rate</td> <td style="width: 50%;">C. Special allocation at more than full rate</td> </tr> <tr> <td>B. Special allocation at less than full rate</td> <td>D. No overhead or G&A is applied</td> </tr> <tr> <td colspan="2" style="text-align: center;">Z. Transaction or cost is not applicable to reporting unit</td> </tr> </table> <table style="width: 100%; margin-left: 40px;"> <thead> <tr> <th style="text-align: left; width: 80%;"><u>Transaction or Cost to Which Indirect Costs May be Allocated</u></th> <th style="text-align: center; width: 20%;"><u>Rate Code</u></th> </tr> </thead> <tbody> <tr><td>(a) Subcontract costs</td><td style="text-align: center;">_____</td></tr> <tr><td>(b) Purchased Labor</td><td style="text-align: center;">_____</td></tr> <tr><td>(c) Government-furnished materials</td><td style="text-align: center;">_____</td></tr> <tr><td>(d) Self-constructed depreciable assets</td><td style="text-align: center;">_____</td></tr> <tr><td>(e) Labor on installation of assets</td><td style="text-align: center;">_____</td></tr> <tr><td>(f) Off-site work</td><td style="text-align: center;">_____</td></tr> <tr><td>(g) Interorganizational transfers out</td><td style="text-align: center;">_____</td></tr> <tr><td>(h) Interorganizational transfers in (Also indicate on a continuation sheet the basis used by you as transferee to charge the cost or price of interorganizational transfers to Federal contracts or similar cost objectives. If the charge is based on cost, indicate whether the transferor's G&A expenses are included.)</td><td style="text-align: center;">_____</td></tr> <tr><td>(i) Other transactions or costs (Enter Code B or C on this line if there are other transactions or costs to which either less than full rate or more than full rate is applied. List such transactions or costs on a continuation sheet, and for each describe the major types of expenses covered by such a rate. If there are no other such transactions or costs, enter code Z.)</td><td style="text-align: center;">_____</td></tr> </tbody> </table> <u>1/ Describe on a Continuation Sheet.</u>		A. Full rate	C. Special allocation at more than full rate	B. Special allocation at less than full rate	D. No overhead or G&A is applied	Z. Transaction or cost is not applicable to reporting unit		<u>Transaction or Cost to Which Indirect Costs May be Allocated</u>	<u>Rate Code</u>	(a) Subcontract costs	_____	(b) Purchased Labor	_____	(c) Government-furnished materials	_____	(d) Self-constructed depreciable assets	_____	(e) Labor on installation of assets	_____	(f) Off-site work	_____	(g) Interorganizational transfers out	_____	(h) Interorganizational transfers in (Also indicate on a continuation sheet the basis used by you as transferee to charge the cost or price of interorganizational transfers to Federal contracts or similar cost objectives. If the charge is based on cost, indicate whether the transferor's G&A expenses are included.)	_____	(i) Other transactions or costs (Enter Code B or C on this line if there are other transactions or costs to which either less than full rate or more than full rate is applied. List such transactions or costs on a continuation sheet, and for each describe the major types of expenses covered by such a rate. If there are no other such transactions or costs, enter code Z.)	_____
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COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART IV - INDIRECT COSTS
		NAME OF REPORTING UNIT
Item No.	Item description	
4.6.0	<u>Independent Research and Development (IR&D) and Bid and Proposal (B&P) Costs.</u> Definitions of and requirements for the allocation of IR&D and B&P costs are contained in 48 CFR 9904.420. The full rate of all allocable manufacturing, engineering, and/or other overhead is applied to IR&D and B&P costs as if IR&D and B&P projects were under contract, and the "burdened" IR&D and B&P costs are: (Mark appropriate line(s).) A. ☐ Allocated to Federal contracts or similar cost objectives by means of a composite pool with G&A expenses. B. ☐ Allocated to Federal contracts or similar cost objectives by means of a separate pool. C. ☐ Transferred to the corporate or home office level for reallocation to the benefiting segments. Y. ☐ Other <u>1/</u> Z. ☐ Not applicable	
4.7.0	<u>Cost of Capital Committed to Facilities.</u> In accordance with instructions for Form CASB-CMF, undistributed facilities capital items are allocated to overhead and G&A expense pools: (Mark one.) A. ☐ On a basis identical to that used to absorb the actual depreciation or amortization from these facilities; <u>and is assigned in the same manner as the facilities to which it relates.</u> B. ☐ On a basis not identical to that used to absorb the actual depreciation or amortization from these facilities. (Describe on a continuation sheet the difference for each step of the allocation process.) C. ☐ By the "alternative allocation process" described in instructions for Form CASB-CMF. Z. ☐ Not applicable.	
<u>1/</u> Describe on a Continuation Sheet.		

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART V - DEPRECIATION AND CAPITALIZATION PRACTICES			
		NAME OF REPORTING UNIT			
Item No.	Item description				
5.1.0	<u>Part V Instructions</u> Where a home office either establishes practices or procedures for the types of costs covered in this Part or incurs and then allocates these costs to its segments, the home office may complete this Part to be included in the submission by the segment as indicated on page (i) 4., <u>General Instructions.</u> <u>Depreciating Tangible Assets for Government Contract Costing.</u> (For each of the asset categories listed on Page __, enter a code from A through H in Column (1) describing the method of depreciation (Code F for assets that are expensed); a code from A through C in Column (2) describing the basis for determining useful life; a code from A through C in Column (3) describing how depreciation methods or use charges are applied to property units; and a Code A, B or C in Column (4) indicating whether or not residual value is deducted from the total cost of depreciable assets. Enter Code Y in each column of an asset category where another or more than one method applies. Enter Code Z in Column (1) only, if an asset category is not applicable.) <table style="width: 100%; border: none;"> <tr> <td style="width: 50%; vertical-align: top;"> <u>Column (1)—Depreciation Method Code</u> A. Straight Line B. Declining balance C. Sum-of-the years digits D. Machine hours E. Unit of production F. Expensed at acquisition G. Use charge H. Method of depreciation used under the applicable Internal Revenue Procedures Y. Other or more than one method <u>1/</u> Z. Asset category is not applicable <u>Column (3)—Property Units Code</u> A. Individual units are accounted for separately B. Applied to groups of assets with similar service lives C. Applied to groups of assets with varying service lives Y. Other or more than one method <u>1/</u> </td> <td style="width: 50%; vertical-align: top;"> <u>Column (2)—Useful Life Code</u> A. Replacement experience adjusted by expected changes in periods of usefulness B. Term of Lease C. Estimated on the basis of Asset Guidelines under Internal Revenue Procedures Y. Other, or more than one method <u>1/</u> <u>Column (4)—Residual Value Code</u> A. Residual value is estimated and deducted B. Residual value is covered by the depreciation method (e.g., declining balance) C. Residual value is estimated but not deducted in accordance with the provisions of 48 CFR 9904.409 <u>1/</u> Y. Other or more than one method <u>1/</u> </td> </tr> </table>			<u>Column (1)—Depreciation Method Code</u> A. Straight Line B. Declining balance C. Sum-of-the years digits D. Machine hours E. Unit of production F. Expensed at acquisition G. Use charge H. Method of depreciation used under the applicable Internal Revenue Procedures Y. Other or more than one method <u>1/</u> Z. Asset category is not applicable <u>Column (3)—Property Units Code</u> A. Individual units are accounted for separately B. Applied to groups of assets with similar service lives C. Applied to groups of assets with varying service lives Y. Other or more than one method <u>1/</u>	<u>Column (2)—Useful Life Code</u> A. Replacement experience adjusted by expected changes in periods of usefulness B. Term of Lease C. Estimated on the basis of Asset Guidelines under Internal Revenue Procedures Y. Other, or more than one method <u>1/</u> <u>Column (4)—Residual Value Code</u> A. Residual value is estimated and deducted B. Residual value is covered by the depreciation method (e.g., declining balance) C. Residual value is estimated but not deducted in accordance with the provisions of 48 CFR 9904.409 <u>1/</u> Y. Other or more than one method <u>1/</u>
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5.2.0	<u>Depreciation Practices for Costing, Financial Accounting, and Income Tax.</u> Are depreciation practices the same for costing Federal contracts as for financial accounting and income tax? (Mark either (A) or (B) on each line under Financial Accounting and Income Tax. Not-for-profit organizations need not complete this item.) <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; width: 60%;"><u>Financial Accounting</u></th> <th style="text-align: center; width: 20%;">A. <u>Yes</u></th> <th style="text-align: center; width: 20%;">B. <u>No</u></th> </tr> </thead> <tbody> <tr><td>(a) Methods</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(b) Useful lives</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(c) Property units</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(d) Residual values</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr> <td><u>Income Tax</u></td> <td style="text-align: center;">A. <u>Yes</u></td> <td style="text-align: center;">B. <u>No</u></td> </tr> <tr><td>(e) Methods</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(f) Useful lives</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(g) Property units</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> <tr><td>(h) Residual values</td><td style="text-align: center;">—</td><td style="text-align: center;">—</td></tr> </tbody> </table>					<u>Financial Accounting</u>	A. <u>Yes</u>	B. <u>No</u>	(a) Methods	—	—	(b) Useful lives	—	—	(c) Property units	—	—	(d) Residual values	—	—	<u>Income Tax</u>	A. <u>Yes</u>	B. <u>No</u>	(e) Methods	—	—	(f) Useful lives	—	—	(g) Property units	—	—	(h) Residual values	—	—																																			
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5.3.0	Fully Depreciated Assets. Is a usage charge for fully depreciated assets charged to Federal contracts? (Mark one.) A. ☐ Yes ^{1/} B. ☐ No Z. ☐ Not applicable																				
5.4.0	Treatment of Gains and Losses on Disposition of Depreciable Property. Gains and losses are: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. ☐ Credited or charged currently to the same overhead or G&A pools to which the depreciation of the assets was charged B. ☐ Taken into consideration in the depreciation cost basis of the new items, where trade-in is involved C. ☐ Not accounted for separately, but reflected in the depreciation reserve account Y. ☐ Other(s) ^{1/} Z. ☐ Not applicable																				
5.5.0	Capitalization or Expensing of Specified Costs. (Mark one line on each item to indicate your practices regarding capitalization or expensing of specified costs incurred in connection with capital assets. If the same specified cost is sometimes expensed and sometimes capitalized, mark both lines and describe on a continuation sheet the circumstances when each method is used.) <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; width: 60%;"><u>Cost</u></th> <th style="text-align: center; width: 20%;"><u>A. Expensed</u></th> <th style="text-align: center; width: 20%;"><u>B. Capitalized</u></th> </tr> </thead> <tbody> <tr> <td>(a) Freight-in</td> <td style="text-align: center;">☐</td> <td style="text-align: center;">☐</td> </tr> <tr> <td>(b) Sales taxes</td> <td style="text-align: center;">☐</td> <td style="text-align: center;">☐</td> </tr> <tr> <td>(c) Excise taxes</td> <td style="text-align: center;">☐</td> <td style="text-align: center;">☐</td> </tr> <tr> <td>(d) Architect-engineer fees</td> <td style="text-align: center;">☐</td> <td style="text-align: center;">☐</td> </tr> <tr> <td>(e) Overhauls (extraordinary repairs)</td> <td style="text-align: center;">☐</td> <td style="text-align: center;">☐</td> </tr> </tbody> </table>			<u>Cost</u>	<u>A. Expensed</u>	<u>B. Capitalized</u>	(a) Freight-in	☐	☐	(b) Sales taxes	☐	☐	(c) Excise taxes	☐	☐	(d) Architect-engineer fees	☐	☐	(e) Overhauls (extraordinary repairs)	☐	☐
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COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART V - DEPRECIATION AND CAPITALIZATION PRACTICES
		NAME OF REPORTING UNIT
Item No.	Item description	
5.6.0	Criteria for Capitalization. Enter (a) the minimum dollar amount of acquisition cost or expenditures for addition, alteration and improvement of depreciable assets capitalized, and (b) the minimum number of expected life years of capitalized assets. If more than one dollar amount or number applies, show the information for the majority of your depreciable assets, and enumerate on a continuation sheet the dollar amounts and/or number of years for each category or subcategory of assets involved which differ from those for the majority of assets. (a) Minimum dollar amount capitalized _____ (b) Minimum service life years _____	
5.7.0	Group or Mass Purchase. Are group or mass purchases (original complement) of low cost equipment, which individually are less than the capitalization amount indicated above, capitalized? (Mark one. If <u>Yes</u> is marked, provide the minimum aggregate dollar amount capitalized.) A. ☐ Yes _____ Minimum aggregate dollar amount capitalized B. ☐ No	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VI - OTHER COSTS AND CREDITS	
		NAME OF REPORTING UNIT	
Item No.	Item description		
	Part VI Instructions Where a home office either establishes practices or procedures for the types of costs covered in this Part or incurs and then allocates these costs to its segments, the home office may complete this Part to be included in the submission by the segment as indicated on page (ii) 4., <u>General Instructions</u> .		
6.1.0	Method of Charging and Crediting Vacation, Holiday, and Sick Pay. (Mark the appropriate line(s) in each column of Items 6.1.1, 6.1.2, 6.1.3 and 6.1.4 to indicate the method used to charge, or credit any unused or unpaid vacation, holiday, or sick pay. If more than one method is marked, explain on a continuation sheet.)		
6.1.1	Charges for Vacation Pay	Hourly (1)	Salaried Non-exempt ^{1/} (2) Exempt ^{1/} (3)
	A. When Accrued (earned)	—	—
	B. When Taken	—	—
	Y. Other(s) ^{2/}	—	—
6.1.2	Charges for Holiday Pay		
	A. When Accrued (earned)	—	—
	B. When Taken	—	—
	Y. Other(s) ^{2/}	—	—
6.1.3	Charges for Sick Pay		
	A. When Accrued (earned)	—	—
	B. When Taken	—	—
	Y. Other(s) ^{2/}	—	—
6.1.4	Credits for Unused or Unpaid Vacation, Holiday, or Sick Pay		
	A. Credited to Accounts Originally charged at Least Once Annually	—	—
	B. Credited to Indirect Cost Pools at Least Once Annually	—	—
	C. Carried Over to Future Cost Accounting Periods ^{2/}	—	—
	Y. Other(s) ^{2/}	—	—
	Z. Not Applicable	—	—
	^{1/} For the definition of Non-exempt and Exempt salaries, see the Fair Labor Standards Act, 29 U.S.C. 206. ^{2/} Describe on a Continuation Sheet.		

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VI - OTHER COSTS AND CREDITS
		NAME OF REPORTING UNIT
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6.2.0	<u>Supplemental Unemployment (Extended Layoff) Benefit Plans.</u> Costs of such plans are charged to Federal contracts: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. ☐ When actual payments are made directly to employees B. ☐ When accrued (book accrual or funds set aside but no trust fund involved) C. ☐ When contributions are made to a nonforfeitable trust fund D. ☐ Not charged Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
6.3.0	<u>Severance Pay and Early Retirement.</u> Costs of normal turnover severance pay and early retirement incentive plans, as defined in FAR 31.2 or other pertinent procurement regulations, which are charged directly or indirectly to Federal contracts, are based on: (Mark the appropriate line(s) and if more than one is marked, explain on a continuation sheet.) A. ☐ Actual payments made B. ☐ Accrued amounts on the basis of past experience C. ☐ Not charged Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
6.4.0	<u>Incidental Receipts.</u> (Mark the appropriate line(s) to indicate the method used to account for incidental or miscellaneous receipts, such as revenues from renting real and personal property or selling services, when related costs have been allocated to Federal contracts. If more than one is marked, explain on a continuation sheet.) A. ☐ The entire amount of the receipt is credited to the same indirect cost pools to which related costs have been charged B. ☐ Where the amount of the receipt includes an allowance for profit, the cost-related part of the receipt is credited to the same indirect cost pools to which related costs have been charged; the profits are credited to Other (Miscellaneous) Income C. ☐ The entire amount of the receipt is credited directly to Other (Miscellaneous) Income Y. ☐ Other(s) 1/ Z. ☐ Not applicable	
1/ Describe on a Continuation Sheet.		

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VI - OTHER COSTS AND CREDITS
		NAME OF REPORTING UNIT
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6.5.0	<u>Proceeds from Employee Welfare Activities.</u> Employee welfare activities include all of those activities set forth in FAR 31.2. (Mark the appropriate line(s) to indicate the practice followed in accounting for the proceeds from such activities. If more than one is marked, explain on a continuation sheet.) A. ☐ Proceeds are turned over to an employee-welfare organization or fund; such proceeds are reduced by all applicable costs such as depreciation, heat, light and power B. ☐ Same as above, except the proceeds are not reduced by all applicable costs C. ☐ Proceeds are credited at least once annually to the appropriate cost pools to which costs have been charged D. ☐ Proceeds are credited to Other (Miscellaneous) Income Y. ☐ Other(s) <u>1/</u> Z. ☐ Not applicable <u>1/</u> Describe on a Continuation Sheet.	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VII - DEFERRED COMPENSATION AND INSURANCE COST
		NAME OF REPORTING UNIT

Item No.	Item description																												
7.1.0	<u>Part VII Instructions</u> This part covers the measurement and assignment of costs for employee pensions, post retirement benefits other than pensions (including post retirement health benefits), certain other types of deferred compensation, and insurance. Some organizations may incur all of these costs at the corporate or home office level, while others may incur them at subordinate organizational levels. Still others may incur a portion of these costs at the corporate level and the balance at subordinate organizational levels. Where the segment (reporting unit) does not directly incur such costs, the segment should, on a continuation sheet, identify the organizational entity that incurs and records such costs, and should require that entity to complete the applicable portions of this Part VII. Each such entity is to fully disclose the methods and techniques used to measure, assign, and allocate such costs to the segment(s) performing Federal contracts or similar cost objectives. Necessary explanations required to achieve that objective should be provided by the entity on a continuation sheet. Where a home office either establishes practices or procedures for the types of costs covered in this Part VII or incurs and then allocates those costs to its segments, the home office may complete this Part to be included in the submission by the segment as indicated on page (i) 4., <u>General Instructions</u>. Pension Plans with Costs Charged to Federal Contracts. Identify the types and number of pension plans whose costs are charged to Federal contracts or similar cost objectives: (Mark applicable line(s) and enter number of plans.) <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="text-align: left; width: 80%;"><u>Type of Pension Plan</u></th> <th style="text-align: center; width: 20%;"><u>Number of Plans</u></th> </tr> </thead> <tbody> <tr> <td>A. Defined-Contribution Plan (Other than ESOPs (see 7.5.0))</td> <td></td> </tr> <tr> <td> 1. Non-Qualified</td> <td style="text-align: center;">___</td> </tr> <tr> <td> 2. Qualified</td> <td style="text-align: center;">___</td> </tr> <tr> <td>B. Defined-Benefit Plan</td> <td></td> </tr> <tr> <td> 1. Non-Qualified</td> <td></td> </tr> <tr> <td> a. Costs are measured and assigned on accrual basis</td> <td style="text-align: center;">___</td> </tr> <tr> <td> b. Costs are measured and assigned on cash (pay-as-you-go) basis</td> <td style="text-align: center;">___</td> </tr> <tr> <td> 2. Qualified</td> <td></td> </tr> <tr> <td> a. Trusteed (Subject to ERISA's minimum funding requirements)</td> <td style="text-align: center;">___</td> </tr> <tr> <td> b. Fully-insured plan (Exempt from ERISA's minimum funding requirements) treated as a defined-contribution plan</td> <td style="text-align: center;">___</td> </tr> <tr> <td> c. Collectively bargained plan treated as a defined-contribution plan</td> <td style="text-align: center;">___</td> </tr> <tr> <td>Y. Other 1/</td> <td style="text-align: center;">___</td> </tr> <tr> <td>Z. Not Applicable (Proceed to Item 7.2.0)</td> <td></td> </tr> </tbody> </table> 1/ Describe on a Continuation Sheet.	<u>Type of Pension Plan</u>	<u>Number of Plans</u>	A. Defined-Contribution Plan (Other than ESOPs (see 7.5.0))		1. Non-Qualified	___	2. Qualified	___	B. Defined-Benefit Plan		1. Non-Qualified		a. Costs are measured and assigned on accrual basis	___	b. Costs are measured and assigned on cash (pay-as-you-go) basis	___	2. Qualified		a. Trusteed (Subject to ERISA's minimum funding requirements)	___	b. Fully-insured plan (Exempt from ERISA's minimum funding requirements) treated as a defined-contribution plan	___	c. Collectively bargained plan treated as a defined-contribution plan	___	Y. Other 1/	___	Z. Not Applicable (Proceed to Item 7.2.0)	
<u>Type of Pension Plan</u>	<u>Number of Plans</u>																												
A. Defined-Contribution Plan (Other than ESOPs (see 7.5.0))																													
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7.1.1	General Plan Information. On a continuation sheet for each plan identified in item 7.1.0, provide the following information: A. The plan name B. The Employer Identification Number (EIN) of the plan sponsor as reported on IRS Form 5500, if any C. The plan number as reported on IRS Form 5500, if any D. Is there a funding agency established for the plan? E. Indicate where costs are accumulated: (1) Home Office (2) Segment F. If the plan provides supplemental benefits to any other plan, identify the other plan(s).	
7.1.2	Defined-Contribution Plan(s) and Certain Defined-Benefit Plans treated as Defined-Contribution Plans. Where numerous plans are listed under 7.1.0.A., 7.1.0.B.2.b., or 7.1.0.B.2.c., for those plans which represent the largest dollar amounts of costs charged to Federal contracts, or similar cost objectives, describe on a continuation sheet the basis for the contribution (including treatment of dividends, credits, and forfeitures) required for each fiscal year. (If there are not more than three plans, provide information for all the plans. If there are more than three plans, information should be provided for those plans that in the aggregate account for at least 80 percent of those defined-contribution plan costs allocable to this segment or business unit.) Z. _____ Not applicable. (Proceed to item 7.1.3)	
7.1.3	Defined-Benefit Plan(s). Where numerous plans are listed under 7.1.0.B. (excluding certain defined-benefit plans treated as defined-contribution plans reported under 7.1.0.B.2.b. and 7.1.0.B.2.c.), for those plans which represent the largest dollar amounts of costs charged to Federal contracts, provide the information requested below on a continuation sheet. (If there are not more than three plans, provide information for all the plans. If there are more than three plans, information should be provided for those plans that in the aggregate account for at least 80 percent of those defined-benefit plan costs allocable to this segment or business unit.): A. <u>Actuarial Cost Method.</u> Identify the actuarial cost method used, including the cost method(s) used to value ancillary benefits, for each plan. Include the method used to determine the actuarial value of assets. Also, if applicable, include whether normal cost is developed as a level dollar amount or as a level percent of salary. For plans listed under 7.1.0.B.1.b., enter "pay-as-you-go". B. <u>Actuarial Assumptions.</u> Describe the events or conditions for which significant actuarial assumptions are made for each plan. Do not include the current numeric values of the assumptions, but provide a description of the basis used for determining these numeric values. Also, describe the criteria used to evaluate the validity of an actuarial assumption. For plans listed under 7.1.0.B.1.b., enter "not applicable". C. <u>Market Value of Funding Agency Assets.</u> Indicate if all assets of the funding agency are valued on the basis of a readily determinable market price. If yes, indicate the basis for the market value. If no, describe how the market values are determined for those assets that do not have a readily determinable market price. For plans listed under 7.1.0.B.1.b., enter "not applicable". D. <u>Basis for Cost Computation.</u> Indicate whether the cost for the segment is determined as: 1. An allocated portion of the total pension plan cost. 2. A separately computed pension cost for one or more segments. If so, identify those segments. Z. _____ Not applicable, proceed to item 7.2.0.	

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7.2.0	<u>Post-retirement Benefits (PRBs) Other than Pensions (including post-retirement health care benefits) Charged to Federal Contracts.</u> Identify the accounting method used to determine the costs and the number of PRB plans whose costs are charged to Federal contracts or similar cost objectives. Where retiree benefits are provided as an integral part of an employee group insurance plan that covers active employees, report that plan under 7.3.0. (Mark applicable line(s) and enter number of plans.) <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th style="text-align: left; width: 40%;"><u>Method Used to Determine Costs</u></th> <th style="text-align: right; width: 20%;"><u>Number of Plans</u></th> </tr> </thead> <tbody> <tr> <td>A. Accrual Accounting</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>B. Cash (pay-as-you-go) Accounting</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>C. Purchased Insurance from Unrelated Insurer</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>D. Purchased Insurance from Captive Insurer</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>E. Self-Insurance (including insurance obtained through Captive Insurer)</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>F. Terminal Funding</td> <td style="text-align: right;">_____</td> </tr> <tr> <td>Y. Other <u>1/</u></td> <td style="text-align: right;">_____</td> </tr> <tr> <td>Z. _____ Not Applicable (Proceed to Item 7.3.0)</td> <td style="text-align: right;">_____</td> </tr> </tbody> </table>		<u>Method Used to Determine Costs</u>	<u>Number of Plans</u>	A. Accrual Accounting	_____	B. Cash (pay-as-you-go) Accounting	_____	C. Purchased Insurance from Unrelated Insurer	_____	D. Purchased Insurance from Captive Insurer	_____	E. Self-Insurance (including insurance obtained through Captive Insurer)	_____	F. Terminal Funding	_____	Y. Other <u>1/</u>	_____	Z. _____ Not Applicable (Proceed to Item 7.3.0)	_____
<u>Method Used to Determine Costs</u>	<u>Number of Plans</u>																			
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F. Terminal Funding	_____																			
Y. Other <u>1/</u>	_____																			
Z. _____ Not Applicable (Proceed to Item 7.3.0)	_____																			
7.2.1	General PRB Plan Information. On a continuation sheet for each plan identified in item 7.2.0, provide the following information grouped by method used to determine costs: A. The plan name B. The Employer Identification Number (EIN) of the plan sponsor as reported on IRS Form 5500, if any C. The plan number as reported on IRS Form 5500, if any D. Is there a funding agency or funded reserve established for the plan? E. Indicate where costs are accumulated: (1) Home Office (2) Segment F. Are benefits provided pursuant to a written plan or an established practice? If established practice, briefly describe. G. If this PRB plan is listed under 7.2.0.C., 7.2.0.D., or 7.2.0.E., indicate whether the plan is operated as an employee group insurance program. If this PRB plan is listed under 7.2.0.Y., indicate whether the plan is operated as a group insurance program. If the plan is operated as an employee group insurance program, report this plan under 7.3.0. and 7.3.1., as appropriate. If no, report the plan under 7.2.2. <u>1/</u> Describe on a Continuation Sheet.																			

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7.2.2	PRB Plan(s). Where numerous plans are listed under 7.2.0, for those plans which represent the largest dollar amounts of costs charged to Federal contracts, or other similar cost objectives, provide the information below on a continuation sheet. (If there are not more than three plans, provide information for all the plans. If there are more than three plans, information should be provided for those plans that in the aggregate account for at least 80 percent of those PRB costs allocable to this segment or business unit.) A. <u>Actuarial Cost Method.</u> Identify the actuarial cost method used for each plan or each benefit, as appropriate. Include the method used to determine the actuarial value of assets. Identify the amortization methods and periods used, if any. For plans listed under 7.2.0.B., enter "cash accounting". For plans listed under 7.2.0.F., enter "terminal funding" and identify the amortization methods and periods used, if any. B. <u>Actuarial Assumptions.</u> Describe the events or conditions for which significant actuarial assumptions are made for each plan. Do not include the current numeric values of the assumptions, but provide a description of the basis used for determining these numeric values. Also, describe the criteria used to evaluate the validity of an actuarial assumption. For plans under 7.2.0.B. or 7.2.0.F., enter "not applicable". C. <u>Funding.</u> Provide the following information on the funding practice for the costs of the plan: (For plans under 7.2.0.B. or 7.2.0.F., enter "not applicable".) - Describe the criteria for or practice of funding the measured and assigned cost; e.g., full funding of the accrual, funding is made pursuant to VEBA or 401(h) rules. - Briefly describe the funding arrangement. - Are all assets valued on the basis of a readily determinable market price? If yes, indicate the basis used for the market value. If no, describe how the market value is determined for those assets that are not valued on the basis of a readily determinable market price. D. <u>Basis for Cost Computation.</u> Indicate whether the cost for the segment is determined as: - An allocated portion of the total PRB plan cost - A separately computed PRB cost for one or more segments. If so, identify those segments. E. <u>Forfeitability.</u> Does each participant have a non-forfeitable contractual right to their benefit or account balance? If no, explain. Z. _____ Not applicable, proceed to item 7.3.0.	

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7.3.0	Employee Group Insurance Charged to Federal Contracts or Similar Cost Objectives. Does your organization provide group insurance coverage to its employees? (Includes coverage for life, hospital, surgical, medical, disability, accident, and similar plans for both active and retired employees, even if the coverage was previously described in 7.2.0.) A. ☐ Yes (Complete Item 7.3.1) B. ☐ No (Proceed to Item 7.4.0)																		
7.3.1	Employee Group Insurance Programs. For each program that covers a category of insured risk (e.g., life, hospital, surgical, medical, disability, accident, and similar programs for both active and retired employees), provide the information below on a continuation sheet, using the codes described below: (If there are not more than three policies or self-insurance plans that comprise the program, provide information for all the policies and self-insurance plans. If there are more than three policies or self-insurance plans, information should be provided for those policies and self-insurance plans that in the aggregate account for at least 80 percent of the costs allocable to this segment or business unit for the program that covers each category of insured risk identified.) Description of Employee Group Insurance Program: _____ <table style="width: 100%; border-collapse: collapse; margin-top: 10px;"> <thead> <tr> <th style="text-align: left; border-bottom: 1px solid black;">Policy or Self- Insurance Plan</th> <th style="text-align: center; border-bottom: 1px solid black;">Cost Accumulation</th> <th style="text-align: center; border-bottom: 1px solid black;">Cost Basis</th> <th style="text-align: center; border-bottom: 1px solid black;">Includes Retirees</th> <th style="text-align: center; border-bottom: 1px solid black;">Purchased Insurance Rating Basis</th> <th style="text-align: center; border-bottom: 1px solid black;">Self-Insurance Projected Average Loss</th> <th style="text-align: center; border-bottom: 1px solid black;">Insurance Administrative Expenses</th> </tr> <tr> <th></th> <th style="text-align: center;">(1)</th> <th style="text-align: center;">(2)</th> <th style="text-align: center;">(3)</th> <th style="text-align: center;">(4)</th> <th style="text-align: center;">(5)</th> <th style="text-align: center;">(6)</th> </tr> </thead> </table> Column (1) – <u>Cost Accumulation</u> Enter Code A, B, or Y, as appropriate. A. Costs are accumulated at the Home Office. B. Costs are accumulated at Segment Y. Other <u>1/</u> Column (2) – <u>Cost Basis</u> Enter code A, B, C, or Y, as appropriate. A. Purchased Insurance from unrelated third party B. Self-insurance C. Purchased Insurance from a captive insurer Y. Other <u>1/</u> <u>1/</u> Describe on a Continuation Sheet.					Policy or Self- Insurance Plan	Cost Accumulation	Cost Basis	Includes Retirees	Purchased Insurance Rating Basis	Self-Insurance Projected Average Loss	Insurance Administrative Expenses		(1)	(2)	(3)	(4)	(5)	(6)
Policy or Self- Insurance Plan	Cost Accumulation	Cost Basis	Includes Retirees	Purchased Insurance Rating Basis	Self-Insurance Projected Average Loss	Insurance Administrative Expenses													
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7.3.1	Continued. <u>Column (3) - Includes Retirees</u> Enter code A, B, C, or Y, as appropriate. A. No, does not include benefits for retirees. B. Yes, PRB benefits for retirees that are a part of a policy or coverage for both active employees and retirees are reported here instead of 7.2.0. C. Yes, PRB benefits for retirees are a part of a PRB plan previously reported under 7.2.0. Y. Other <u>1/</u> <u>Column (4) - Purchased Insurance Rating Basis</u> For each plan listed enter code A, B, C, Y, or Z, as appropriate. A. Retrospective Rating (also called experience rating plan or retention plan). B. Manually Rated C. Community Rated Y. Other, or more than one type <u>1/</u> Z. Not applicable <u>Column (5) - Projected Average Loss</u> For each self-insured group plan, or the self-insured portion of purchased insurance, enter code A, B, C, Y, or Z, as appropriate. A. Self-insurance costs represent the projected average loss for the period estimated on the basis of the cost of comparable purchased insurance. B. Self-insurance costs are based on the contractor's experience, relevant industry experience, and anticipated conditions in accordance with accepted actuarial principles. C. Actual payments are considered to represent the projected average loss for the period. Y. Other, or more than one method <u>1/</u> Z. Not applicable <u>Column (6) - Insurance Administration Expenses</u> For each self-insured group plan, or the self-insured portion of purchased insurance, enter code A, B, C, D, Y, or Z, as appropriate, to indicate how administrative costs are treated. A. Separately identified and accumulated in indirect cost pool(s). B. Separately identified, accumulated, and allocated to cost objectives either at the segment and/or home office level (Describe allocation method on a Continuation Sheet). C. Not separately identified, but included in indirect cost pool(s). (Describe pool(s) on a Continuation Sheet) D. Incurred by an insurance carrier or third party (Describe accumulation and allocation process on a Continuation Sheet). Y. Other <u>1/</u> Z. Not applicable <u>1/</u> Describe on a Continuation Sheet.	

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7.4.0	<u>Deferred Compensation, as defined in CAS 9904.415.</u> Does your organization award deferred compensation, other than ESOPs, which is charged to Federal contracts or similar cost objectives? (Mark one.) A. ☐ Yes (Complete Item 7.4.1.) B. ☐ No (Proceed to Item 7.5.0.)	
7.4.1	General Plan Information. On a continuation sheet for all deferred compensation plans, as defined by CAS 9904.415, provide the following information: A. The plan name B. The Employer Identification Number (EIN) of the plan sponsor as reported on IRS Form 5500, if any C. The plan number as reported on IRS Form 5500, if any D. Indicate where costs are accumulated: (1) Home office (2) Segment E. Are benefits provided pursuant to a written plan or an established practice? If established practice, briefly describe .	
7.4.2	Deferred Compensation Plans. Where numerous plans are listed under 7.4.1, for those plans which represent the largest dollar amounts of costs charged to Federal contracts, or other similar cost objectives, provide the information below on a continuation sheet. (If there are not more than three plans, provide information for all the plans. If there are more than three plans, information should be provided for those plans that in the aggregate account for at least 80% of these deferred compensation costs allocable to this segment or business unit): A. Description of Plan. 1. Stock Options 2. Stock Appreciation Rights 3. Cash Incentive 4. Other (explain) B. Method of Charging Costs to Federal Contracts or Similar Cost Objectives. 1. Costs charged when accrued and the accrual is fully funded 2. Costs charged when accrued and the accrual is partially funded or not funded 3. Costs charged when paid to employee (pay-as-you-go) 4. Other (explain)	

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7.5.0	<u>Employee Stock Ownership Plans (ESOPs)</u>. Does your organization make contributions to fund ESOPs that are charged directly or indirectly to Federal contracts or similar cost objectives? (Mark one) A. ☐ Yes (Proceed to Item 7.5.1) B. ☐ No (Proceed to Item 7.6.0)	
7.5.1	General Plan Information. On a continuation sheet, for all ESOPs provide the following information: A. The plan name B. The Employer Identification Number (EIN) of the plan sponsor as reported on IRS Form 5500, if any C. The plan number as reported on IRS Form 5500, if any D. Indicate where costs are accumulated: (1) Home office (2) Segment E. Are benefits provided pursuant to a written plan or an established practice? If established practice, briefly describe. F. Indicate whether the ESOP plan is a defined-contribution plan subject to CAS 9904.412. (Answer Yes or No). G. Indicate whether the ESOP is leveraged or nonleveraged. H. <u>Valuation of Stock or Non-Cash Assets</u>. Are the plan assets valued on the basis of a readily determinable market price? If yes, indicate the basis for the market value. If no, indicate how the market value is determined for those assets that do not have a readily determinable market price. I. <u>Forfeitures and Dividends</u>. Describe the accounting treatment for forfeitures and dividends, on both allocated and unallocated shares, in the measurement of ESOP costs charged directly or indirectly to Federal contracts or similar cost objectives for each plan identified. J. <u>Administrative Costs</u>. Describe how the costs of administration of each plan listed are identified, grouped, and accumulated.	

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Item No.	Item description												
7.6.0	Worker's Compensation, Liability, and Property Insurance. Does your organization have insurance coverage regarding worker's compensation, liability and property insurance? A. ___ Yes (Complete Item 7.6.1.) B. ___ No (Proceed to Part VIII)												
7.6.1	Worker's Compensation, Liability and Property Insurance Coverage. For each line of insurance that covers a category of insured risk (e.g., worker's compensation, fire and similar perils, automobile liability and property damage, general liability), provide the information below on a continuation sheet using the codes described below: (If there are not more than three policies or self-insurance plans that are applicable to the line of insurance, provide information for all the policies and self-insurance plans. If there are more than three policies or insurance plans, information should be provided for those policies and self-insurance plans that in the aggregate account for at least 80 percent of the costs allocable to this segment or business unit for each line of insurance identified.) Description of Line of Insurance Coverage: _____ <table style="width: 100%; border-collapse: collapse; margin-top: 10px;"> <thead> <tr> <th style="text-align: left; border-bottom: 1px solid black;">Policy or Self- Insurance Plan</th> <th style="text-align: center; border-bottom: 1px solid black;">Cost Accumulation</th> <th style="text-align: center; border-bottom: 1px solid black;">Cost Basis</th> <th style="text-align: center; border-bottom: 1px solid black;">Crediting of Dividends and Earned Refunds</th> <th style="text-align: center; border-bottom: 1px solid black;">Projected Average Loss</th> <th style="text-align: center; border-bottom: 1px solid black;">Self-Insurance Insurance Administrative Expenses</th> </tr> <tr> <th></th> <th style="text-align: center;">(1)</th> <th style="text-align: center;">(2)</th> <th style="text-align: center;">(3)</th> <th style="text-align: center;">(4)</th> <th style="text-align: center;">(5)</th> </tr> </thead> </table> Column (1) – <u>Cost Accumulation</u> Enter code A, B, or Y, as appropriate. A. Costs are accumulated at the Home Office. B. Costs are accumulated at Segment Y. Other <u>1/</u> Column (2) – <u>Cost Basis</u> Enter code A, B, C, or Y, as appropriate. A. Purchased insurance from unrelated third party B. Self-insurance C. Purchased insurance from a captive insurer Y. Other <u>1/</u> 1/ Describe on a Continuation Sheet.	Policy or Self- Insurance Plan	Cost Accumulation	Cost Basis	Crediting of Dividends and Earned Refunds	Projected Average Loss	Self-Insurance Insurance Administrative Expenses		(1)	(2)	(3)	(4)	(5)
Policy or Self- Insurance Plan	Cost Accumulation	Cost Basis	Crediting of Dividends and Earned Refunds	Projected Average Loss	Self-Insurance Insurance Administrative Expenses								
	(1)	(2)	(3)	(4)	(5)								

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VII - DEFERRED COMPENSATION AND INSURANCE COST
		NAME OF REPORTING UNIT
Item No.	Item description	
7.6.1	Continued. <u>Column (3) - Crediting of Dividends and Earned Refunds</u> For each line of coverage listed, enter code A, B, C, D, E, Y, or Z, as appropriate. A. Credited directly or indirectly to Federal contracts or similar cost objectives in the year earned B. Credited directly or indirectly to Federal contracts or similar cost objectives in the year received, not necessarily in the year earned C. Accrued each year, as applicable, to currently reflect the net annual cost of the insurance D. Not credited or refunded to the contractor but retained by the carriers as reserves in accordance with 48 CFR 9904.416-50(a)(1)(iv) E. Manually Rated - not applicable Y. Other, or more than one <u>1/</u> Z. Not applicable <u>Column (4) - Projected Average Loss</u> For each self-insured group plan, or the self-insured portion of purchased insurance, enter code A, B, C, Y, or Z, as appropriate. A. Costs that represent the projected average loss for the period estimated on the basis of the cost of comparable purchased insurance. B. Costs that are based on the contractor's experience, relevant industry experience, and anticipated conditions in accordance with generally accepted actuarial principles and practices. C. The actual amount of losses are considered to represent the projected average loss for the period. Y. Other, or more than one method. <u>1/</u> Z. Not applicable <u>Column (5) - Insurance Administration Expenses</u> For each self-insured group plan, or the self-insured portion of purchased insurance, enter code A, B, C, D, Y, or Z, as appropriate, to indicate how administrative costs are treated. A. Separately identified and accumulated in indirect cost pool(s). B. Separately identified, accumulated, and allocated to cost objectives either at the segment and/or home office level (Describe allocation method on a Continuation Sheet). C. Not separately identified, but included in indirect cost pool(s). (Describe pool(s) on a Continuation Sheet). D. Incurred by an insurance carrier or third party. (Describe accumulation and allocation process on a Continuation Sheet). Y. Other <u>1/</u> Z. Not applicable <u>1/</u> Describe on a Continuation Sheet.	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VIII - HOME OFFICE EXPENSES						
		NAME OF REPORTING UNIT						
Item No.	Item description							
	Part VIII Instructions <u>FOR HOME OFFICE, AS APPLICABLE (Includes home office type operations of subsidiaries, joint ventures, partnerships, etc.). 1/</u> This part should be completed <u>only</u> by the office of a corporation or other business entity where such an office is responsible for administering two or more segments, where it allocates its costs to such segments and where at least one of the segments is required to file Parts I through VII of the Disclosure Statement. Data for this part should cover the reporting unit's (corporate or other intermediate level home office's) most recently completed fiscal year. For a corporate (home) office, such data should cover the entire corporation. For a intermediate level home office, they should cover the subordinate organizations administered by that group office.							
8.1.0	<u>Organizational Structure.</u> On a continuation sheet, provide the following information: 1. In column (1) list segments and other intermediate level home offices reporting to this home office, 2. In column (2) insert "yes" or "no" to indicate if reporting units have recorded any CAS-covered Government Sales, and 3. In column (3) provide the percentage of annual CAS-covered Government Sales as a Percentage of Total Sales (Government and Commercial), if applicable, as follows: A. Less than 10% B. 10%-50% C. 51%-80% D. 81%-95% E. Over 95% <table style="width: 100%; margin-top: 10px;"> <thead> <tr> <th style="text-align: center; width: 40%;">Segment or Other Intermediate Home Office (1)</th> <th style="text-align: center; width: 30%;">CAS Covered Government Sales (2)</th> <th style="text-align: center; width: 30%;">Government Sales as a Percentage of Total Sales (3)</th> </tr> </thead> <tbody> <tr> <td colspan="3" style="height: 20px;"> </td> </tr> </tbody> </table>		Segment or Other Intermediate Home Office (1)	CAS Covered Government Sales (2)	Government Sales as a Percentage of Total Sales (3)			
Segment or Other Intermediate Home Office (1)	CAS Covered Government Sales (2)	Government Sales as a Percentage of Total Sales (3)						
8.2.0	<u>Other Applicable Disclosure Statement Parts.</u> (Refer to page (i) 4., <u>General Instructions</u> , and Parts V, VI and VII of the Disclosure Statement. Indicate below the parts that the reporting unit has completed concurrently with Parts I and VIII.) A. ☐ Part V - Depreciation and Capitalization Practices B. ☐ Part VI - Other Costs and Credits C. ☐ Part VII - Deferred Compensation and Insurance Costs Z. ☐ Not Applicable							
1/ For definition of home office see 48 CFR 9904.403.								

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VIII - HOME OFFICE EXPENSES
		NAME OF REPORTING UNIT
Item No.	Item description	
8.3.0	<u>Expenses or Pools of Expenses and Methods of Allocation.</u> For classification purposes, three methods of allocation, defined as follows, are to be used: (i) Directly Allocated—those expenses that are charged to specific corporate segments or other intermediate level home offices based on a specific identification of costs incurred, as described in 9904.403; (ii) Homogeneous Expense Pools—those individual or groups of expenses which are allocated using a base which reflects beneficial or causal relationships, as described in 9904.403; and (iii) Residual Expense—the remaining expenses which are allocated to all segments by means of a base representative of the total activity of such segments. <u>Allocation Base Codes</u> A. Sales B. Cost of Sales C. Total Cost Input (Direct Material, Direct Labor, Other Direct Costs, and Applicable Overhead) D. Total Cost Incurred (Total Cost Input Plus G&A Expenses) E. Prime Cost (Direct Material, Direct Labor, and Other Direct Costs) F. Three factor formula (CAS 9904.403-50(c)) G. Processing or Conversion Cost (Direct Labor and Applicable Overhead) H. Direct Labor Dollars I. Direct Labor Hours J. Machine Hours K. Usage L. Unit of Production M. Direct Material Cost N. Total Payroll Dollars (Direct and Indirect Employees) O. Headcount or Number of employees (Direct and Indirect Employees) P. Square Feet Q. Value Added Y. Other, or More than One Basis <u>1/</u> (On a continuation sheet, under each of the headings 8.3.1, 8.3.2, and 8.3.3 enter the type of expenses or the name of the expense pool(s). For each of the types of expense or expense pools listed, also indicate as item (a) the major functions, activities, and elements of cost included. In addition, for items listed under 8.3.2 and 8.3.3 enter one of the Allocation Base Codes A through Q, or Y, to indicate the basis of allocation and describe as item (b) the make up of the base(s). For example, if direct labor dollars are used, are overtime premiums, fringe benefits, etc. included? For items listed under 8.3.2 and 8.3.3, if a pool is not allocated to all reporting units listed under 8.1.0, then list those reporting units either receiving or not receiving an allocation. Also identify special allocations of residual expenses and/or fixed management charges (see 9904.403-40(c)(3)). <u>1/</u> Describe on a Continuation Sheet.	

COST ACCOUNTING STANDARDS BOARD DISCLOSURE STATEMENT REQUIRED BY PUBLIC LAW 100-679		PART VIII - HOME OFFICE EXPENSES
		NAME OF REPORTING UNIT
Item No.	Item description	
8.3.3	<u>Residual Expenses</u> <u>Allocation Base Code</u> (a) Major functions, activities, and elements of cost include: _____ _____ (b) Description/Make up of the allocation base: _____ _____	
8.4.0	<u>Transfer of Expenses.</u> If there are normally transfers of expenses from reporting units to this home office, identify on a continuation sheet the classification of the expense and the name of the reporting unit incurring the expense.	

COMPARISON OF THE CAS AND FAR COST PRINCIPLES

Adjusting the CAS applicability criteria could result in a larger number of contracts being exempt from CAS coverage. Generally, these non-CAS-covered, cost-based contracts would continue to be subject to FAR Part 31 and would still be required to comply with the three standards concerning deferred compensation and pensions, since these standards are incorporated by reference into FAR Part 31. In addition, contractors would still be entitled to recover the cost of money on these non-CAS-covered contracts, since the cost of money standards are also incorporated by reference into FAR Part 31. These non-CAS-covered contracts would also continue to be subject to the basic concepts embodied in four of the standards, including direct/indirect charging, segregation of unallowable costs, self-insurance, and B&P/IR&D costs. By relying on GAAP, these non-CAS-covered contracts would also continue to be subject to the fundamental concepts embodied in the standards that address compensated personal absence and purchased insurance.

In addition, non-CAS-covered contracts of any contract type would not be subject to the specific CAS requirements regarding cost allocations, asset capitalization and depreciation, cost accounting period, standard costs, and material costs. In addition, there would be no price adjustments for non-CAS-covered contracts for changes in accounting practice. Furthermore, the non-CAS-covered fixed-price contracts would not be subject to price adjustment for failure to comply with the FAR Part 31 requirements.

The following summary compares the CAS with related FAR provisions.

Comparison attribute	Number of standards
Incorporation by reference (CAS 412, 413, 414, 415, 417)	5
Substantial duplication (CAS 402, 405, 416, 420)	4
Reliance on GAAP (CAS 408)	1
Significant differences with FAR providing only general guidelines (CAS 403, 404, 406, 407, 409, 410, 411, 418)	8
No related FAR Part 31 (CAS 401)	1

The five standards that are incorporated by reference into FAR Part 31 address deferred compensation, pensions, and cost of money. The four standards that have FAR Part 31 provisions that duplicate the requirements contained in the standards address consistency in direct/indirect charging, segregation of unallowable costs, self-insurance, and IR&D/B&P costs excluding allocation provisions. The eight standards for which the FAR Part 31 requirements differ significantly address cost allocation, asset capitalization/depreciation, cost accounting period, standard costs, and material costs. In addition, CAS 401, which addresses consistency in estimating and accumulating costs, has no related FAR Part 31 requirement.

The results of the comparison by standard are as follows:

CAS	<i>Related FAR provision</i>	<i>Results of comparison</i>
401	None	No related FAR requirements
402	31.202 and 31.203	Substantial duplication
403	31.201-4 and 31.203	FAR provides only general guidelines
404	31.205-11, 31.205-24, and 31.205-52	FAR provides general guidelines/ some duplication
405	31.201-6	Substantial duplication
406	31.203	FAR provides general guidelines
407	31.201-1	FAR provides only general guidelines
408	None	Reliance on GAAP
409	31.205-11 and 31.205-16 guidelines/some duplication	FAR provides some general
410	31.201-4 and 31.203	FAR provides only general guidelines
411	31.205-26	FAR provides general guidelines
412	31.205-6(j)	Incorporation by reference
413	31.205-6(j)	Incorporation by reference
414	31.205-10	Incorporation by reference
415	31.205-6(k)	Incorporation by reference
416	31.205-19	Reliance on GAAP for purchased insurance/incorporates CAS 416 for self-insurance
417	31.205-10	Incorporation by reference
418	31.201-4 and 31.203	FAR provides only general guidelines
420	31.205-18	Substantial duplication, incorporates CAS 420 for all provisions except 420.50(e)(2) and (f)(2). Where differences exist, FAR provides only general guidelines

COMPARISON OF THE CAS AND FAR PART 31.2

CAS 401: Consistency in Estimating, Accumulating, and Reporting Costs:

The requirements of this standard are not covered in FAR Part 31.2. CAS 401 requires consistency in the estimating, accumulating, and reporting of costs. FAR Part 31.2 contains no similar or related requirements.

CAS 402: Consistency in Allocating Costs Incurred for the Same Purpose:

The requirements of CAS 402 are duplicated in FAR 31.202, "Direct Costs," and FAR 31.203, "Indirect Costs." CAS 402 requires that each type of cost be allocated only once and on only one basis to each contract. FAR 31.202 and 31.203 provide the same basic requirements.

CAS 403: Allocation of Home Office Expenses:

The specific requirements of CAS 403 are not addressed. However, general guidelines on allocation principles are provided at FAR 31.201-4, "Determining Allocability," and FAR 31.203, "Indirect Costs."

CAS 403 establishes criteria for allocating home office expenses to segments. The standard requires that such allocations be made on a beneficial or causal relationship. It also provides a hierarchy of allocation practices: (1) direct identification whenever possible, if not (2) indirect cost pools allocated on a beneficial or causal relationship, and if that is not possible, (3) allocation of residual expenses using a three-factor formula.

FAR 31.201-4 states that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Under FAR 31.201-4, a cost is allocable to a government contract if it (1) is incurred specifically for the contract, (2) benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received, or (3) is necessary for the overall operation of the business.

FAR 31.203 requires that indirect costs be grouped in logical cost groupings, that cost groupings be determined so as to distribute costs on the basis of benefits accruing to cost objectives, that the base for allocating these costs not be fragmented by removing individual elements, and that the method of allocating costs be in accordance with GAAP.

CAS 404: Capitalization of Tangible Capital Assets:

For the most part, the specific requirements of this standard are not addressed in the FAR. However, general guidelines for depreciation are provided at FAR 31.205-11, "Depreciation," and FAR 31.205-24, "Maintenance and Repair Costs," requires that expenditures for plant and equipment be capitalized in accordance with GAAP.

CAS 404 provides criteria for capitalization. The standard requires capitalization if the asset benefits more than one period and the cost of the asset exceeds the minimum capitalization threshold. The standard also includes a "no step-up, no

step-down” rule for establishing values of certain assets acquired in a business combination.

FAR 31.205-11 considers contractor capitalization practices to be reasonable if the contractor follows policies and procedures that are (1) consistent with those followed in the same cost center for business other than government, (2) reflected in the contractor’s books of accounts and financial statements, and (3) both used and acceptable for federal income tax purposes. In addition, FAR 31.205-11(m) incorporates CAS 404 for assets acquired under capital leases.

FAR 31.205-24 requires capitalization and depreciation of expenditures for plant and equipment according to the contractor’s established policy in conformance with GAAP. In addition, the cost principle requires that extraordinary maintenance and repair be capitalized and assigned to applicable cost accounting periods.

The cost principle also provides for a “no step-up, no step-down” rule at FAR 31.205-52, which is substantially the same as that provided for under CAS 404.

CAS 405: Accounting for Unallowable Costs:

FAR 31.201-6, “Accounting for unallowable costs,” duplicates the requirements of CAS 405 through text and incorporation. CAS 405 and FAR 31.201-6 require contractors to segregate unallowable costs.

CAS 406: Accounting Period:

The requirements of CAS 406 are addressed generally at FAR 31.203.

CAS 406 provides specific criteria on what constitutes an accounting period. The standard defines the fiscal year as the normal accounting period and provides specific instances in which a period other than the fiscal year may be used. CAS 406 also provides guidance on the measurement, assignment, and allocation of restructuring costs.

FAR 31.203, “Indirect Costs,” requires that the base period for allocating indirect costs be the contractor’s fiscal year but permits use of a shorter period (1) for contracts in which performance involves only a minor portion of the fiscal year, or (2) when there is general practice in the industry to use a shorter period.

CAS 407: Use of Standard Costs for Direct Material and Direct Labor:

The specific requirements of this standard are not addressed in the FAR. However, the concept of standard costs is mentioned at FAR 31.201-1, “Composition of Total Cost.” FAR Part 31.201-1 includes a general requirement regarding standard costs, while CAS 407 has detailed criteria.

CAS 407 permits use of standard costs if (1) the standard costs are entered into the books of account, (2) the standard costs and related variances are appropriately accounted for at the level of the production unit, and (3) the practices regarding the use of standard costs, revisions to standard costs, and disposition of variances is stated in writing and consistently followed. In addition, CAS 407 requires that variances be allocated to cost objectives at least annually and on the same basis as the standard costs.

FAR 31.201-1 permits the use of standard costs in determining the composition of total cost if the standard costs are properly adjusted for applicable variances.

CAS 408: Accounting for the Costs of Compensated Personal Absence:

FAR Part 31.2 does not specifically address accounting for the costs of compensated personal absences and thus relies on GAAP in this area. As noted in the CAS versus GAAP analysis, the CAS and GAAP have overlap/duplication in this area.

CAS 408 requires costs of personal absences to be assigned to the period in which they are earned and to be allocated pro-rata to all final cost objectives of that period.

GAAP (Financial Accounting Standards Board (FASB) 43), and thus by default FAR Part 31.2, requires an employer to accrue a liability for employee's rights to receive compensation for future absences when an obligation exists. For example, GAAP requires a liability to be accrued for vacation benefits that employees have earned but have not yet taken; however, it generally does not require a liability to be accrued for future sick pay benefits, holidays, and similar compensated absences. This requirement is similar to the requirement at CAS 408.

CAS 409: Depreciation of Tangible Capital Assets:

The specific requirements of this standard are not incorporated in the FAR. However, general guidelines are provided in FAR 31.205-11, "Depreciation." In addition, there is duplication in the requirements for treatment of gains or losses on disposition of assets at FAR 31.205-16, "Gains and Losses on Disposition or Impairment of Depreciable Property or Capital Assets."

CAS 409 (1) provides specific criteria for determining when an asset is placed in use, (2) requires that expected periods of usefulness be used in determining depreciation periods, (3) requires that the contractor maintain records of past retirement of similar assets used in similar circumstances, (4) requires that the records of past retirement be adequate to show the age at retirement for a sample of assets for each significant category, (5) requires that the depreciation method used for financial accounting also be used for contract costing (unless the method is unacceptable for income tax purposes or does not reasonably reflect the expected consumption of services), (5) limits the direct allocation of costs to those

allocated on the basis of usage, and (6) requires that any sale gain/loss be allocated in the same manner as the asset was depreciated.

FAR 31.205-11 considers contractor depreciation practices to be reasonable if the contractor follows policies and procedures that are (1) consistent with those followed in the same cost center for business other than government, (2) reflected in the contractor's books of accounts and financial statements, and (3) both used and acceptable for federal income tax purposes. FAR 31.205-11 also states that depreciation should usually be allocated as an indirect cost (but there is no prohibition against allocating depreciation as a direct cost).

In addition, FAR 31.205-16 contains criteria for allocating gains/losses similar to that contained in CAS 409.

CAS 410: Allocation of Business Unit General and Administrative Expenses (G&A) to Final Cost Objectives:

The specific requirements of CAS 410 are not addressed in the FAR. However, general guidelines on allocation principles are provided at FAR 31.201-4, "Determining Allocability," and FAR 31.203, "Indirect Costs."

CAS 410 provides criteria for the allocation of business unit G&A to final cost objectives based on their beneficial or causal relationship. This standard requires use of a single business unit G&A pool allocated over a total activity base. The total activity base can be one of three: total cost input, value added, or single element.

FAR 31.201-4 states that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Under FAR 31.201-4, a cost is allocable to a government contract if it (1) is incurred specifically for the contract, (2) benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received, or (3) is necessary for the overall operation of the business.

FAR 31.203 requires that indirect costs be grouped in logical cost groupings, that cost groupings be determined so as to distribute costs on the basis of benefits accruing to cost objectives, that the base for allocating these costs not be fragmented by removing individual elements, and that the method of allocating costs be in accordance with GAAP.

CAS 411: Accounting for Acquisition Costs of Material:

Most of the specific requirements of CAS 411 are not addressed in the FAR. However, general guidelines and a few specific requirements are incorporated at FAR 31.205-26, "Material Costs."

CAS 411 (1) requires consistent contractor policies for accumulating and allocating material costs, (2) permits direct allocation of material costs to cost objectives if the cost objective was specifically identified at the time of purchase or production of the units, (3) states that indirect material not consumed by the end of the period cannot be charged in that period but must instead be established as an asset, and (4) provides for five acceptable inventory costing methods: first-in-first-out (FIFO), moving average, weighted average, standard cost, and last-in-first-out (LIFO).

FAR 31.205-26 states that when materials are purchased solely for and are identifiable with a contract, the actual purchase cost of those materials shall be charged directly to that contract. FAR 31.205-26 also states that, for materials issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable.

CAS 412: Composition and Measurement of Pension Costs:

FAR 31.205-6(j), "Pension Costs," incorporates the requirements of CAS 412 by reference, and thus the FAR duplicates the CAS for this issue.

CAS 412 and FAR 31.205-6(j) (through incorporation of CAS 412) (1) define the four components of pension cost for defined benefit pension plans, (2) measure defined contribution pension plan costs as the net contribution for the period, (3) require the use of an immediate gain actuarial cost method for measuring defined benefit pension plan costs other than those accounted for on a pay-as-you-go method, (4) provide requirements for determining actuarial assumptions/estimates, and (5) provide criteria for reassignment of pension costs.

CAS 413: Adjustment and Allocation of Pension Costs:

FAR 31.205-6(j), "Pension Costs," incorporates the requirements of CAS 413 by reference, and thus the FAR duplicates the CAS for this issue.

CAS 413 and FAR 31.205-6(j) (through incorporation of CAS 412) (1) provide criteria for computing/assigning gains and losses, (2) provide criteria for actuarial assumptions, (3) requires allocation of pension costs to all segments having participants in the pension plan, (4) require segment accounting when certain conditions exist, (5) provide for the concept of an assignable cost deficit, and (6) require an adjustment for segment closings and plan terminations.

CAS 414: Cost of Money as an Element of the Cost of Facilities Capital:

FAR 31.205-10, "Cost of money," incorporates the requirements of CAS 414 by reference, thus duplicating the CAS for this issue.

CAS 414 and FAR 31.205-10 (through incorporation of CAS 414) provide criteria for the measurement and allocation of the costs of facilities capital.

CAS 415: Accounting for the Cost of Deferred Compensation:

FAR 31.205-6(k), "Deferred compensation," incorporates the requirements of CAS 415 by reference, and thus the FAR duplicates the CAS for this issue.

CAS 415 and FAR 31.205-6(k) (through incorporation of CAS 415) provide criteria for measuring and assigning the costs of deferred compensation, including (1) requirements that deferred compensation be assigned to the period in which the contractor incurs an obligation to the employee, and (2) that the costs be measured as the present value of the future benefits.

CAS 416: Accounting for Insurance Costs:

For contractors that establish self-insurance programs, FAR 31.205-19, "Insurance and Indemnification," incorporates the requirements of CAS 416, and thus the FAR duplicates the CAS for this issue. For purchased insurance, CAS 416 and FAR 31.2 (through the use of GAAP) have similar requirements.

For self-insurance charges, CAS 416 (and thus FAR 31.2 for contractors that establish self-insurance programs) requires that (1) insurance costs be assigned to a cost accounting period using a projected average loss, and (2) insurance costs be allocated based on the beneficial and causal relationship between the insurance costs and the benefiting/causing cost objectives.

For purchased insurance costs, CAS 416 requires that (1) the premium costs applicable to a given policy term be assigned pro rata among the cost accounting periods covered by the policy term and (2) a refund become an adjustment to the pro rata premium costs for the earliest cost accounting period in which the refund is received. FAR 31.205-19 does not address the treatment of purchased insurance and thus would follow the GAAP requirements. The GAAP requirements for the various types of insurance policies that can be purchased are too numerous to list. However, the general principle that underlies the specific accounting treatment for each of these policies is similar to the CAS 416 requirement, i.e., the premium cost should be assigned among the accounting periods covered by the policy term.

CAS 417: Cost of Money as an Element of the Cost of Capital Assets Under Construction:

FAR 31.205-10, "Cost of money," incorporates the requirements of CAS 417 by reference and thus duplicates the CAS for this issue.

CAS 417 and FAR 31.205-10 (through incorporation of CAS 417) provide criteria for measuring the cost of money attributable to capital assets under construction, including the requirement that the cost of money applicable to investment in tangible and intangible capital assets being constructed, fabricated, or developed for a contractor's own use be included in the capitalized acquisition cost of such assets.

CAS 418: Allocation of Direct and Indirect Costs:

The specific requirements of this standard are not addressed in the FAR. However, general guidelines on allocation principles are provided at FAR 31.201-4, "Determining Allocability," and FAR 31.203, "Indirect Costs."

CAS 418 requires the contractor to (1) have written policies for classifying costs as direct or indirect, (2) accumulate the indirect costs in homogeneous cost pools, and (3) allocate the cost pools in reasonable proportion to the beneficial or causal relationship.

FAR 31.201-4 states that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Under FAR 31.201-4, a cost is allocable to a government contract if it (1) is incurred specifically for the contract, (2) benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received, or (3) is necessary for the overall operation of the business.

FAR 31.203 requires that indirect costs be grouped in logical cost groupings, that cost groupings be determined so as to distribute costs on the basis of benefits accruing to cost objectives, that the base for allocating these costs not be fragmented by removing individual elements, and that the method of allocating costs be in accordance with GAAP.

CAS 420: Accounting for IR&D and B&P Costs:

FAR 31.205-18, "Independent Research and Development and Bid and Proposal Costs," incorporates the requirements of CAS 420, except for paragraphs (e)(2) and (f)(2). Thus the FAR duplicates the CAS by reference for most of this area.

CAS 420 and FAR 31.205-18 (through incorporation of CAS 420) require that IR&D/B&P costs be (1) accumulated by project, (2) allocated on a beneficial or causal relationship, and (3) assigned only in the period in which they are incurred (except that IR&D costs may be assigned to other periods if permitted by existing laws or regulations).

CAS 420, but not FAR 31.205-18, requires that IR&D/B&P costs be allocated among segments by means of the same base used by the company to allocate residual expenses under CAS 403 and that IR&D/B&P costs be allocated to final cost objectives using the same base used to allocate G&A expenses under CAS 410.

FAR 31.2 does not incorporate CAS 403 or CAS 410 and thus relies upon the general allocability criteria at FAR 31.201-4 for allocating IR&D/B&P costs. This criteria states that a cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Under FAR 31.201-4, a cost is allocable to a government contract if it (1) is incurred specifically for the contract, (2) benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefits received, or (3) is necessary for the overall operation of the business.

**LIST OF SURVEYED CONTRACTORS
AND IDCC FIRMS**

Listing of Department of Defense contractors surveyed:

1. **Aerojet General Corporation**
 - GenCorp Aerojet
 - Aerojet - Sacramento
2. **Alegany Teledyne**
 - Brown Engineering
 - Ryan Aeronautical
 - Wahchang Albany
3. **Alliant Techsystems**
 - Commercial Propellant Segment
 - Defense Systems
 - Space and Strategic Systems Group
4. **Allied Signal**
 - Technical Services
 - Electronics and Avionics Systems
 - Aerospace Equipment Systems
5. **Ball Corporation**
 - Ball Aerospace and Technical Corporation
6. **BDM**
 - Enterprising Management Systems
 - Federal Systems
7. **Boeing**
 - Boeing Commercial Airplanes Group
 - Defense & Space Segment
 - Aircraft & Missiles Segment
 - C-17 Segment
8. **Eaton Corporation**
 - Pressure Sensors Division
 - Specific Industry Controls Division
 - Valve Actuator Division

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9. **General Electric Company**
 - GE Aircraft Engines - Evendale
 - GE Aircraft Engines - Lynn
 - GE Power Systems
 10. **Harris Corporation**
 - Information Systems Division
 - Government Aerospace Systems Division
 11. **Honeywell**
 - Honeywell Technology Center
 - Solid State Electronics Center
 12. **L-3**
 - Explosive Detection System
 - Medical Systems
 13. **Lockheed Martin Corporation**
 - LM Tactical Aircraft Systems
 - LM Aeronautical Systems
 - LM Missiles and Space
 - LM Federal Systems
 14. **Lockheed Martin Sanders**
 - MED
 - Telecommunications
 15. **McDermott Incorporated**
 - Naval Nuclear Fuels Division
 - Nuclear Equipment Division
 - Contract Research Division
 16. **Orbital Sciences Corporation**
 - Space Systems Group
 - Electronic Sensor Systems Group
 - Launch Systems Group
 17. **Scott Technologies**
 - Interstate Electronics Corporation
 - Scott Aviation
 18. **Sundstrand**
 - Sundstrand Aerospace Electric Systems
 - Aerospace Mechanical Systems
 - Aerospace Power Systems

19. Textron, Inc.

- Bell Helicopter Textron
- Textron Systems Division
- Fuel Systems Textron

List of IDCC firms:

1. Corning Incorporated
2. Cummins Engine Company
3. Dow Chemical Company
4. Dow Corning Company
5. Eastman Kodak Company
6. Hoechst
7. Honeywell
8. IBM
9. Motorola
10. W. L. Gore and Associates, Inc.
11. 3M Company

TESTIMONIES AND OTHER STATEMENTS

PERSON AND ORGANIZATION	TOPIC
Ms. Danielle Brian, Executive Director, Project on Government Oversight	Government oversight
Mr. Alan Brown, Attorney, McKenna & Cuneo	Staffing support and communications with industry
Mr. Bert M. Concklin, President, Professional Services Council	Application of the CAS for the service industry
Mr. Tim Foster, President, TAF, Inc.	Vital role of the CAS in government today - with a historical perspective
Mr. Stanley Fry, Manager of Contracts for Commercial and Government Systems, Eastman Kodak	The CAS application for predominately commercial companies
Mr. Stephen W. Gammarino, Senior Vice President, Federal Employee Program, Blue Cross-Blue Shield Association; Mr. Nelson Shapiro, Consultant; Mr. Bill Preskin, Attorney	The CAS application for the Blue Cross-Blue Shield Federal Employee Program
Mr. Sanders P. Gerson, Deputy Assistant Inspector General for Audits, Office of the Inspector General, U.S. Office of Personnel	Application of the CAS to the Federal Employee Health Care Program
Mr. Patrick Gnazzo, Vice President of Business Practices, and Mr. Joel Marsh, United Technology Corporation	Corporate perspective of the CAS
Ms. Helaine Gregory, Compliance Officer, Government Operations, United Health Care Insurance Company	The CAS application to Medicare contractors
Mr. Alfred King, Chairman, Management Accounting Committee, Institute of Management Accountants	Management accounting for government cost accounting purposes

Mr. Paul Lindahl, Manager, Government
Controllars Department, 3M Corporation

The CAS application for
predominately commercial
companies

Mr. John Lordon, Vice President for
Business Affairs, Johns Hopkins
University

The CAS application for
universities and colleges

Mr. Merritt Marquardt, Chairman,
Integrated Dual-use Commercial Companies

Predominately commercial
companies with small
government market

Mr. Rodney Mateer, National Partner,
Deloitte & Touche

The CAS and GAAP: overlap,
duplication and conflict

Ms. Eileen Morrissey, Director, Advanced
Cost Management, AlliedSignal, Inc.
Chairperson, Consortium for Advanced
Manufacturing - International

The importance of advanced
cost and management in today's
complex environment

Mr. Anthony O'Falt, Resident Auditor,
Defense Contract Audit Agency, United
Technology Corporation

Resident DCAA auditor's
perspective on the CAS

Mr. Charles Ream, Executive
Vice President for Finance, and
Mr. Robert Morales, Director,
Government Accounting, The Raytheon
Corporation

Corporate perspective on the CAS

Mr. William Romenius, Assistant
Comptroller for Finance, The Boeing
Company

Corporate perspective on the CAS

Mr. Ronald D. Sabado, Resident Auditor,
Defense Contract Audit Agency, Boeing
Corporation Resident Office

Resident DCAA auditor's
perspective on the CAS

Mr. Bernard Sacks, President, Sacks
Bonuccelli, Inc., Certified Public
Accountants

Organizational placement of
the CAS

Mr. Lynn Saylor, Corporate Director of
Finance, General Electric Company

Corporate perspective on the CAS

Mr. Charles Tiefer, Associate Professor,
University of Baltimore School of Law

Academic perspective on the CAS

Mr. Alan Tinti, Defense Corporate
Executive, Defense Contract Management
Command, United Technology Corporation

Defense Corporate Executive's
perspective on the CAS

Mr. Frank D. Titus, Assistant Director for
Insurance Programs, United States Office
of Personnel Management

The CAS in the Federal Employee
Health Care Program

Ms. Margaret Worthington, Partner, Price
Waterhouse

The CAS and Cost Principles:
overlap, duplication and conflict

The following individuals did not appear at the hearing but submitted statements
for the record:

Mr. Bertold Bodenheimer, Partner, Caldwell
and Bodenheimer, CPA

Need for the CAS

Mr. Dan C. Heinemeier, President,
Government Electronics and
Information Technology Association

Applicability of the CAS

Ms. Eleanor Hill, Inspector General,
Department of Defense

Need for the CAS

Mr. Gordon Shillinglaw, Professor of
Accounting Emeritus, Columbia University,
and former member of the Cost Accounting
Standards Board

The CAS versus the GAAP

Testimonies and Other Statements

Tim Foster, President, TAF, Inc.
6370 Brampton Court, Alexandria, VA 22304
703-461-0855

**Vital Role of Cost Accounting
Standards in Government
Procurement Today—with
Historical Perspective**

Statement to the Cost Accounting Standards
Board Review Panel

June 16, 1998

Main Points regarding Cost Accounting Board Review

1. In recent years, Government contractor lobbyists have been exploiting federal budget reduction initiatives in an effort to dismantle long-established procurement safeguards. This panel is meeting today, at the request of two Congressional Committee chairmen, as part of this effort. The question before the panel is whether conditions today might warrant relaxation of cost accounting standards, exemption of special interest groups, or transfer of function to another forum such as the Financial Accounting Standards Board.
2. I was Admiral Rickover's point man for the accounting standards effort in the years leading up to the cost accounting standards legislation. I helped the new Cost Accounting Standards Board staff focus on problem areas. I watched helplessly as contractor lobbyists later succeeded in cutting off all funding for the original Board.
3. I know why the Cost Accounting Standards Board came to be. I know how persistently contractor lobbyists have worked to avoid the standards. I am very aware of the business climate that has accompanied the downturn in defense spending. From this perspective, I strongly urge the panel to resist pressures to weaken the Cost Accounting Standards Board or to narrow its application.
4. Upon arriving at Naval Reactors, in March 1963, one of my first assignments was to review nearly a dozen General Accounting Office "Blue Book Reports". Each described excessive profits made by naval nuclear component manufacturers under firm-fixed-priced, competitively awarded contracts. The GAO had also issued reports of this nature regarding other defense programs.
5. After calculating the profits realized on these orders, the GAO recommended that we seek voluntary price reductions from the contractors. We declined on the basis that "a contract is a contract".
6. Dealing with the GAO reports, however, taught us how difficult it was to determine how much our equipment cost to manufacture and how much profit our contractors were making in producing it. One GAO report resulted in 7 subsequent audits, 11 different results, a 50 percent variance in cost estimates, and estimated profits ranging between 10 and 100 percent.
7. The GAO reports also undermined our confidence that competitive bids from four or five experienced contractors would automatically ensure reasonable prices. We began requiring certified contractor cost and pricing data that we could examine before contract award.

8. We shifted from firm-fixed-priced contracts to fixed-priced-incentive contracts. Fixed-priced-incentive contracts help mitigate both contractor and Government pricing risks. Final prices depend on actual incurred cost.
9. As we began examining more contractor cost data, we gained a better understanding of the work. We also discovered how contractors were able to exploit the lack of cost accounting standards to the Government's detriment -- all within generally accepted accounting principles.
10. Among the abuses we discovered:
 - a. Propose and account for costs on different bases. One contractor repeatedly certified cost breakdowns that showed a 25% G&A rate and a 13% loss. Defense auditors found that this was really a 12 % G&A rate and a 13% profit.
 - b. Avoid accounting for costs by individual contract. One large, sole source contractor quoted a price four times higher than previously. The firm insisted that its accounting system did not segregate costs by individual contract. We therefore had no reasonable basis for evaluating the proposed price.
 - c. Charging Government contracts for commercial losses. One large contractor redefined more than \$100 million in commercial losses as "manufacturing process development costs". Supported by a prestigious accounting firm and attorneys, the company litigated for the right to amortize these so-called costs over future Government work.
 - d. Charge the same type of costs directly to noncompetitive or cost reimbursement contracts and as overhead cost to fixed-priced, competitive contracts. Several large contractors did this extensively with administrative support costs and warehousing services. The effect is that cost reimbursement contracts subsidize fixed-priced contracts, sole source contracts subsidize competitive contracts, or Government contracts subsidize commercial work.
 - e. Manipulate contract costs by retroactive accounting policy changes. A contractor facing a cost overrun could lessen the impact by changing retroactively its accounting policy to reduce the depreciation costs charged to current contracts. Conversely, a contractor might change its accounting policy to charge off assets quickly on current contracts and therefore improve future profits. Contractors could later reverse the process.
 - f. Inflate progress payment billings. One large contractor, on paper, charged stores inventories to contracts at the end of the month and included these amounts as cost incurred for progress billings. Several days later, the company would reverse the charges and take the material back up on its books as inventory. This was a paper entry. No material left the shelf.

g. Juggle contract cost and progress estimates to enhance financial reports to stockholders. This was a significant factor in the large claims that, during the 1970's, virtually stopped Navy shipbuilding programs. Under percentage-of-completion accounting, annual profit figures published in financial reports are largely management estimates that even the best of public accountants cannot actually validate.

11. For seven years, the defense industry, Department of Defense officials, and the accounting profession dismissed Admiral Rickover's examples of the need for cost accounting standards. Not until the GAO documented over 200 cases of similar accounting abuses, were we able to overcome this opposition.

12. Although originally opposed to cost accounting standards, the Defense Contract Audit Agency subsequently issued a May 1969 report confirming that:

- a. There was no authoritative code of definitive cost accounting principles.
- b. In the absence of cost accounting standards, accounting disputes had to be settled through other means.
- c. Forty-eight judicial or quasi-judicial decisions in the past ten years had been directed specifically to cost accounting principles and practices.
- d. These forty-eight decisions represented "an infinitesimal portion of the controversies in this area".

13. Even after Congress enacted the cost accounting standards legislation, contractor lobbyists continued their efforts to move standard-setting function to a more favorable forum. As a result of these efforts, they:

- a. Failed to convince the courts that it was unconstitutional for the Cost Accounting Standards Board to be in the legislative branch under the Comptroller General.
- b. Succeeded in terminating congressional funding for the Board.
- c. Later resurrected the Cost Accounting Standards Board in the executive branch to provide a mechanism for modifying the standards.

14. The reasons for sustaining a strong Cost Accounting Standards Board are as valid today as they were over thirty years ago.

- a. There is even less competition for specialized government needs. In the defense business, - lower quantities, fewer suppliers.
- b. The financial pressures on managers and corporate executives to portray their performance in the best possible light are no less today than they were then.
- c. The vigor with which contractors pursue government contracts belies claims that they are scared away by Government procurement policies.

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d. Public servants can no more afford to waste their time today on unnecessary accounting disputes than they could thirty years ago.

15. The pressures on management to apply creative accounting are substantial. Performance and executive compensation frequently depend on reported results. The temptation to charge higher prices, or to present financial figures in their most favorable light, or to exploit accounting loopholes can be great. Moreover, managers can achieve these improvements with only a pen. Achieving equivalent results through workforce productivity improvements tends to be more difficult. Cost accounting standards help to mitigate these pressures to manipulate cost figures.

16. Contractor lobbyists have advocated transferring some or all of the Cost Accounting Standards Board functions to the Financial Accounting Standards Board. That is not a good idea.

- a. The Financial Accounting Standards Board is to set standards pertaining to periodic reporting on the overall financial condition of businesses. The Cost Accounting Standards Board sets standards for measuring and assigning costs to individual contracts that may take years to perform.
- b. The primary interest of the Financial Accounting Standards Board is to maintain public confidence in financial reports relied upon by investors, lenders, buyers, and sellers. It is not concerned with how companies charge their customers.
- c. Even in the executive branch, the Cost Accounting Standards Board enjoys a measure of visibility and independence from contractor pressure. One could not reasonably expect to achieve equivalent results at the Financial Accounting Standards Board.
- d. The Government, not the private sector, should set and administer standards for measuring and allocating costs to Government contracts.

17. The accounting profession established the Financial Accounting Standards Board to blunt public and congressional criticism of its generally accepted accounting practices. The profession was hard-hit by widely publicized instances of large companies declaring bankruptcy in the face of audited financial reports that gave no hint of problems. Today, accountants and companies seem to appreciate the importance of the Financial Accounting Standards Board in sustaining public confidence. Companies that value their reputation would not dare to seek exemption from financial accounting standards. The same should be true with respect to cost accounting standards.

18. Congress and the Executive Branch are repeatedly asking public servants to do more with less. It makes no sense to deny them use of cost accounting standards that make their jobs easier.

19. Historical cost data is an important consideration in requirements-determination, cost estimating, budgeting, and management of Government programs. Consistent, reliable cost collection and reporting are critical to these processes.

Summary:

- Congress established the Cost Accounting Standards Board to curb accounting abuses and to reduce time-consuming and costly contract and accounting disputes.
- Contractor lobbyists and the public accounting profession have not been objective in their advice in Government procurement policy matters due to their self-interest.
- The reasons for sustaining a strong Cost Accounting Standards Board are as valid today as they were over thirty years ago.
- Contractor arguments against the Cost Accounting Standards Board and in favor of broader exemptions are essentially the same as thirty years ago, and no more valid.
- Contractors or government agencies that advocate weakening procurement safeguards such as cost accounting standards should carefully consider the long-term ramifications of doing so.
- The Cost Accounting Standards Board should keep abreast of Financial Accounting Standards Board activities, and vice versa. However, the Cost Accounting Standards Board must remain separate and independent.

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Presentation for
Cost Accounting Standards Board
Review Panel

By

Ronald D. Sabado
Resident Auditor, DCAA
Boeing Corporation Resident Office

June 16, 1998

Cost Accounting Standards Board Review Panel
Washington, D.C., 20548

In response to your Notice of Public Meeting, I provide the following comments on the Cost Accounting Standards Board (CASB). My name is Ron Sabado and I am an auditor with the Defense Contract Audit Agency (DCAA). I graduated from the University of Washington in 1973 with a BA in accounting. Currently, I am enrolled in a graduate program at Central Michigan University. I am a certified public accountant (CPA) and a certified management accountant (CMA). I am a member of the American Institute of Certified Public Accountants (AICPA), Institute of Management Accountants (IMA), and National Contract Management Association (NCMA). During my 25 year DCAA career, I have performed, supervised, and managed contract audits at small, medium and large contractors and I have been exposed to a variety of accounting practices. Currently, I manage a resident office covering a large contractor with a significant amount of commercial and government work. Prior to my current assignment I managed a branch office covering small and medium contractors some of which were CAS covered. I have taught financial and managerial accounting classes at a community college over the past 20 years. The financial accounting class includes coverage of measurement and assignment of costs and the managerial accounting class includes coverage of measurement, assignment and allocation of costs.

My current assignment covers a large multi-segment contractor with operations throughout the world. The contractor employs about 235,000 people worldwide and has sales of about \$45 billion. My responsibility is limited to one geographical area that has four major contractor organizations. The organizations are a home office, a service organization, a commercial organization, and a government organization. All of these organizations are CAS covered and file a disclosure statement. My day-to-day interaction on CAS issues depends on which organization I'm interacting with but the government organization represents the greatest dollar risk. For the past few years I have been periodically meeting with the vice president of finance of the government organization

and his accounting staff. The purpose of the meeting is to share current items of interest. At these meetings, the company has discussed future accounting issues prior to formal disclosure. The company will provide additional briefings on issues that we identify as particularly important. In addition, recently we have been using an integrated product team (IPT) approach to auditing the contractor's disclosure statement. Under this approach we work together to try to resolve all issues before we publish our audit report. This resolves most disclosure statement adequacy issues before the audit report is issued to the contracting officer. This new process requires cooperation among all parties and a willingness to improve the process as barriers are confronted. Over the past two years my office spent about 3.2 staff years, or about six percent of available audit resources, on cost accounting standards disclosure statements, compliance audits, and reviews of cost impact statements. In my opinion, if cost accounting standards did not exist we would spend the 3.2 staff years doing equivalent work. For example, our audit scope on any particular audit is driven by risk assessment. The risk assessment is partly determined by the system of internal controls. We audit the contractor's systems, including the accounting system, compensation system, and materials and labor systems, to ensure adequate policies and procedures are in place and are operating. Our audit coverage of cost accounting standards is supplemented by our audit work on internal controls systems and our audit work on internal controls systems is supplemented by our audit work on cost accounting standards. Accordingly, strong internal controls do not eliminate the need for cost accounting standards.

As a professional accountant, auditor, and teacher, I believe that accounting standards, in general, are essential because decisions about the use and allocation of resources, in a constantly changing environment, rely heavily on credible, concise, and understandable financial information. The CASB's work on both concepts and standards is based on research aimed at gaining new insights and ideas and has made significant contributions to the body of accounting knowledge.

The accounting profession has long been concerned with the differences in accounting practices and techniques and the problems associated with those differences.

In its preface to an accounting research bulletin issued in 1953, the Committee on Accounting Procedure wrote, "Since its organization the American Institute of Accountants, aware of divergences in accounting procedures and of an increasing interest by the public in financial reporting, has given consideration to problems raised by these divergences". The primary objective of the CASB is to achieve increased degree of uniformity and consistency in cost. Increased uniformity and consistency improve understanding and communication, reduce the incidence of disputes and disagreements, and facilitate contract settlements. Cost accounting standards cover the measurement of costs, assignment of costs to cost accounting periods and the allocation of costs to cost objectives. In addition, part of the CASB role is to keep standards current to reflect changes in methods of doing business and changes in the economic environment and consider promptly any significant areas of deficiency that might be improved through the standard-setting process.

In my opinion, standards are desirable. Standards provide a framework that organizations use to measure performance and, as noted by the American Institute of Accountants, to narrow the divergent procedures in the interest of users. In my opinion, the move to commercial practices, does not diminish, and may even strengthen, the need for some fundamental standards. Commercial practices whether manufacturing processes, human processes, or accounting procedures, require some standards to measure against the outcome. Standards ensures some consistency, uniformity, and quality of expected output. Without standards, whether process standards or accounting standards, an undesirable outcome may occur. For example, the government has purchased commercial items that were subsequently modified to government requirements. During production the contractor allocated certain tooling costs to each unit. However, believing that it had not fully recovered the cost of certain program equipment, the contractor developed an allowance factor to add to the government purchased items after completion. The allowance factor included costs already allocated as tooling costs and resulted in double recovery of the same costs. This practice was not compliant with CAS 402, Consistency in Allocating Costs Incurred for the Same Purpose. The contractor did not initially agree with the noncompliance but after

discussions the contractor agreed to remove the tooling costs from the allowance factor resulting in savings to the government of about \$4 million.

The alternative to promulgated cost accounting standards is to rely on the Federal Acquisition Regulations (FAR) or generally accepted accounting principles (GAAP). FAR Part 31 has concentrated primarily on the allowability of costs. FAR Part 31 does not provide for specific guidelines for measurement, assignment, and allocation of costs except where incorporated from duly promulgated cost accounting standards. Accordingly, the FAR alone is not adequate to address complex cost accounting issues in a dynamic business environment. For example, during the late 1960s and early 1970s a contractor was allocating state tax costs over a headcount allocation base when specific identification of tax costs to cost objectives provided a better causal or beneficial relationship. The contractor's allocation practice resulted in the government absorbing more tax costs than it would on an allocation base reflecting a causal or beneficial relationship. Nevertheless, the contractor prevailed because FAR or GAAP did not adequately address allocation of costs based on causal or beneficial relationships. The very broad allocation concepts in FAR and GAAP did not narrow the diversity of allocation methods that could be used. Shortly after this dispute, CAS 403, Allocation of Home Office Expenses to Segments, was promulgated. Nevertheless, the contractor continued to dispute any noncompliance with its allocation method. The government successfully challenged the contractor's practice at the ASBCA and subsequent appeals. Ultimately the contractor changed its cost accounting practices to a method that was compliant with the Standard. The change resulted in several million-dollar savings to the government to correct prior practices and more equitable annual tax costs being allocated to government cost objectives.

GAAP has some application to allocation of costs but the principle purpose of promulgating GAAP was not to address allocation of costs to cost objectives. The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information.

To accomplish its mission, the FASB acts to:

1. Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency;
2. Keep standards current to reflect changes in methods of doing business and changes in the economic environment;
3. Consider promptly any significant areas of deficiency in financial reporting that might be improved through the standard-setting process;
4. Promote the international comparability of accounting standards concurrent with improving the quality of financial reporting; and
5. Improve the common understanding of the nature and purposes of information contained in financial reports.

The FASB develops broad accounting concepts as well as standards for financial reporting. Concepts are useful in guiding the FASB in establishing standards and in providing a frame of reference, or conceptual framework, for resolving accounting issues. The framework will help to establish reasonable bounds for judgment in preparing financial information and to increase understanding of, and confidence in, financial information on the part of users of financial reports. It also will help the public to understand the nature and limitations of information supplied by financial reporting.

The CASB's mission is similar to the FASB's mission except that the FASB concentrates on improving standards of financial accounting and reporting while the CASB concentrates on improving cost accounting standards. Their activities are

generally complementary. Without the CASB, divergent cost accounting practices would continue to exist.

The CASB has long been committed to promulgating standards only when the expected benefits exceed the perceived costs. While reliable quantitative cost-benefit calculations are seldom possible, the Board strives to determine that a proposed standard will fill a significant need and that the costs it imposes, compared with possible alternatives, are justified in relation to the overall benefits. DCAA takes a similar pragmatic view of cost and benefit when its auditors perform cost accounting standards compliance audits. The DCAA contract audit manual states that auditors should report only major violations with cost accounting standards, regardless of the effect on contract costs, or the noncompliance has a significant effect on covered contracts either now or in the future. In my experiences, the pursuit of trivial or immaterial noncompliance is an inappropriate use of government and contractor resources and is discouraged. For example, prior to beginning an audit DCAA performs a risk assessment of the subject area. The risk assessment considers, among other things, cost materiality and ability of the contractor's internal controls to detect problems. The assessment of internal controls includes whether the contractor has a system to ensure compliance with applicable laws and regulations. During DCAA's annual planning cycle and during planning for a specific audit, we perform a risk assessment, which drives the audit resources committed to the audit. If the contractor's systems are adequate and comply with policies and procedures and laws and regulations we will reduce our audit scope resulting in savings of contractor and government resources.

The CASB has stated that one of the principal purposes of setting Standards is to measure the full cost of supplies and services acquired by the Government in a way that is fair to both buyer and seller; that is, the cost accounting standard shows neither bias nor prejudice to either party. The CASB recognized that a fair cost accounting standard might result in a shift of cost either to or from government contracts. In formulating standards, shifts of costs should not be determinative. My experience shows that the promulgated cost accounting standards have achieved the CASB's goal of fairness,

because they are based on extensive research of the pertinent issues, considered comments from the affected parties, have theoretically sound basis, and reflect generally accepted accounting practices. For example, during the early 1980s, when CAS 416, Accounting for Insurance Costs, became applicable to a particular contractor, the contractor and I worked on present value concepts for a self-insured worker compensation program. Both parties agreed that the time value of money should provide a fair measurement of the cost and should be reflected in the cost measurement. This resulted in saving the government about \$250,000 annually. The results of contract pricing, however, may be regarded as fair or unfair by either or both parties to a specific contract because fairness is viewed from the personal point of the particular party. Without cost accounting standards the contracting parties will price specific contracts by relying on interpretation of the cost measurement, assignment, and allocation principles in FAR or GAAP. The results on a case-by-case basis, or overall basis, to either the government or the contractor will be decided on without benefit of the exhaustive research or public comment and, as a result, may be unfair. In addition, there may be some unintended costs of each contracting action dealing with similar issues. The standards provide the framework within which the contracting parties can negotiate the contract. The cost accounting standards have placed the contracting parties, in general, on a more equal basis.

In summary, the CASB has developed standards that have narrowed the divergent accounting practices and has resulted in savings to the government far in excess of the implementation costs. I appreciate the opportunity to express my views. Thank you.

**Written Statement to General Accounting Office Panel on Cost
Accounting Standards Board - June 16, 1998**

My name is Bill Romenius. I am the Assistant Controller - Cost Accounting at Company Offices for The Boeing Company and I welcome the opportunity to speak before this panel on issues related to the Cost Accounting Standards Board (CASB). This panel's review of the CASB mission is of particular interest to me due to the fact that my present position's responsibilities include Cost Accounting Standards (CAS) compliance of company-wide policies as well as Company Office costs and centralized payments. In addition, I provided staff support to the first industry representative to the reestablished CASB, Art Lowell.

Another perspective I have of the CASB is gained by virtue of Boeing's significant participation in both commercial and government markets. This is particularly relevant in light of recent Government initiatives such as the Federal Acquisition Streamlining Act (FASA) and the Clinger-Cohen Act with their emphasis on streamlining the acquisition process through, among other things, encouraging the procurement of commercial items and the adoption of commercial practices. Also, with the majority of Boeing business still in commercial aircraft sales, the DOD's focus on Civil/Military Integration is of particular interest in this era of downsizing and increased emphasis on more efficient use of commercial facilities and personnel.

It is from all of these perspectives that I offer my personal thoughts and suggestions for your consideration related to the CASB mission, process and location.

However, before providing those thoughts and comments it might be beneficial to discuss the structure of The Boeing Company. Boeing is currently divided into four principal segments, Commercial Airplane Group, Information Systems Defense and Space (ISDS), Shared Services Group and Company Offices. Utilizing sales dollars over the last five years adjusted for the mergers with Boeing North American and McDonnell Douglas, the split between Commercial and Government business has been approximately 60% Commercial and 40% Government.

For further breakdown, less than 1% of Commercial Airplane Group's business base is Government prime work. Furthermore, concerning Civil/Military Integration, Boeing in Puget Sound has for many years been able to shift work between its commercial and government segments. This has allowed for maintaining core competencies in key technical areas to offset cyclical changes in the commercial versus government business mix.

But taking advantage of these efficiencies has been difficult due to the administrative burden of complying with both CAS and the Federal Acquisition Regulation (FAR). For example, although the prime business base of Commercial Airplane Group is more than 99% commercial, its Government business has exceeded CAS coverage thresholds which requires completing CAS Disclosure Statements, complying with all the CAS Standards and filing an incurred cost overhead claim. In addition, when Commercial Airplane Group supports an ISDS activity, ISDS flows many Government terms and conditions onto Commercial Airplane Group. Because Commercial Airplane Group procured commercial off the shelf

software to run its accounting systems, it has become increasingly difficult for them to provide ISDS the cost information at the level required for ISDS to satisfy government procurement regulations. Taken in their entirety these factors can lead to results counter to FASA, Clinger-Cohen and Civil/Military Integration initiatives.

The CASB was established to provide uniformity and consistency in cost accounting so that the Government would be able to assess the comparability of bids on procurements that were based upon cost rather than price. This was especially the case for long term Government Research and Development Contracts. In theory, cost based pricing protects both the Government's and its contractors' interests by reimbursing contractors on the actual costs of providing the product with a calculated profit or fixed fee. In short, the Government was assured that contractors would not receive excess profits, while the contractor was comforted by the fact that it would be reimbursed for the costs of undertaking long term Research and Development contracts.

But there are costs associated with this system. Contractors are required to disclose in detail their accounting practices for the determination of direct versus indirect costs and the measurement, assignment and allocation of costs to cost objectives. Contractors are also required to comply with CAS as well as the FAR. Compliance with the CAS and FAR requires contractors to develop elaborate cost accounting systems to ensure direct costs are charged to benefiting contracts and indirect costs are allocated over a base that is reflective of the beneficial or causal relationship between the cost incurrence and benefiting cost objective. This is a key objective of

CAS, i.e., to detail the methodology of allocating indirect costs to intermediate or final cost objectives. The FAR cost allowability provisions also impact the contractor's accounting systems. The accounting system required to comply with the CAS and FAR, is complex and labor intensive.

These complex accounting rules have led to disputes related to issues of measurement, assignment, allocation and allowability and the focus has often shifted away from the actual services or products to cost accounting issues. Rather than centering on whether the cost of the product is fair and reasonable, efforts are focused on whether the base used to allocate a cost is CAS compliant, whether a particular cost element is unallowable per the FAR or whether a cost should be recognized when the liability is incurred or when it is paid. It seems that if all the boxes are checked, to verify that the accounting is CAS compliant, and unallowable costs are not charged to the contract, then we are to assume that the product's cost is reasonable.

But is that really the case? Accounting for costs on Government contracts is not a science. Uniformity between contractors is not required in most cases. Further, different interpretations of the CAS and the FAR can lead to different accounting treatments of costs. For example, one company may charge life-cycle cost estimating direct while another charges the function to an indirect cost pool. One company might use a base of hours to allocate an overhead pool expense, while another a labor dollar base. One company could assign a cost element to a manufacturing pool, while another company could assign the same cost to its General & Administrative cost pool. All of these practices could be CAS compliant.

Furthermore, if a contractor funds its supplemental pension plan costs to a certain level it can recognize the entire actuarially derived cost in that period and allocate that amount to contracts. On the other hand, if the supplemental pension plan costs are not funded, only the amount paid will be allocated to contract. Consequently, while both companies are CAS compliant, the costs of the same product could be significantly different. My point is that while CAS provides detailed instructions and acknowledged administrative burdens, it is not mathematics or physics - interpretations can and do lead to different costs of the same product. Accordingly, is such a level of detail required to determine whether the cost of the product is reasonable or are there other alternatives?

FASA and Clinger-Cohen evidenced recognition by the Government that efficiencies in the procurement process can be gained through the expansion of the commercial product definition as well as adoption of commercial practices. Pricing of Government work should be consistent with these initiatives to the greatest extent possible.

I would suggest for your consideration that we should first encourage pricing of the product utilizing market based pricing. This would include catalogue price for the product, bench marking of outside vendor cost or parametrics. For example, Commercial Airplane Group previously negotiated its subcontract work after auditing its subcontractor's cost data. Now, however, the baseline for these negotiations is parametric modeling. This methodology could include internal estimates of the cost of the product and/or reviewing the cost of similar products and applying complexity factors to these costs to parametrically estimate the cost.

Even if the price of the product cannot be determined on market price, cost based pricing is not required if the procurement is competitively bid. It would seem that cost base pricing should only be considered if the price of the product is not determined by either market factors and/or competitive pricing. But here again, how detailed should the requirements associated with determining the "cost" of the product be? I would offer that thresholds for determining CAS and FAR coverage could be raised and such requirements could be less specific, while continuing to protect the Government's interests.

Evaluations in determining thresholds for CAS and FAR should be based upon risk. One suggestion is adoption of a risk mitigation process. Under this process, risks should be identified and their significance calibrated. Consideration should be given to the adequacy of existing accounting systems and percentage of commercial and other competitive based sales. If flexibility is built into the CAS and FAR, through more general requirements and calibration of risks, it may be possible to streamline the procurement process for cost based contracting.

In summary, I believe that in identifying the CASB mission, consideration should be given to such factors as: encouraging market based pricing (including commercial items, bench marking and parametric models), increasing CAS and FAR thresholds in terms of dollars and adding percent of Government business (excluding market based pricing and competitive awards in the Government business definition), and making the regulations more flexible to streamline the cost based pricing process.

Once the Panel determines the CASB mission, it is important to evaluate whether the present CASB structure and location will allow for meeting that mission statement. In my opinion the CASB should be independent of the procurement process and thus able to focus on the development of sound accounting rules and regulations. It would be helpful if the staff would include individuals with experience in industry. This would allow for different perspectives and allow for incorporation of industry initiatives in the CASB deliberations. The location of the CASB should be such that it can act independently of the procurement process and allow more not less discussion and involvement with interested parties.

In conclusion, the CASB can play a pivotal role in determining the ultimate success of FASA, Clinger-Cohen and Civil/Military Integration initiatives. If these initiatives are to succeed, then there is the need to shift from a cost based to a priced based approach. This may be achieved by the expansion of the commercial product definition, use of parametric modeling, and competitive bids. For cost based pricing the raising of CAS/ FAR thresholds (including consideration of market and competitive based pricing as a percentage of total business) and a movement towards more general CAS and FAR would allow for the flexibility that could streamline that pricing process. Maintaining independence from the procurement policy process, infusing industry experience into the staff support function and allowing for greater communication in the promulgation process are further suggested means by which the CASB may meet this mission.

Summary of Presentation to the Cost Accounting Standards Board Revise Panel

My name is Anthony O'Falt, and I have been employed by DCAA since June 1966. I have spent my entire career in the field. Since 1983 I have worked as an FAO (Field Audit Office) Chief at a branch office and four different resident offices. It is from this perspective (a field auditor) that I address you today.

I am advocating the retention of CAS on those negotiated contracts where it is appropriate. This advocacy is based on CAS as an effective deterrent to the misallocation of costs to cost objectives and as an equalizer when costs have been misallocated.

CAS as a deterrent is a difficult concept to demonstrate, but I feel that a review of current DCAA, contractor, and DCMC practices makes this clearer. Particularly when you consider what would happen to these practices and disclosures without CAS. It is hard to monetize the effect of CAS as a deterrent, but one measure is the amounts contractors voluntarily exclude from certified incurred cost claims in compliance with CAS 405. At one major multi-segment company, the contractor voluntarily deleted over \$805 million dollars for a three-year period.

CAS provides a very effective means of recovering the impacts of misallocations and cost accounting changes. This is easily demonstrated by reviewing four actual cases which were settled administratively without recourse to the ASBCA or federal courts. The first concerns a voluntary cost accounting change in the method of reporting income for State Franchise Tax purposes. The others deal with CAS noncompliance issues related to material handling (CAS 418), home office allocations (CAS 403) and workers compensation insurance (CAS 416). The effectiveness of this aspect of CAS is made even clearer when contrasted with the FAR allocability cost principle.

CAS and FARA/FASA do not conflict. If contracts are awarded under any of the means, other than cost data, outlined in these acts, then those contracts are simply not CAS covered. However, as long as companies

have a variety of contract types, including CAS covered contracts, we need CAS to protect the Government from misallocations of costs between CAS covered and commercial contracts.

Presentation for
Cost Accounting Standards Board
Review Panel

By

Anthony O'Falt
Resident Auditor, DCAA
UTC Pratt & Whitney Manufacturing Resident Office

June 16, 1998

Good day. My name is Anthony O'Falt and I've been with DCAA since June 1966 with two years off in 1968 - 1970 for the military. I have spent my entire career in the field. Since 1983, I've worked as an FAO (Field Audit Office) chief, as a Branch Manager, and a Resident Auditor at four major defense contractors and also as a Contract Audit Coordinator for a top ten Department of Defense multi-segment contractor. I've been stationed at locations which manufactured major weapons systems, from nuclear submarines to jet engines and from helicopters to tank engines. Most of my experience, especially as a manager, has been at resident offices.

At DCAA, a branch office covers a specific territory where we audit, on a mobile basis, all contractors within that area that do not have a resident staff. DCAA has resident offices (our auditors actually reside within the contractor's facilities) at contractor locations, which do a substantial amount of flexibly priced and/or negotiated government work. We also have suboffices, where government business is less than a resident office, but still substantial enough to warrant a full time DCAA presence. Suboffices for unaffiliated contractors are organized under a branch office, while suboffices of affiliated contractors are generally organized under an affiliated resident office.

In terms of CAS, there can be a world of difference between branch and resident operations. Contractors at all of the resident offices where I've worked, have been fully CAS covered and most of the cost accounting standards are applicable. While at the branch offices, more and more of our contractors are not covered by CAS or subject to only modified coverage primarily because of the increased thresholds for CAS applicability and perhaps due to the declining value of CAS covered contracts. At branches, we have to constantly be alert to the award of a contract which triggers CAS coverage, while at all the residencies, where I've worked, that was not a concern. Another difference, which I have noticed, is that all of the residencies within my experience have undergone significant system changes, including the cost accounting system. These have involved changes from job order to standard costs, expansion of the number of overhead pools, and changes in the composition of allocation bases. Basically, the difference between CAS at branches and residencies is one of materiality. While I have experienced substantial issues

(monetary value) at branch contractors, the largest cost impacts have occurred at resident offices.

Through the years, I've grown up with Cost Accounting Standards, from the promulgation of the first standard, through the initial Disclosure Statement adequacy reviews; from implementation of CAS 410 and 418, and review of related cost impact statements through determinations over what constitutes a change in cost accounting practices. In those early years, most companies had CAS experts, as did DCAA. These people were groomed, primarily through continual training and exposure, as the office's CAS monitors. At DCAA, a CAS monitor was the office's CAS expert; someone you could confer with on CAS-related problems. Particularly during the early years of standard promulgation, we needed someone to concentrate on this area. Through the gradual processes of training, exposure and auditing, and the cessation of new standards, CAS became as familiar to most auditors as FAR. Today, you will be hard pressed to find a CAS monitor in a field audit office. You may find auditors whom once occupied that position, but they no longer concentrate solely on CAS. Much the same can be said for industry. Over the past 5-10 years, I can not think of one contractor representative whose job is only related to CAS. Like DCAA, contractor government accounting/liaison personnel have become familiar and used to CAS.

All of the major defense contractors that I have audited now have cost accounting systems in place to accommodate the requirements of Public Law 87-653. For the most part, these systems are integrated into their normal financial systems and require no more off-book records, than does tax accounting.

I'm here before you to be an advocate for the retention of the CAS Board and Cost Accounting Standards. I'm not advocating an expansion of CAS to currently exempted contracts, but only for its continuation on those negotiated contracts where it's appropriate. I believe that CAS serves as both a deterrent to the misallocation of cost to contracts and an equalizer when costs have been misallocated.

I'll attempt to tackle the hardest of these concepts, CAS as a deterrent, first. Since the promulgation of CAS, we have not had a period

without CAS. Therefore, a before and after CAS comparison is not feasible to determine the impact of CAS as a deterrent. Maybe by discussing some of the practices industry and DCAA now use, you may get a feel for this concept. It's rare, in recent times, that when a major contractor makes significant changes to its cost accounting practices, that DCAA finds out about these changes through a Disclosure Statement Submission after the changes have been made. My experience is that contractors discuss their contemplated changes with DCAA openly prior to implementing them. Many times after periods of discussion, we come to some basic agreement concerning the change. Generally, this results in the elimination of potential noncompliances, before they actually become noncompliant practices. If there's an issue over whether or not a practice is compliant, generally the parties can identify the appropriate cost accounting.

I'll use the change of including fringe benefits in the direct labor allocation bases as opposed to overhead pools as an example. Fringe benefits, such as health insurance, life insurance, payroll taxes, and worker compensation are normally included in indirect cost pools and allocated to cost objectives over a direct labor dollar base. This change, which many companies have adopted, deletes benefits from the overhead pools and adds them to the direct labor base by means of a fringe benefit factor. If done properly, the cost per direct labor hour (labor, fringes and overhead) will not change. The contractor, in my example, wanted to use one overall factor for engineering and manufacturing labor. DCAA pointed out that while the benefits for both the engineer and the factory worker may not be significantly different, the relationship to direct labor may vary significantly because of the higher pay scale of the engineer. The use of an overall factor for engineering, where most of the labor on flexibly priced contracts is incurred, will be overstated, while the use of an overall factor for manufacturing, where most of the labor on fixed price contracts is incurred, will be understated. The company responds that they don't accumulate benefits by engineering and manufacturing. However, they do accumulate them by hourly and salary and it turns out that hourly and salary and manufacturing and engineering are virtually synonymous. A solution was found and a noncompliance avoided.

After the practice is agreed to, the company prepares a draft disclosure statement revision for DCAA's review. Here the issue is the adequacy of the description of the proposed change. DCAA and the contractor don't always agree, but through the same open process of candid fact-finding, the parties iron out their differences. Not surprisingly, these early discussions and drafts, lead to a better understanding of the change and its cost impact on CAS covered contracts, at least in terms of whether or not it's material. But you may say, and I have said, since companies have systems in place to handle CAS, why would anything need to change if CAS were abolished or significantly weakened? First off, remember I said CAS was a deterrent. Without formal Disclosure Statement requirements and procedures, why would companies engage in the above discussed practices? By what other vehicle would the government be aware of cost accounting changes? If there were no CAS, what would require the contractor to make the disclosure? And if you would have to add a new law or regulation to accomplish this, why bother? Simply keep CAS.

So we'll keep the Disclosure Statement requirements and get rid of the Standards. Go back to my discussion on how the fringe benefit issue was resolved, but now attempt to do it without CAS 418. Without CAS, we would have to rely on FAR, in particular FAR 31.201-4 - Determining allocability. A reading of this cost principle discloses that it is very general. It states: A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. A cost is allocable to a Government contract if it is:

- (a) incurred specifically for the contract,
- (b) benefits both the contract and other work and can be distributed in reasonable proportion to benefits received, or
- (c) is necessary for the overall operation of the business.

That's it! FAR lacks the specificity, criteria and examples of the Cost Accounting Standards. For example, CAS 418 provides for: (i) consistent determination of direct and indirect costs, (ii) criteria for the accumulation of indirect costs in indirect cost pools and (iii) guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives.

Admittedly, misallocations or noncompliances with CAS are the exception rather than the rule. But when these exceptions occur, without CAS, we are left with the FAR allocability cost principle. As I stated above, I do not believe that this cost principle has the teeth or specificity of CAS. I'll illustrate by citing a few actual cases without reference to the companies involved. All of these cases were settled administratively without recourse to the courts or ASBCA, although prior court or ASBCA rulings may have eased the administrative settlements.

Back in the early 1980s, many companies changed from a percentage of completion to a completed contract method of recognizing income for state franchise tax (SFT) purposes. This practice was eventually recognized as a cost accounting change and resulted in the government recovering millions of dollars on previously negotiated firm fixed price contracts. Companies would have estimated SFT using the percentage of completion method for determining income and recovered these estimates in their negotiated firm fixed prices, without paying the taxes until the contracts were completed, thereby recognizing windfall gains. Further, in their subsequent estimates for future contracts, they would include the SFT based on the completed contract method, thereby, recovering part of the total tax again. I don't have statistics on how much the government recovered as a result of this change, but at the one company I was involved with, the government recovered close to \$5 million. Since this was a popular accounting practice change in industry, the total recovery was probably many times that amount. Without CAS, what would have been the vehicle for recovery of these amounts? Unlike a lot of other accounting practice changes, whether voluntary or to resolve a noncompliance, these savings were a one-time occurrence. After recovery of the overstatements, franchise taxes were estimated and costed on the same basis – the completed contract method.

My next example involves a subsidiary of a major defense contractor. This company's business was primarily cost-type design, development and prototype manufacturing of one of-a-kind high tech items. It recovered its material handling expenses over manufacturing and engineering direct labor dollars. It received a huge firm fixed price contract for thousands of production items, which almost doubled its sales, but the company did not

revise its cost accounting practices. The vast majority of its direct material was now purchased for the production contract, but cost-type engineering contracts with little or no direct material absorbed over half of the material handling expenses. The answer was a material handling pool with direct material cost as the allocation base and it took a CAS 418 noncompliance to achieve this end. This change saved the government almost \$1 million dollars of misallocated costs on flexibly priced contracts. In terms of avoidance, there was no continuing impact, because virtually all of the company's business was with the government. Once the misallocation was corrected, the government's various contracts received their allocable share of material handling expenses. But imagine if all flexibly priced contracts are government R&D contracts, while all production contracts are commercial work. Without CAS 418, the government could continue to be charged with inequitable material handling costs.

Another example pertains to CAS 403, allocation of home office expenses. A company was allocating some of its home office expenses over bases consisting of only a portion of its commercial segments, but all of its government segments, thereby disproportionately charging its government operations tens of millions of dollars which should have been absorbed by its commercial operations. Perhaps this situation could have been remedied through the FAR allocability cost principle, which I doubt for reasons previously explained, but thanks to CAS 403, there's no doubt it was corrected. The government recovered over \$16 million as a result of the overpricing of CAS-covered contracts. Further, unlike the previous examples, these savings continue every year from the corrected allocations.

CAS 416 requires the discounting of self-insurance estimates. Thus, the government pays for the estimates of current year's claims up front on a discounted basis. Intrinsic in this method of calculating and paying claims is that once the government pays the present value of the claims, it is off the hook unless there's a change in the liability or payment stream. Through its reforecast adjustment, a company was claiming the difference between the discounted liability and the cash payments. Therefore, over time it was actually charging the government for the actual payments made on claims despite the government having paid for the discounted value of the claims in prior years.

This case also represents an excellent example of the three parties (DCAA, DCMC and the contractor) working to resolve a CAS problem. DCAA identified the problem and convinced the ACO that immediate corrective action was needed. The ACO, without a noncompliance report, issued an initial finding of noncompliance and within a week, the contractor ceased its practice. Thereafter, the parties worked together with the company's actuaries to develop a compliant practice and to determine the impact. A methodology for the cost impact was developed among the parties and a Memorandum of Agreement was executed. The company identified over \$41 million of excess payments which were excluded from incurred cost submissions resulting in savings of \$3.3 million on flexibly priced contracts. The parties are still working on the impact applicable to fixed price CAS covered contracts using the agreed-to procedures. Also, like the prior example, these costs continue to be avoided, saving the government millions of dollars annually.

These are but a few examples that show that CAS is an excellent vehicle for correcting the affects of inequitable charging practices. But they represent only the very tip of the iceberg when measured against the amounts that have been avoided by compliance with CAS. For example, at one major multi-segment company, the contractor voluntarily excluded, in accordance with CAS 405, in excess of \$256, \$237, and \$312 million from its final overhead submissions for the last three fiscal years for which it submitted certified claims.

Before closing, I'd like to offer a few comments concerning CAS and the Federal Acquisition Reform and Streamlining Acts. In my opinion, the two do not conflict. If a company is awarded a contract through any of the many means introduced and encouraged by FASA and FARA, that don't involve contractor submission of any cost data, that contract is simply not CAS covered. And if that same contractor successfully wins all of its business on a non-CAS-covered basis, such as commercial pricing, CAS is not a factor. However, in my experience, I haven't come across many contractors whose business is all of one kind. There's usually a mix and included in that mix are cost type contracts, negotiated fixed price contracts, as well as commercial contracts. This is where CAS is most needed. CAS deals with allocability and ensures that one contract or class

of contracts, such as negotiated fixed price contracts, are not bearing an unallocable share of costs that rightfully should be charged to commercial contracts. The commercial contracts are not CAS-covered, but some of the government contracts are, and those CAS-covered contracts require an equitable allocation of costs. As I said in starting, I'm not advocating an expansion of CAS to exempted contracts, but I strongly urge you to keep it in place for those contracts that currently warrant it to protect American taxpayers.

In closing, I would like to remind you of a few points that hopefully I've made:

- First, CAS is an effective deterrent to misallocations;
- Second, in those cases when it is not effective, it provides an excellent means of recovery;
- Third, it is a vehicle which keeps the government apprised of contractor cost accounting changes;
- Fourth, it does not conflict with FARA or FASA;
- And lastly, try to answer the following questions before you make any recommendations regarding CAS. How will we enforce consistency in estimating and costing without CAS 401? What would happen to pension costs governed by CAS 412 and 413 and deferred compensation and insurance without CAS 415 and 416?

Thank you for your time and patience. I will be happy to try to answer any questions you may have.

REMARKS FOR COST ACCOUNTING STANDARDS BOARD REVIEW PANEL

JUNE 16, 1998

**ALAN R. TINTI, DEFENSE CORPORATE EXECUTIVE
DEFENSE CONTRACT MANAGEMENT COMMAND**

Thank you for this opportunity to address the CAS Board Review Panel. My name is Alan Tinti. I work for Defense Contract Management Command. I am currently the Defense Corporate Executive for United Technologies Corporation, the parent company of Pratt & Whitney (which manufactures aircraft engines), Sikorsky Aircraft (helicopters), Otis (elevators), Carrier (air conditioners), and a variety of other units producing both commercial and military products and services. I have worked as a contract administrator and contracting officer for the Air Force and DLA for 26 years, starting in 1972 (the same year CAS 401 was promulgated). Over those 26 years, I have administered contracts with literally hundreds of different contractors of all sizes, providing everything from burial services to jet engines. In all cases, the responsibility for resolution of any cost accounting standards issues with these contractors was mine as the contract administrator or contracting officer.

In my current position as DCE for United Technologies, I not only have the responsibility for resolution of any CAS issues that arise on UTC Corporate Headquarters expenses and corporate-wide costs such as insurance and pension plans, but also to provide advice and assistance to administrative contracting officers at UTC's operating units to ensure consistent approaches to CAS and other business issues involving Government contracting throughout the Corporation. In this role, I have been directly or indirectly involved in numerous issues involving CAS disclosure statements, accounting changes, and noncompliances.

As you can probably tell by my listing of UTC's major operating unit products, the company I deal with now is heavily involved in commercial as well as government business. In fact, out of \$24.7 billion in total sales on a consolidated basis in 1997, only \$3.3 billion, or about 14%, were to the U.S. Government. While \$3.3 billion is a large figure in absolute terms, and the U.S. Government is still UTC's largest single customer, this is an organization that is primarily designed to succeed in highly competitive domestic and international commercial marketplaces. Moreover, the operating units of UTC which have the largest amount of government business (Pratt & Whitney, Sikorsky, and Hamilton Standard) all develop and manufacture products for the government in the same facilities and on the same production lines in which commercial products are developed and manufactured. They all have standard cost-type accounting systems, which do not differentiate between military and commercial costs prior to output. Put another way, United Technologies and its aerospace operating units have been practicing real civil-military integration out of necessity long before it became a topic of interest for our acquisition reform initiatives.

Based on 13 years of experience dealing with UTC in this mixed environment, I believe I am in a good position to comment on the Panel's stated interest in the role of

Cost Accounting Standards and the CAS Board in an evolving integrated civil-military industry; so I would like to focus my remarks in that area. In general, it is my feeling that experience instructs us that CAS requirements for disclosure of accounting practices, mechanisms for handling accounting changes, and at least certain of the CAS Standards, remain key tools for protecting the Government's interests where we continue to use cost-based contract forms, and in some instances of price-based contracting, in dealing with civil-military integrated organizations.

I suspect most commentators will agree that disclosure requirements and standards involving basic consistency in accounting (401,402) are needed to at least maintain a "level playing field" in the Government-contractor relationship. A sophisticated and knowledgeable contractor like UTC will rarely have difficulties in these areas. However, of the three aspects of cost that CAS governs; measurement, assignment, and allocation of costs; the vast preponderance of CAS issues that have in the end had significant impact on costs at UTC have involved allocation, or how overhead costs are shared across a contractor's business. It should be fairly obvious why this is true; when making decisions about how to account for costs in an integrated facility, the method that allocates more costs to Government cost-based contracts makes commercial products more competitive and Government price-based contracts more profitable. The CAS standards that establish the general rules for equitable allocation of costs across a contractor's business (403, 410, 418, and 420) also happen to be those that are least intrusive in terms of requiring specific accounting treatments that may be at variance with a contractor's commercial practices.

I would like to describe a matter to you on which a hearing was held in April of this year before the Armed Services Board of Contract Appeals that illustrates the risk of eliminating or radically modifying CAS in integrated facilities. In the early 1980's, Pratt & Whitney started acquiring components for commercial jet engines from some foreign suppliers under arrangements the company termed collaboration agreements. These arrangements differed from normal purchase orders in that the "collaborators" received a percentage share of the revenue from the ultimate sale of the engines as payment for their parts. Now I am fairly certain this practice was initially conceived without consideration to its effect on the Government's business at P&W; it was primarily intended as a method of sharing the risk of selling commercial jet engines during a difficult period in the passenger airline business. However, the powers that be in government accounting at P&W at some point made a decision to adopt the practice of not allocating any overhead costs or G&A to collaborator components; whereas similar components purchased for government engines received full material overhead, G&A, and IR&D. Since the government and commercial work at P&W share common overhead cost pools, this practice reduces the allocation base for the pool costs, drives rates up, and increases costs on U.S. Government production engine programs. The Divisional ACO at P&W cited the company for CAS 410, 418, and 420 noncompliances; and calculated that this accounting practice has resulted in increased costs to government programs to the tune of more than \$260 million (inclusive of interest).

It is not my intention to try this case before this Panel. Pratt & Whitney has appealed the ACO's decision and presented a number of arguments at length to the Armed Services Board as to why their practice is appropriate and compliant. They may prevail in the Board's decision or through a subsequent appeal. Nor do I want to portray P&W or UTC as "bad guys"; there are no allegations of fraud, and UTC has a strong internal ethics program. This is an honest difference of opinion and a matter of public record. Yet I think it is indisputable that it is the existence of an integrated civil-military facility and accounting system that created an incentive for the collaboration accounting adopted by P&W. And it was only the existence of CAS that gives the government a remedy should we be proven correct in court.

There is no doubt that civil-military integration, where feasible, can have huge benefits for both sides of the business. "Aviation Week & Space Technology" recently quoted Carl Meece, the Director of Pratt's turbine component center, as crediting the military ATEGG (Advanced Turbine Engine Gas Generator Program) with providing the technology that made the radically advanced PW8000 geared fan commercial engine possible. "We finally realized—again—that leveraging our military technology into our commercial products makes sense". Likewise, many developments on commercial engine components and manufacturing techniques have found their way into government programs over the years. It is this sharing of technology, and of R&D expenses and other overhead costs, that makes integration so attractive to us. But to have the maximum benefit to government programs, this sharing must be done fairly and equitably, and it is CAS that gives auditors and administrative contracting officers the rules and tools to assure that it is.

None of this is to say that CAS should be retained in its entirety. Other commentators have already pointed out standards, originally promulgated in the name of uniformity, which cover issues adequately addressed in commercial accounting standards. CAS 404 and 409, the capitalization and depreciation standards, are often offered as examples of standards which could be looked at for elimination. I would not argue with that conclusion. There may be other standards, or sections of standards, that fall into the same category.

I have tried to make an argument that CAS, particularly its general consistency and allocation provisions, is an important tool to assure that the full benefits of integration are achieved by the government when contracting in an integrated civil-military environment. A real opportunity for acquisition reform in an integrated business environment may lie in the area of cost reasonableness vs. cost allocations. Some of the rules governing allowability of costs in FAR Part 31 are designed to establish criteria for reasonableness of costs. The definition of a reasonable cost in FAR; i.e., a cost which "...in its nature and amount, does not exceed that which would be incurred by a prudent person in the conduct of competitive business"; itself recognizes market forces as the benchmark for determining reasonableness. Certainly, at a company like UTC, investor pressures and the competitive marketplace do a far better and more finely calibrated job of controlling costs than our regulations can do. Yet the current regulations allow for no presumption of reasonableness for costs incurred by commercially oriented companies

vs. those with a heavy preponderance of cost-based government business where the incentive to control costs may not be so strong.

The Department of Defense once had a program called Contractor Weighted Average Share, or CWAS, that largely eliminated the regulatory requirement to apply reasonableness standards to companies that qualified as having a substantial percentage of commercial or competitive business, and where costs pools were shared between the government and commercial work in an integrated environment. CWAS died in the early 1980's, for reasons that I am not entirely familiar with. It may be the appropriate time to re-look at the concept.

This concludes my remarks. I would be happy to try to address any questions that you may have.

McKenna & Cuneo, LLP

Attorneys at Law

**Statement of Alan C. Brown
Partner, McKenna & Cuneo, L.L.P.
Before The
Cost Accounting Standards Board Review Panel**

June 16, 1998

Messrs. Chairmen, Members of the Panel, I appreciate the opportunity to testify here today. My name is Alan C. Brown, and I am a Partner in the law firm of McKenna & Cuneo. I have practiced government contract law for over twenty years, and a significant portion of my practice over those years has involved counseling contractors on, and litigating controversies involving, the interpretation and application of Cost Accounting Standards. As I am sure you have heard and will continue to hear from various witnesses during these three days of hearings, the issues this Panel is confronting are important and need to be addressed.

I will leave it to others to address whether, with the new and commendable emphasis on commercial procurement practices, and with development of other accounting standards bodies such as the Financial Accounting Standards Board, the CAS Board has become an expensive and counterproductive anachronism. I hope, nonetheless, that the starting point for the Panel's recommendations will be whether government-contractor specific Cost Accounting Standards are necessary at all. My comments today, though, will assume that the existing or a similar CAS Board will continue to exist for some period into the future, and I will limit my remarks to the role of the Industry Representative Member of the Board.

During the ten years since the Cost Accounting Standards Board was recreated within the Office of Federal Procurement Policy, something has gone awry. During the Congressional

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hearings on the reauthorization of the CAS Board, the Comptroller General testified, and the Senate Government Affairs Committee in its Report on the OFPP Act Amendments of 1988 agreed, that allocability – the single issue assigned to the CAS Board – is an accounting issue, not a procurement policy issue. S. Rep. No. 100-424, 100th Cong. 2d Sess. at 17. The Governmental Affairs Committee also emphasized the importance of public participation in developing Cost Accounting Standards. Yet the recent actions of the CAS Board manifest an abandonment of both of these principles – the primacy of sound accounting, and openness and public participation.

One manifestation of this is the extent to which the edicts of OFPP and OMB have hamstrung the Industry Representative on the CAS Board in fulfilling her or his responsibilities. In recreating the CAS Board, Congress made a clear distinction between “procurement policy” which it considered a governmental function and with exclusive preview of the procuring agencies, and cost allocability, which it considered an accounting issue and assigned to a Board made up of a diverse group of government and non-government members. Two of the members are required by statute to be from the private sector – one an expert in accounting problems and systems, and one “shall be a representative of industry.” 41 U.S.C. § 422(a)(1)(B).

Each Board Member brings to the table her or his specific background and interests. Each member also needs staffing support that reflects that Board Member’s unique perspective. The CAS Board staff plays an important role in supporting the Board as a whole, but does not have the industry, accounting profession, or DCAA experience to meet the needs of the individual Board members. Each member needs a staff that can support her or his own analysis

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and preparation of proposals, data, and positions. Equally importantly, as a policy as well as a practical matter, the CAS Board staff should not be asked to develop position papers or proposals that reflect the views of only one member or that dissent from the majority position.

For most of the period since 1988, this staffing problem was addressed without difficulty. Since, as anticipated by Congress, each Industry Representative Member has while serving on the Board remained a senior official of a CAS-covered Government contractor, each member designated one of his own company staff to assist him on CAS Board matters. Mr. Bill Romenius of Boeing, who is also testifying before you, served as the staff assistant to Board Member Lowell; Mr. Neil Woodson of Texas Instruments served in that capacity to Board Member Self. These staff assistants accepted and were bound by the same conflict of interest and confidentiality provisions that applied to the Member himself.

With the appointment of Yvonne Perlberg to the Board in 1997, however, that practice was abandoned. Despite the stated willingness of Hughes Electronics Corporation – Ms. Perlberg's employer – to provide a member of her staff to assist her as Boeing and Texas Instruments had done before, she has been prohibited from discussing any CAS Board matters with anyone other than a person who works for OMB, is detailed to OMB, or has been hired as a consultant by OMB.

Other steps have been taken or proposed to further isolate the Industry Representative Member from her constituency, including a requirement to share any communications received from industry with all other members of the Board, and a requirement to maintain a log of all contacts.

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There is no legal basis for these requirements. Their only effect – and I must assume their intended effect – is to inhibit communications between industry and the person that Congress identified as its representative on the Board. It is as if Congressmen and Senators were prohibited from communicating with or receiving proposals and assistance on legislation from their constituents. No person can serve as a “representative” if she or he is barred from discussing ideas with those being represented. The mentality that produces these restrictions is one that insists that the Industry Representative Member abandon that statutory role and instead act as a dedicated “Government” representative when serving on the Board. The result is a loss of the balance in the deliberations of the Board that Congress mandated.

The proceedings of the CAS Board should become more, not less, open and participatory. Section 26 of the OFPP Act specifically mandates consultation and discussion with professional accounting organizations, contractors and other interested parties. It requires that the Board in making its pronouncements consider the cost of implementation, the advantages and disadvantages in the administration of constructs and settlement of contract disputes that will result, and available alternatives. 41 U.S.C. § 422(g)(1).

Similarly, the Board’s May 1992 Statement of Objectives, Policies and Concepts, (published at 57 F.R. 31036, July 13, 1992), states that “the promulgation of any Cost Accounting Standard is characterized by an in-depth study of the subject and by participation of various interested parties.” The Statement requires research into existing practices as well as new concepts.

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Indeed, the Board's Statement of Objectives, Policies and Concepts specifically contemplates discussions with individual members and states:

Sometimes, interested members of the public may be invited to meet with individual Board Members or the Board's staff.

These openness requirements can only be satisfied if there is meaningful input from the affected contractors while proposals are being conceived and developed, not just after the proposals have been published. Beyond the public comment process, Congress created a specific mechanism for input from industry by requiring that industry be represented on the Board itself.

Had this not been the intent, Congress could easily have specified that one member of the Board be merely a person knowledgeable about industry, as it did with respect to the "knowledgeable accountant" member. But it instead created a "representational" status. This statutory role requires full and unfettered communications between that representative and her constituents.

The explanation for the new restrictions on the use of staff is the litigation before the Armed Services Board of Contract Appeals involving Gould. Gould Inc., ASBCA No. 46759. In that case, the contractor sought through discovery testimony and documents from the CAS Board and argued that any governmental or deliberative process privilege applicable to the documents had been waived by disclosure to persons outside the Government. But the Gould case is at most an excuse for the prohibition; it is not a justification.

First, in Gould the Board rejected virtually all of the contractor's discovery demands. The Board did not agree that disclosure to the staff of the Industry Representative Member had

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waived any privilege. At least one of the documents at issue, however, had been distributed far beyond any "staff," but had been provided by the CAS Board staff to the American Society of Actuaries.

The truth is that not one document was ordered disclosed because it had been provided to Mr. Romenius or Mr. Woodson. The Gould case provides no basis whatsoever for banning use of personal staff in the future.

The prohibition also ignores well-established case law that the governmental or deliberative process privilege extends beyond Government employees. See, e.g., Public Citizen, Inc. v. Dept. of Justice, 111 F.3d 168, 170 (D.C. Cir. 1997); CNA Financial Corp. v. Donovan, 830 F.2d 1132, 1161-62 (D.C. Cir. 1987) cert. denied, 485 U.S. 977 (1988); Ryan v. Dept. of Justice, 617 F.2d 781 (1980).

In Donovan, the Court explained:

It likewise is clear that the agency's privilege to withhold the reports is unaffected by the fact that they were prepared by a consultant from outside the agency. In Ryan v. Department of Justice, we recognized that

[I]n the course of its day-to-day activities, an agency often needs to rely on the opinions and recommendations of temporary consultants, as well as its own employees. Such consultations are an integral part of its deliberative process; to conduct this process in public view would inhibit frank discussion of policy matters and likely impair the quality of decisions.

* * *

Similarly, courts have repeatedly found that a privilege attaches to reports of outsiders commissioned by an agency to perform agency

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work, when such reports would be protected if compiled within the agency itself. Whether the author is a regular agency employee or a temporary consultant is irrelevant; the pertinent element is the role, if any, that the document plays in the process of agency deliberations. If information communicated is deliberative in character it is privileged from disclosure, notwithstanding its creation by an outsider.

830 F.2d at 1161 (footnotes omitted).

Moreover, it is not necessary that the outsider be a paid consultant of the Government, or that there be any formal relationship with the agency. In Formaldehyde Institute v. Dept. of Health and Human Services, 889 F.2d 1118 (D.C. Cir. 1989), the Court determined that unsolicited comments received by the agency from the editorial board of a scholarly journal were part of the deliberative process of the agency.

These cases make clear that inclusion of the non-Government staff of Board members in the Board's deliberations is not a barrier to the assertion of the deliberative process privilege. While the treatment of non-federal employee staff under previous CAS Board procedures was adequate to meet this standard, if there is any lingering concern, simple action by the CAS Board could assure that such an interpretation would prevail. The CAS Board could announce publicly (by publication in the Federal Register, for example) the names and positions of the non-federal employee staff members selected to assist the industry and accounting representatives on the CAS Board. This notice would serve to establish a specific and important role for the non-federal employee staff and thereby bolster the argument that they play a role that is essential to the accomplishment of decision-making by the CAS Board.

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Alternatively, the CAS Board regulations could be amended to explicitly designate non-federal employee staff of the Industry Representative and Accounting Profession Members as agents of those Members. The amendment could specify that the conduct of the non-federal employee staff is governed by the same standards, rules, and regulations as the conduct of the industry and accounting representatives. Again, this action would formalize the relationship of the non-federal employee staff to the CAS Board and enhance the basis upon which to maintain the deliberative process privilege.

In addition, the non-federal employee staff of the industry and accounting representatives should be bound by the same confidentiality obligations as their principals with whom they serve. CAS Board policy could be modified to explicitly preclude the staff from sharing any CAS Board documents they have received with any person other than those officially authorized to act on behalf of the CAS Board. In addition, the policy should require that internal controls be put in place at the private sector employees of the non-federal employee staff to ensure that others would not gain access to, nor in any way review, documents produced by the CAS Board.

Again, it is important to note that it would not be necessary to make the non-federal assistants employees of the United States to accomplish these goals. The key to the applicability of the deliberative process privilege here is that the communications with the non-federal employee staff is crucial to the effective deliberations of the CAS Board, and thus confidentiality must be maintained to encourage candor. See Army Times Publ'g Co. v. Dept. of the Air Force, 998 F.2d 1067, 1072 (D.C. Cir. 1993).

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In sum, the CAS Board was not structured by Congress to be a partisan body, but to be a balanced group, with representatives of all concerned parties, guided by sound accounting practices. The Board's own Statement of Objectives, Policies and Concepts emphasizes the importance of fairness and equity, and of input from all parties. It states:

The Board considers a Cost Accounting Standard to be fair when in the Board's best judgment it provides equitable allocation of costs to contracts and shows neither bias nor prejudice to either party to affected contracts.

The recent actions of the Board suggest that this principle has been lost; the limitations placed on the Industry Representative Member of the Board suggest a desire to stifle meaningful input and participation by contractors.

No legislation is necessary to correct these problems. What is required is a commitment from OMB to abide by the Congressional mandate that one member of the Board shall be a representative of industry. What is required is a commitment to openness in the Board's actions and deliberations, to participation by all affected parties, and to meaningful and unfettered communications between industry and its representative on the Board.

I urge the Panel, as part of its proceedings, to examine these issues. If it should ultimately recommend that the current or a similarly structured CAS Board continue in existence, I hope that the recommendations will include improved staffing for all of the Board members, and procedures to ensure full and open communications with all affected parties.

I would be happy to answer any questions you may have.

**Testimony of Bert M. Concklin
President, Professional Services Council**

before the CAS Board Review Panel

June 16, 1998

The Professional Services Council appreciates the opportunity to offer our views on the future of the Cost Accounting Standards Board.

In its May 21, 1998 Federal Register notice, the GAO Cost Accounting Standards Board Review Panel stated that it is especially interested in:

- 1) The CAS Board's mission in a rapidly evolving integrated civil-military industry;
- 2) The costs, benefits, and risk assessment in the application of CAS to government contractors (including differences based on industry, segment, type of cost, character of goods or services, contract type, etc.)
- 3) The relationship of cost accounting standards to GAAP, activity-based cost systems, and cost allowability principles (including levels of complexity, overlap, duplication, conflict, etc.)

Ultimately, all of these issues overlap and interact with one another. The Professional Services Council believes that the need for cost accounting standards has changed dramatically since 1968, when Congress passed the legislation authorizing the CAS Board. The context of acquisition differs fundamentally from the context over the last 30 years. The major dynamics which have transformed the federal acquisition system include: (1) Intense competition for most goods and especially services; (2) Increasing availability of commercial solutions, especially in the information technology domain; (3) Major reform and deregulation of the federal acquisition system and; (4) An absolute imperative to achieve civil-military integration in major areas of DoD purchasing. Accordingly, the application of cost accounting standards is no longer appropriate in the same manner as it was previously.

According to the May 1977 Restatement of Objectives, Policies and Concepts issued by the original CAS Board:

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The primary objective of the Cost Accounting Standards Board is to implement P. L. 91-379 by issuing clearly stated Cost Accounting Standards to achieve (1) an increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and (2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time. . . .

Increased uniformity and consistency in accounting improve understanding and communication, reduce the incidence of disputes and disagreements, and facilitate equitable contract settlements.

The cost accounting standards were not ends to themselves but were believed to be necessary to aid the government in negotiation of contracts. In its feasibility study (B-39995) undertaken pursuant to statutory direction contained in Section 718 of the Defense Production Act of 1950, as amended (82 Stat. 279, July 1, 1968), the GAO focused on the need for cost accounting standards to aid the government in negotiating contract prices. The GAO stated:

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.

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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 endure 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.

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.

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. . . .

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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.

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.

-- 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.

(Emphasis added.)

Clearly, one of the driving concerns which led to the conclusion that cost accounting standards were needed was the large number of negotiated procurements in which prices were based on cost estimates, supported by cost data, in the context of a lack of competition and a lack of market restraints. In short, Congress concluded that cost accounting standards were necessary where cost data must play a large role in contract negotiations not subject to effective competitive or market restraints. Within that context, Congress chartered the CAS Board to issue standards

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to achieve an increased degree of uniformity and consistency in contractor cost accounting practices.

The context of acquisition today is entirely different that it was 30 years ago. Under acquisition reform, the mandate is for the government to rely on cost analysis and cost or pricing data submission as the exception rather than the rule. Congress requires that the government rely on commercial items rather than government-unique goods and services to fulfill government requirements. Under these circumstances, the need for cost accounting standards to serve the role originally envisioned does not exist in the same manner as previously. Accordingly, to the extent that the CAS Board has any continuing mission -- and there is no forgone conclusion that any such mission does continue -- such mission must recognize these significantly changed circumstances.

The CAS Board has no mission with respect to contracts for which cost or pricing data are not required or submitted. Any procurement that does not require cost or pricing data submission must also not require compliance with cost accounting standards.

We believe that the strategic focus of the CAS Board should be fundamentally altered. First, the Board's life should be sunsetted, perhaps in the three- to five-year range. Second, the board should embark on an aggressive reform and deregulation path, substituting GAAP standards for government-unique standards except in the minority situations where an absence of competition cannot assure fair prices. And third, the Board should be more independent, have

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broader private sector representation, provide a mechanism for fast track, interactive, issue processing and be augmented with an objective, independent staff.

The Professional Services Council thanks the Review Panel for the opportunity to offer our views on this important issue. We are available, at your convenience, to further elaborate our position.

GENERAL ACCOUNTING OFFICE
COST ACCOUNTING STANDARDS
BOARD PANEL REVIEW
PUBLIC MEETING

RAYTHEON COMPANY COMMENTS

JUNE 17, 1998

**RAYTHEON COMPANY
COMMENTS ON PENDING GENERAL ACCOUNTING OFFICE PANEL REVIEW OF
COST ACCOUNTING STANDARDS BOARD**

Mr. Chairman and members of the committee, thank you for this opportunity to appear before you today to provide Raytheon Company's thoughts on the GAO's pending review of the Cost Accounting Standards Board.

My name is Chuck Ream and I am the Senior Vice President, Finance of Raytheon Systems Company. Accompanying me today is Bob Morales, who is our Director of Government Accounting.

Raytheon Company is a world leader in defense electronics, including missiles, radar, surveillance and intelligence, training, simulation and services and naval and air traffic control systems. We are the third largest US military contractor with more than \$14 billion in defense sales and over 120,000 employees worldwide.

My comments today will not dwell on any particular aspect or action of the CAS Board. Instead, my remarks will focus on those issues Raytheon feels are of particular importance to the pending CAS Board review.

A summary of the issues I will speak upon today are as follows:

- I. Need for a review of the CAS Board;
- II. Impact of CAS on a contractor's business decisions;
- III. Existing CAS and Generally Accepted Accounting Principles (GAAP);
- IV. CAS Board focus: accounting principles vs. public policy;
- V. Need for examining the independence of the CAS Board;
- VI. Need for examining staff support to CAS Board members;

I. NEED FOR A REVIEW OF THE CAS BOARD

The past few years have also been a period of significant change for the defense procurement environment. The Administration, Congress and DoD have implemented several far reaching policy initiatives that have changed the economic structure of the defense industry and the process of acquisition and oversight. Raytheon fully supports these initiatives.

However, with respect to the CAS Board, an issue bears examination. Regardless of one's position on the Board itself, the fact remains that despite dramatic changes in acquisition processes since the Board's inception, an examination of the Board's role and mission in this new environment has not taken place. Raytheon believes the review panel is necessary to ensure actions of the CAS Board conform to the objectives of Congress, DoD and the Administration and to determine if regulatory processes required by CAS Board promulgations support or defeat policy initiatives.

The cost accounting standards are a critical component of the government procurement process due to the extent and nature of cost based pricing. As such, Raytheon does not support or propose the complete elimination of CAS or the CAS Board. We strongly believe however, that certain reforms are necessary. Reforms that will result in a more focused CAS Board, streamlined policies and processes and a reduction of administrative costs associated with CAS compliance.

II. IMPACT OF CAS ON A CONTRACTOR'S BUSINESS DECISIONS

Raytheon Company, like other members of the defense industry have been driven by market forces toward consolidation as a way to reduce fixed costs and improve its competitive position. Having just recently completed the merger of Hughes Aircraft Company and Raytheon Company, we are deeply involved in a significant restructuring effort. As part of this restructuring, we are bringing together the former Texas Instruments, Hughes Aircraft, Raytheon Electronics Systems, and Raytheon E-Systems to create a new Raytheon Systems Company composed of five operating segments as follows:

- **Defense Systems:** anti-tactical ballistic missile systems; air defense; air-to-air, surface-to-air, and air-to-ground missiles; naval and maritime systems; ship self-defense systems; torpedoes; strike, interdiction and cruise missiles; and advanced munitions.
- **Sensors and Electronics Systems:** ground, shipboard and airborne fire control and surveillance systems, primary and secondary air traffic control radars; ground, space-based, night vision, and reconnaissance sensors; electronic warfare; and GPS systems
- **Command Control and Communications Systems:** command, control and communications systems, air traffic control systems; tactical radios; satellite communication and ground terminals; wide area surveillance systems; advanced transportation systems; and simulators and simulation systems
- **Intelligence, Information and Aircraft Integration Systems:** ground-based information processing systems, large scale information retrieval, processing and distribution systems; global broadcast systems; airborne surveillance and intelligence systems integration; aircraft modification; and head-of-state aircraft systems
- **Training and Services:** training services and integrated training programs; technical services; and logistics and lifetime support

Under its new operating structure, the percentage of DoD business of Raytheon Systems Company will be over 80 percent.

I have included slides within your package which provide a more detailed overview of Raytheon Systems Company's organizational and program structure.

I would like to discuss two examples where CAS has an impact on a contractor's business decisions.

From a cost accounting perspective, our restructuring effort will potentially effect over 30 existing CAS business units, and literally hundreds of direct labor and expense rate structures. In addition, we are also streamlining our process to further reduce costs. The results of this action will be a more efficient enterprise, with significant savings to our customers.

Our planned restructuring has a unique relationship to cost accounting and the cost accounting standards. In many respects, the problem of effecting our restructuring is a problem of cost accounting—that is, determining the optimum and compliant cost accumulation structures for the organization, the effect of such a structure on the allocation of costs and hence the final cost of our products and services. Additionally, there are significant disclosure requirements once final determinations have been made on the final organization and rate structures. A complete and thorough understanding of CAS requirements is essential in performing these actions.

A critical element of the finance organization's responsibility with respect to our restructuring, is the ability to provide the company with an accurate assessment of the financial impacts, exposures, risks and resource requirements pertaining to our planned organizational actions. With respect to restructuring, under the FAR, costs incurred to effect the restructuring must meet certain criteria before they are allowable against US government contracts. These requirements are known with certainty, with measurable and quantifiable financial effects to the organization. Under CAS, the issues of restructuring move away from the allowability of costs and into the realm of the allocability of costs. In some significant cases, however, certainty as to requirements, interpretation and application of CAS, specific to aspects of the restructuring does not exist.

An example of this condition lies in the area of organizational changes and the CAS governing cost accounting practice changes. Raytheon's experience in this area is that there is a significant gap between the government and industry on what aspects of an organizational change constitute a cost accounting practice change. The differences are more than academic. If as part of Raytheon's restructuring action, a change to a cost accounting practice as defined in CAS occurs, we are obligated to generate a cost impact having with it, a potential liability for the Company. Conversely, if no change to a cost accounting practice occurs, then the company is not obligated to generate a cost impact and there is no liability for the Company. Besides the significant differences in resources consumed between generating and not generating a cost impact, there is significant compliance and financial risk involved with making the wrong call. (The financial risk relates to the government's ability to adjust contract prices on contracts already negotiated).

But what is the right call? To answer this question, Industry looks to historical interpretations and guidance as well as applicable court decisions. Yet differences of

interpretation and application of the CAS rules still remain between government and industry. Without commenting on the merits of the positions of either industry or the government in this area, the current uncertainty on what is the governing baseline for cost accounting practice changes related to organizational changes causes confusion, complexity, undo financial risk and strains already limited organizational resources.

It is also important to note that CAS and FAR essentially treat restructuring as separate and unique transactions. The effect of savings and costs to the government under CAS and FAR have different meanings. Under existing policy, there is no means to integrate the effects of the two, notwithstanding the fact that the same business transaction is involved in both. For example, a contractor can demonstrate billions of dollars in savings to the government resulting from its restructuring action, yet still be required to expend a considerable amount of resources to effect contract price adjustments under CAS.

Another example of the impact of CAS on a contractor's business operations relates to the implementation of Activity Based Costing Systems. We believe that one factor hampering the benefits of full implementation of such a system relates to the uncertainty of the financial impact resulting from the requirements of CAS. Does the conversion represent a change in cost accounting practice? Will the conversion to such a system leave the contractor open to allegations of noncompliance with CAS? What has been the result of such uncertainty? Instead of achieving the full benefits of an activity based costing system, contractors have implemented parallel systems to their existing cost accumulation systems under such names as activity based management systems, which mimic the effect of a fully implemented ABC system without achieving its full benefits.

We believe the conditions and effects described in the above examples are misplaced during this time of acquisition reform and result from limited flexibility in the application cost accounting standards requirements. We ask the review board to consider the degree to which such issues could be resolved through increased flexibility in the application of CAS, as for example when overall savings and benefits to the government resulting from a particular transaction can be demonstrated.

III. EXISTING COST ACCOUNTING STANDARDS AND GAAP

In the interests of streamlining the regulatory process, we recommend that the review panel consider evaluating existing CAS regulations in terms of need and risk to the government. We suggest that such an evaluation could be framed in terms of the following:

1. Those standards that focus on the allocation of costs where there is no comparable guidance in the Financial Accounting Standards;
2. Those standards that duplicate requirements already existing in the Financial Accounting Standards;

3. Those standards that appear to serve no useful purpose or whose provisions are adequately addressed in other CAS or the FAR.

Although we feel that the use of Generally Accepted Accounting Principles (GAAP) should be paramount, it must be recognized that GAAP has a different orientation than the cost accounting standards. GAAP is not directed towards the allocation of costs to specific products or contracts. Its focus is on how to categorize costs for an accounting period and reflecting costs on financial statements.

Should consideration be given by the review panel on the proposal described above, we believe that the optimal end state would be the condition where there was no redundancy or duplication between CAS and GAAP.

IV. CAS BOARD FOCUS: ACCOUNTING THEORY VS. PUBLIC POLICY

We request that the review panel examine the extent to which the CAS Board has expanded its role beyond establishing cost accounting rules and policies based on sound accounting theory and into areas of public policy. Two examples illustrate the need for such an examination. The cost accounting standards prohibition against the step up or step down of assets and the proposed modification to CAS governing changes in cost accounting practices which appears to emphasize contract price controls as opposed to cost accounting practices of business units. My purpose here is not to argue the merits of industry's or the CAS Board's position in these areas. However, it seems a prudent exercise for the review panel to determine the extent to which CAS Board's actions have deviated from cost accounting principles and determine if the basis for establishing such policy is properly placed in CAS or the CAS Board.

V. NEED TO EXAMINE THE INDEPENDENCE OF THE CAS BOARD

We request the review panel examine if the movement of the CAS Board towards matters of public policy coupled with the organizational alignments of CAS Board members, provides for a board capable of being independent to develop sound accounting principles. For example, if rules and regulations promulgated by the CAS Board cannot be severed from public policy considerations, can it reasonably be expected for the DoD or Industry representative to not lobby for and propose those positions that minimize the financial impact of the organizational interests they represent? Does this not build in a perpetual system of conflict? If the CAS Board can not separate itself from matters of public policy, then we request the review panel to give consideration to a Board made up of subject matter experts not aligned to any particular organization.

VI. NEED FOR EXAMINING STAFF SUPPORT TO THE BOARD

We request the review panel to examine the logic of existing constraints placed upon CAS Board members to fulfill their functions. Take for example, the industry

representative to the CAS Board. As we understand it, the industry representative is not able to share with the defense industry, any information that does not exist in the public domain. Although permitted to meet with industry to discuss specific concerns and recommendations, no information of what is being proposed or considered during CAS Board deliberations is permitted. Although contractors as well as procurement agencies are willing to participate in supporting the research and standards development process, we have been told certain laws restrict participation by industry leaving the government procurement agencies as a primary source for research and standards development assistance. We believe this places the procurement agencies in an advantageous position to influence the process. We recommend that the review panel consider provisions to permit direct industry support of the Board's research and standards development process. This would help reduce the difficulties currently experienced in CAS promulgation by getting broader input in the early stages of standards development and improve the overall fairness of the final rules.

We also ask the review panel to support greater balance of the board by expanding participation to the CASB to seven members---three from the government/public sector, two from the private sector, one from academia and one from public accounting.

In the interest of timing, I have not commented on other areas Raytheon believes to be important in the GAO's review of the CAS Board. Listed below are those areas Raytheon Company recommends for consideration by the review panel:

- Refocusing the efforts of the CAS Board on sound and equitable accounting theory and concepts consistent with DoD initiatives to reinvent government;
- Identify and eliminate CAS provisions that are barriers to strengthening the defense industrial base, stimulating competition and promoting U.S. economic growth;
- Preserve the sanctity of firm fixed price contracting;
- Advocate granting CAS waivers if a contractor has institutionalized commercial business "best" practices;
- Greater CAS Board focus on risk management, rather than risk avoidance;
- Increased CAS Board consideration of materiality criteria and thresholds;
- Promote OFPP's guiding principles over rigid, detailed standards where uniformity and consistency are not essential;
- Elimination of unnecessary existing standards and regulatory burdens before expending efforts to create new standards;
- Requirement to conduct field testing prior to promulgation of a standard.

In closing I would again like to thank you for the opportunity to discuss Raytheon's views on this important issue and I would be happy to now answer any of your questions.

***The Importance of Advanced Cost Management
in Today's Complex Environment***

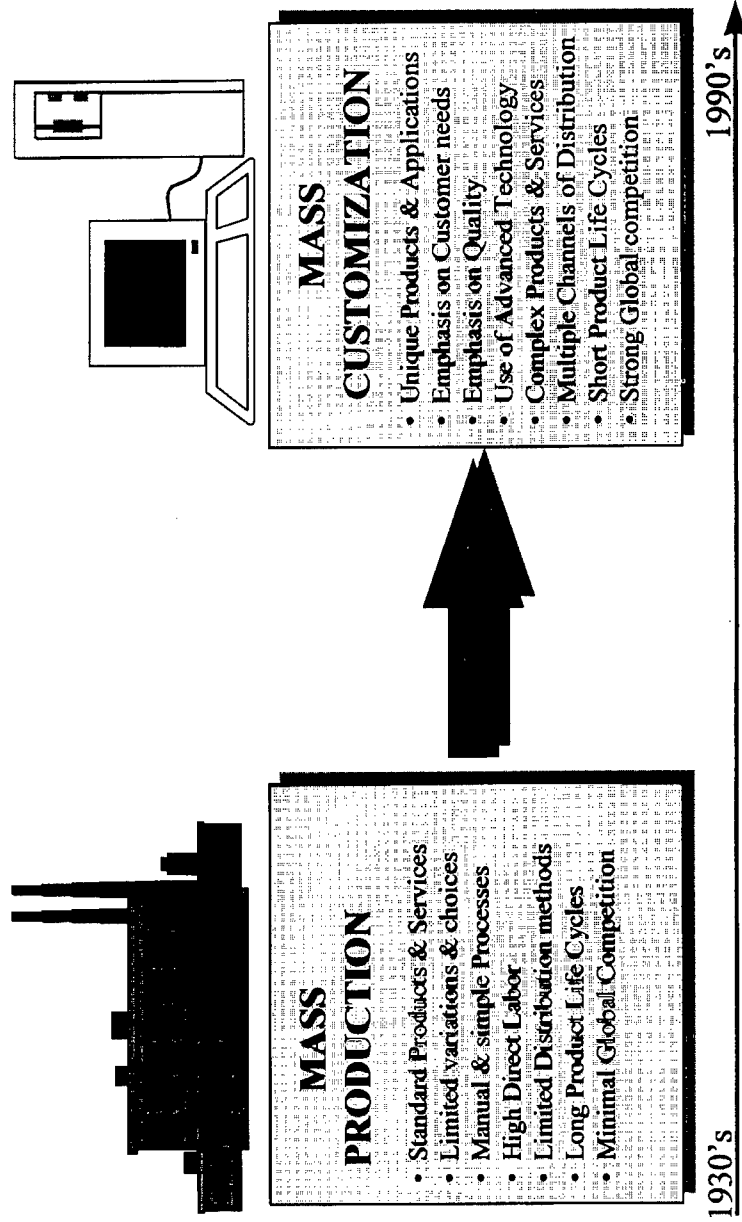
CAS Board Review Panel

**June 17, 1998
Washington, D.C.**

Presented by:

**Eileen Morrissey, Chairperson, CAM-I
Director, Advanced Cost Management, AlliedSignal**

Conceptual Overview

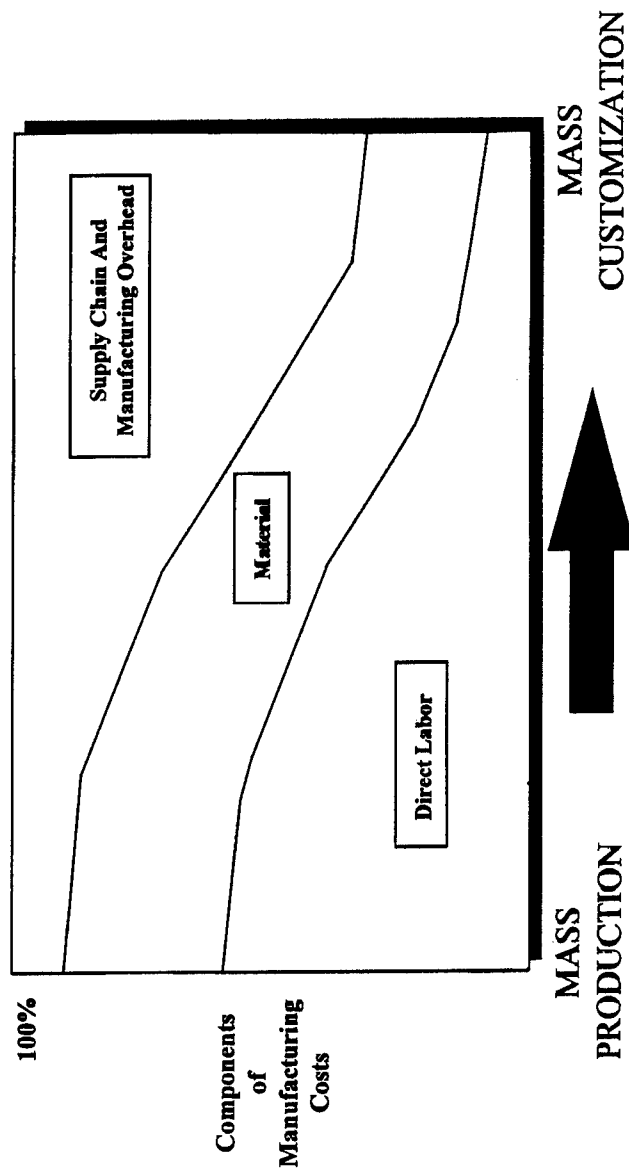


The world around us has changed.....

From: B. Joseph Pine II. Pine is the author of *Mass Customization: The New Frontier in Business Competition* (Harvard Business School Press, 1993)

The Effect On Cost Structure

These changes in the Manufacturing environment has changed the structure of product costs from primarily direct to predominantly indirect costs resulting in an increasing need to understand & manage overhead costs.



***In Today's World, Using Direct Labor As A Basis
For Applying Overhead Has Become Meaningless***

Example Of ABM Activities vs Traditional

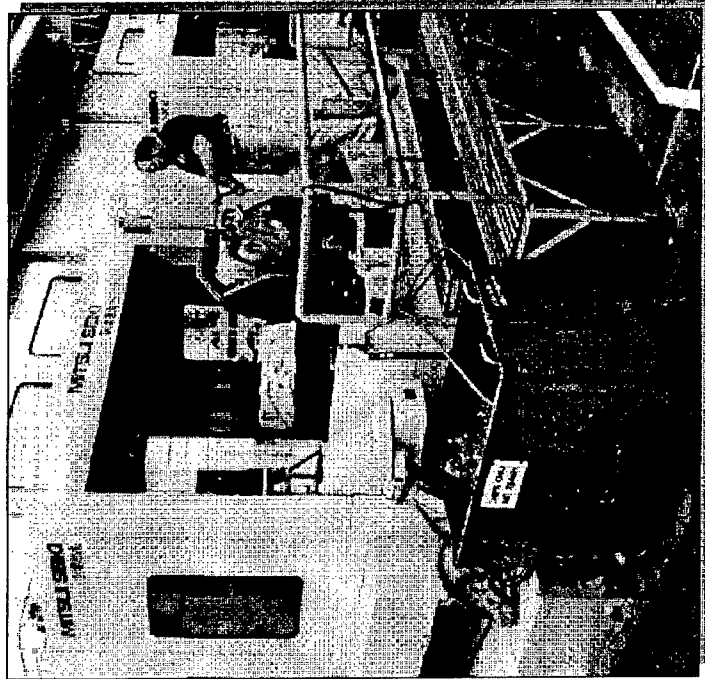
Traditional Versus Activity Views of Cost

Scheduling Department	
<u>CHART OF ACCOUNTS VIEW</u>	
Salaries	\$500,000
Depreciation	100,000
Travel Expense	50,000
Supplies	20,000
Facilities	30,000
TOTAL	\$700,000

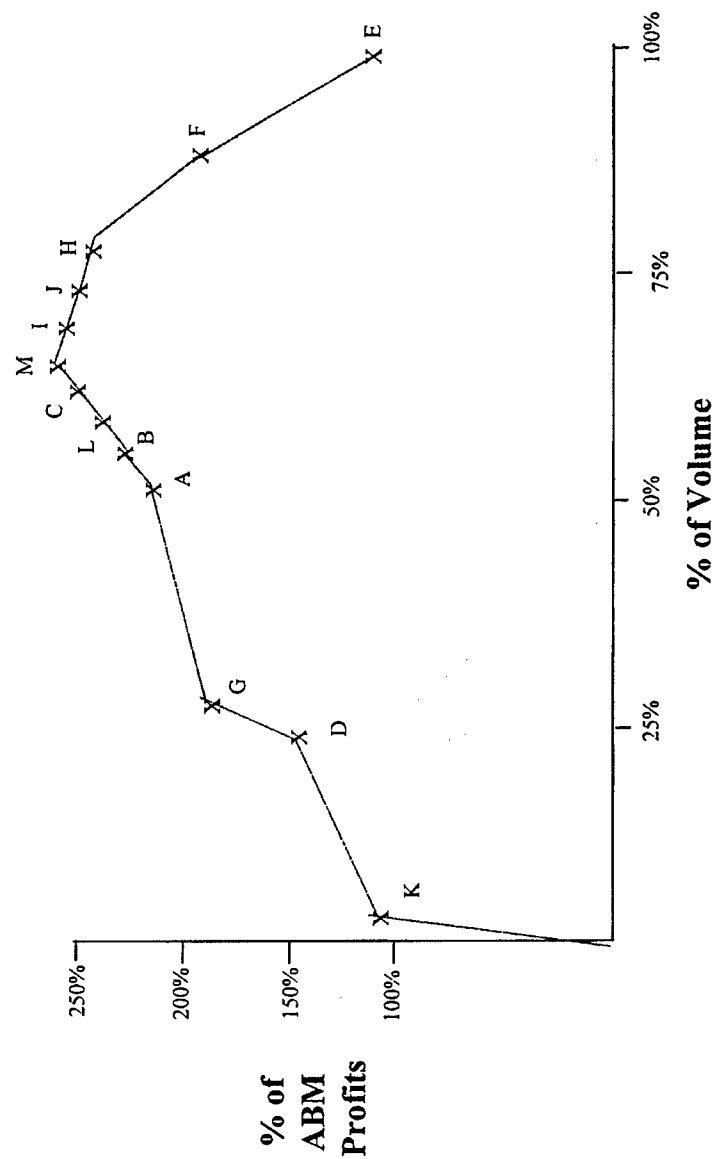
Scheduling Department	
<u>ACTIVITY VIEW</u>	
Expedite Items	\$200,000
Reschedule Items	170,000
Schedule Items	100,000
Check Item Status	90,000
Release Items	80,000
Develop Master Schedule	60,000
TOTAL	\$700,000

Both Sets of Data are Critical for Managing Costs

What's the Difference Between These Pictures?



Identifying Winning & Losing Products With ABM



Typically 25% of the Volume makes up 150% of the profits. In this example, the total cumulative profits before losers, is 258% of current profits.

ABM Activity Hierarchy

ABM Reveals That Costs Occur At Different Levels.
Identifying Activities In This Hierarchy Provides Better Insight Into Cost Behavior.

Description

Activity is done to maintain the business regardless of products manufactured.

Activity is performed to sustain products, product lines, markets or customers, regardless of volume produced or sold.

Activity varies with each batch of products and is less volume sensitive.

Activity is volume sensitive and will vary with each unit of product.

Examples

Building Maintenance
Security
SEC Reporting

Product Certification
Develop Parts
Machine Maintenance
Training
Marketing Brochures

Shipping
Setup Equipment
Production Planning
Inspection

Run Parts
Handle Scrap Material
Assembly
Machine Run Time

**FACILITY
SUSTAINING**

**PRODUCT/MARKET
SUSTAINING**

BATCH

UNIT



ABM for Strategic Planning

Win Win for Customer and Shareholders

Background

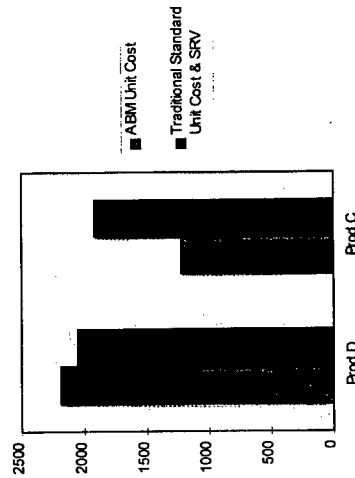
Competitors for 35 years, 2 similar Products
Now built in same factory due to acquisition.
Customer wants lowest cost Products that
meets performance specification.
But which design is truly lowest cost ?

Use

Rationalize Product Line by Converting
Customers to Prod C from Prod D.

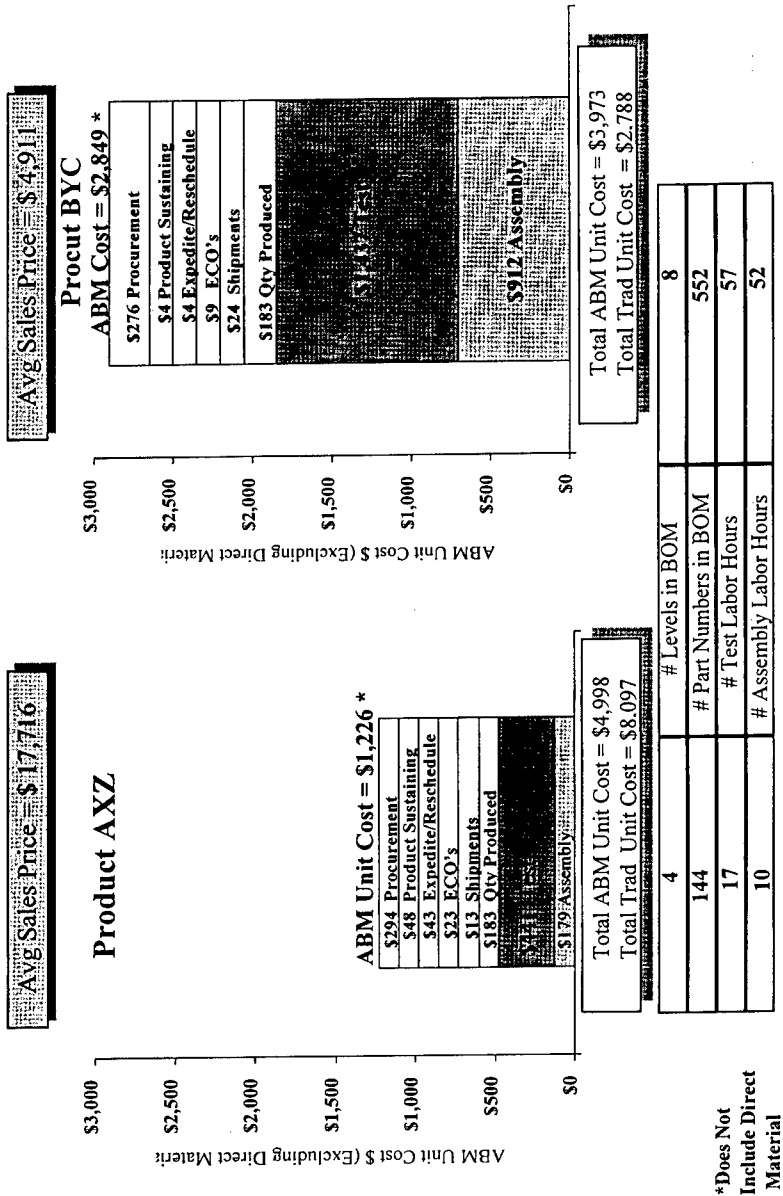
ABM shows that Strategic Focus
should be Product C

Potential Business Impact \$12M
Cost Savings over 5 Years



ABM provided the answer that best satisfied customers and shareholders

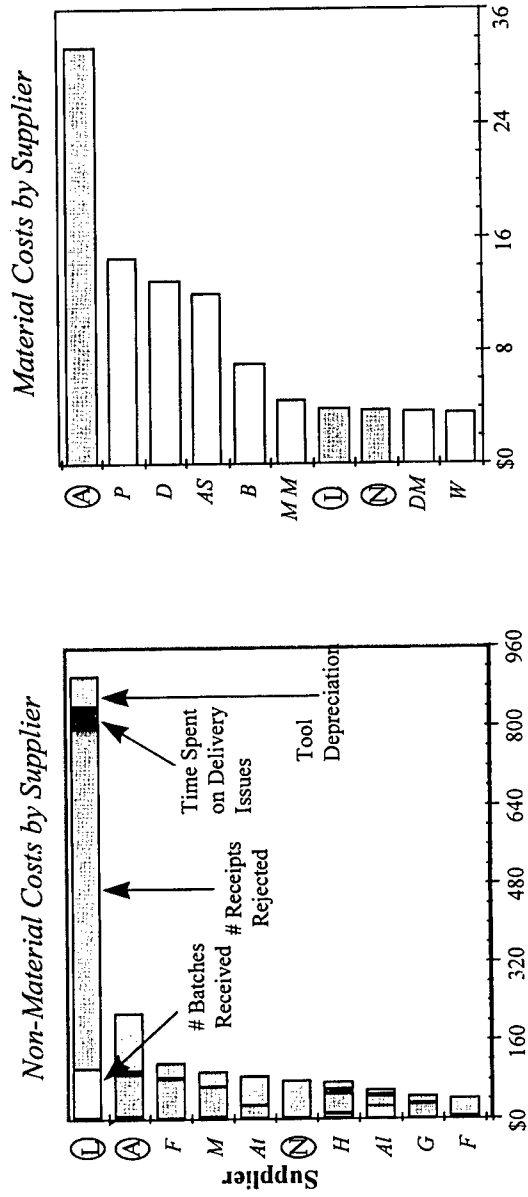
Effects of Complexity on Unit Cost



Procurement Costing

Total Procurement Costing Results: Top 10 Suppliers by Cost

- Only 3 of the top 10 suppliers by materials costs are in the top 10 list of suppliers by non-materials costs



Non-Material Cost Issues Vary Greatly By Supplier

ABM for Tactical Make/Buy Decisions

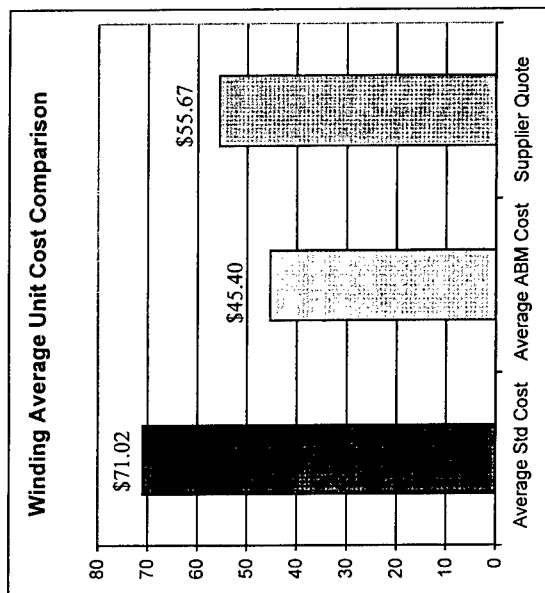
Background

- Business was considering outsourcing of entire subassembly department.
- Quote from Supplier showed considerable savings when compared to standard costs.
- ABM analysis showed cost of outside supplier actually higher than internal costs.

Use

Decision made to make winding subassemblies.

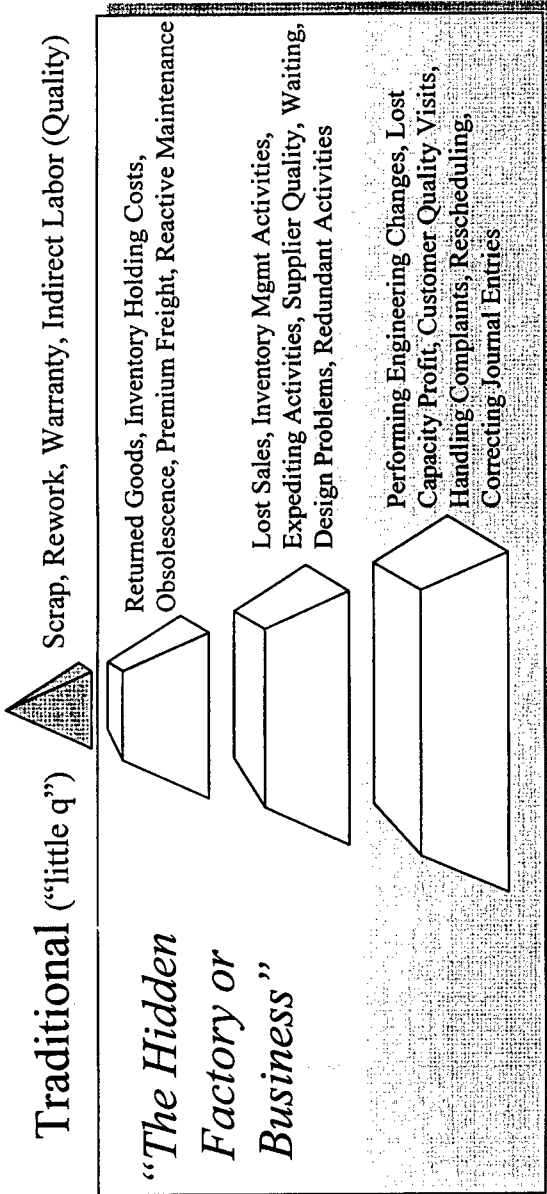
Cost Avoidance \$299,000



*"Excellent use of ABM techniques
to collect DATA useful for decisions"*

VP Operations

ABM Linkage To Cost of Quality



Cost of Poor Quality ("Big Q")

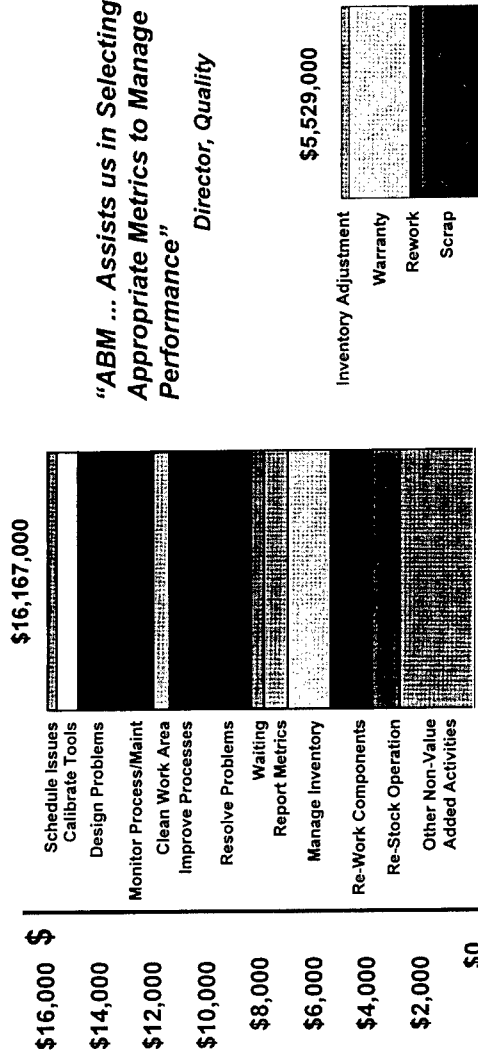
ABM makes the total COPQ visible.

An example of ABM COPQ



"ABM ... Assists us in Selecting Appropriate Metrics to Manage Performance"

Director, Quality

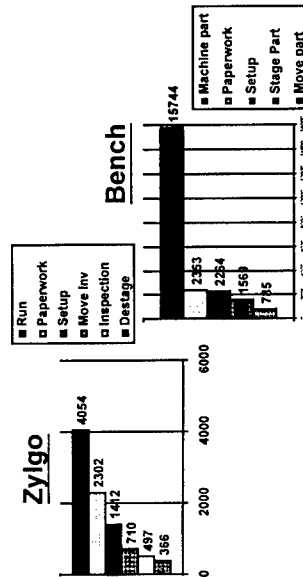


ABM Providing a Brutal Understanding of Reality

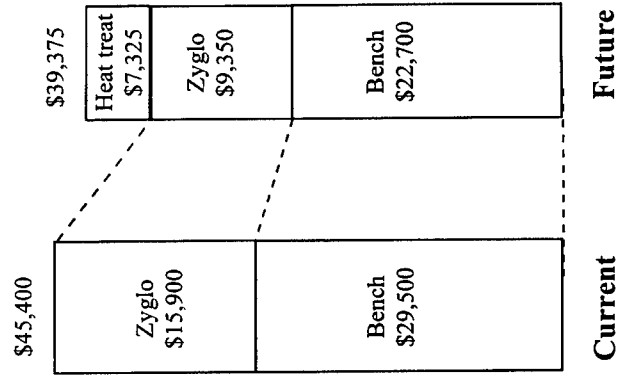
Measuring Process Improvements

Actions Taken

- During the *project*, the following actions were taken:
- Reduced run, set-up, stage and inspection activities within the Zygo process
 - Reduced set-up, move inventory and prepare paperwork activities within the Bench process
 - Outsourced product for additional savings
 - Added additional Heat Treat step prior to outsourcing

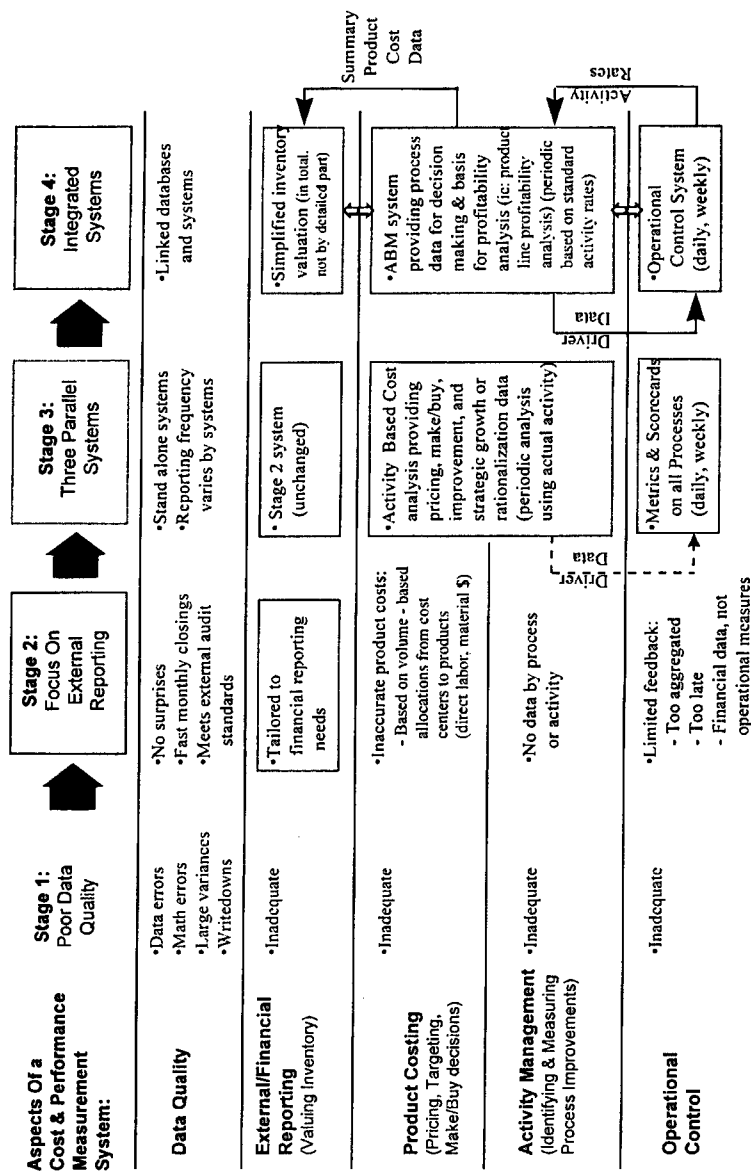


Using ABM data to estimate potential results:



ABM Data is Used to Select & Measure Improvement Efforts

Cooper / Kaplan's Four Stages of Evolution in Advanced Cost Management *



*We can view the development of our integrated cost & performance measurement systems as a journey through four sequential stages *.*

* Robert S. Kaplan & Robin Cooper, *Cost & Effect: Using Integrated Cost Systems to Drive Profitability and Performance*, 1998 Harvard Business School Press

Recommended Reading

Robert S. Kaplan & Robin Cooper, *Cost & Effect, Using Integrated Cost Systems to Drive Profitability and Performance*, 1998 Harvard Business School Press

Robin Cooper, *When Lean Enterprises Collide*, 1995 Harvard Business School Press

Robin Cooper, Robert S. Kaplan, Lawrence S. Maisel, Eileen Morrissey, & Ronald Oem, *Implementing Activity-Based Cost Management: Moving From Analysis to Action*, 1992 Institute of Management Accountants

The CAM-I Capacity Interest Group, Thomas Klammer, *Capacity Measurement & Improvement*, 1996 Irwin Professional Publishing

Robin Cooper & Regine Slagmulder, *Target Costing & Value Engineering*, 1997 Institute of Management Accountants

Shahid L. Ansari, Jan E. Bell & The CAM-I Target Cost Core Group, *Target Costing*, 1997 Irwin Professional Publishing

Timothy S. White, Chrysler Corporation & CAM-I, *The 60 Minute ABC Book*, 1997 Consortium for Advanced Manufacturing-International

Mr. Chairman and Members of the Panel. I am Merritt Marquardt of 3-M representing a consortium of large commercial companies known as the Integrated Dual-Use Commercial Companies (IDCC). I want to thank you for the opportunity to appear here today and to discuss one of the primary barriers, which restrict the sale and government use of commercial products and services, government Cost Accounting Standards.

The IDCC is a consortium of large commercial companies that strongly advocates acquisition reform to remove barriers member companies face in doing business with the Federal Government. Members of IDCC include Corning, Cummins Engine, Dow Chemical, Dow Corning, Eastman Kodak, Motorola, IBM, W.L. Gore & Associates, Hoechst, Honeywell and 3M. Member companies have significant operations in 41 states, 842,000 employees, and annual sales exceeding \$207 billion. Member companies invest approximately \$13 billion in R&D per year, which averages approximately 6.5% of sales, and which totals approximately 8% of all R&D performed by U.S. companies annually.

We appreciate the significant changes made by the Federal Acquisition Streamlining Act (FASA) of 1994 and the Clinger-Cohen Act of 1998. FASA and the Clinger-Cohen Act have made commercial items more accessible to Government customers by eliminating many government-unique contract requirements. However, the ability of our member companies to perform research and development for the Government and to manufacture government-unique products remains severely hampered by a complex regime of laws and regulations that discourages our participation because they add significant costs to our commercial processes, they stifle innovation and frankly, are counter-cultural. One of the most significant government-unique contract requirements that do not allow our companies to follow commercial practices is government Cost Accounting Standards. We think it is time for a new approach, and this current examination of Cost Accounting Standards offers an opportunity for dramatic improvement.

Each member of IDCC is primarily a commercial company. More than 95% of IDCC's \$207 billion in annual sales are made to commercial customers. Less than 5% of IDCC's annual sales are made to the Government but this represents over \$10 billion in government purchases. The vast majority of IDCC's government sales are commercial products. However, several IDCC members have a number of Government R&D FAR-covered contracts, such as 3M's own Metal Matrix Composite Program, a seven-year, \$110 million R&D contract with DARPA to develop low cost, high strength, metal matrix composite materials.

In order to perform traditional government cost-based contracts, several members of IDCC have established systems in certain business units of their companies to comply with government-unique contract requirements, such as the Truth in Negotiations Act, the FAR cost principles, and Cost Accounting Standards. Although these members of IDCC are able to comply with such requirements, they find them very costly, administratively burdensome and not supported in a primarily commercial company in

any manner equivalent to what is demanded under a government contract regime. government-unique contract requirements have been a barrier to the members of IDCC making more of their products and services available to the Government, particularly R&D and government-unique products. Many business units of IDCC members are either unable or unwilling to accept FAR-covered contracts for R&D and government-unique products. For example, W.L. Gore and Associates is a high technology privately held firm with diverse product lines. The company carefully investigated what is necessary to achieve CAS compliance. It concluded that a CAS compliant system added no value to its accounting for its predominantly commercial business, that it would increase costs and risks and would involve considerable expense to integrate with its accounting systems. Gore turned away from pursuit of any business that requires CAS compliance. Dow Corning manages its government business to remain under the CAS threshold for full coverage. The expense of modifying systems and processes to achieve full CAS coverage could not be justified by the potential of incremental government revenues. Therefore, at a point the company reacts to preclude increasing government business.

IDCC members participated in three separate cost studies by the GAO, DSMC and CSIS that were used by the Section 800 committee. IN each study the members provided data clearly demonstrating the significantly increased cost of doing business when contracting with the government due to government-unique contract requirements. The capstone to these cost studies was a final study commissioned by the Under Secretary of Defense for the Secretary of Defense which was conducted jointly by Coopers & Lybrand and TASC. This study found that compliance with non-value added DoD acquisition laws, regulations and oversight resulted in an eighteen percent cost premium on defense contracts. Cost Accounting Standards was rated as the #7 cost driver in that report.

Cost Accounting Standards create substantial administrative burdens and require changes to accounting systems, increasing the costs of products for no commercial advantage or product improvement, and which reduce a company's ability to react to changing market conditions by imposing rigid requirements. Most of our member companies are world class leaders in certain technologies but face ever increasing competition in the marketplace. Each of the members strives routinely to become more efficient to beat-back the competition. Our management cannot allow any customer to impose unique requirements that increase costs. Therefore, in most of our cases, we manage our government business so that we do not exceed the threshold requiring full CAS compliance. In some cases, an IDCC member company will attempt to separate government business requiring CAS coverage from similar work for the commercial marketplace. Where this is done, both the company and the government lose. Perhaps the most significant impact of CAS and other unique government requirements is yet to be felt. I firmly believe that the commercial marketplace leads in numerous technologies today. The government needs to do business with those on the leading edge of these technologies. To the extent the government attempts to impose unique requirements, companies operating on the leading edge often conclude the risks are

too great, the costs too high and the distractions very significant. While the government may need unique requirements to get at the pricing of a nuclear aircraft carrier or submarine, as commercial companies the marketplace determines our pricing. The government needs to join that marketplace.

The IDCC understands that the Under Secretary of Defense (Acquisition and Technology) has requested the authority for DoD to grant CAS waivers for the award of firm-fixed price contracts where the contracting officer required offerors to submit some cost data, but not certified cost or pricing data. The IDCC applauds efforts such as this by the USD(A&T) - it is certainly a step in the right direction.

My fellow IDCC representatives would like to give their statements at this time.

Thank you again for the opportunity to present our views. Mr. Fry of Eastman Kodak, Mr. Lindahl of 3M and I would be pleased to answer any questions you may have. Also, I offer the resources of IDCC to work with the members of the panel in order to seek solutions that would accomplish our mutual goal of improving the government acquisition process.

**Prepared Comments for Presentation to
the GAO
Cost Accounting Standards Board Review Panel**

June 16, 1998

Good afternoon. My name is Stanley Fry and I am Manager of Contracts for Commercial and Government Systems, Eastman Kodak Company in Rochester, New York. As an IDCC member, Kodak is pleased to have this opportunity to comment on the Cost Accounting Standards from the perspective of a small government segment in a large commercial company. My division is subject to full CAS coverage and is the only segment within Eastman Kodak Company which must comply with CAS. In 1997, our sales were about one (1) percent of Kodak's total sales of almost \$15 billion.

My division of Kodak performs most of the Government contract work within Eastman Kodak Company. Sales of Kodak's standard commercial products on GSA and VA Multiple Award Schedule contracts are handled by a separate group within Kodak. The work in my division primarily involves development of unique optical and/or digital imaging systems or performance of image quality or image related R&D studies for various Federal civilian and military agencies. Some of the contracts are sole-source, some are classified, and most of the work is done under cost reimbursement contracts.

I fully support the comments you have heard that CAS is very expensive to implement and provides no benefit to commercial companies. Mr. Marquardt indicated that commercial enterprises could not support the accounting overhead and controls called for by CAS and still remain competitive. To give you an example of the extra overhead, my division which is fully CAS covered, has twice the number of staff in accounting and finance as our Office Imaging (OI) division, a commercial division, even though OI has more than twice our total sales. As a result of the increased staff, our indirect rates are increased, and that directly impacts our competitiveness.

The controls also have more direct effect on some costs. For example, within Kodak commercial divisions, it costs about a \$1 - \$2 to process a business expense report while in my division it costs more than \$20 because of the extra review and handling to identify and segregate unallowable travel costs in compliance with FAR and CAS regulations. In 1997, the total unallowable cost identified, which was less than 5% of the total travel cost for the division, was roughly equivalent to the extra administrative expense to find the unallowable cost. In effect, we are spending a dollar to save a dollar. A commercial firm would not do that except to meet FAR and CAS requirements.

Another aspect of the cost of performing CAS covered contracts is the detrimental effect on the enterprise caused by setting up a CAS covered segment. We have an alleged CAS 407 non-compliance related to a standard cost system used by another segment in Kodak which does some work for our division. That segment is not CAS covered, yet the government expects them to change their accounting method to become CAS compliant.

There are other segments of Eastman Kodak Company which have refused to do business with my division because of the audit and oversight costs which accompany the work.

Another very real impact which CAS requirements levy on a company is the impact on business flexibility. Within my division, we generally try to avoid organization changes which involve cost accounting practice changes even when there is a potential for greater efficiency or effectiveness. For example, we have been looking at combining some functions and reducing the number of burden centers in our division. The change would streamline part of our operation, improve efficiency, and probably result in lower overall cost to the government. However, it would involve some shift of costs between contracts. We have not yet implemented this change because, based on our experience, it would certainly result in an issue with the government and potentially cost Kodak money.

To illustrate some additional issues surrounding implementation of CAS at primarily commercial companies, I will provide some further examples based on Kodak's experiences. First, a little background:

Kodak is host to a DCAA field detachment with responsibilities covering a number of contractors in several states. There are approximately 19 DCAA personnel resident at Eastman Kodak Company although only about half of the DCAA auditors have direct responsibility for Kodak's contracts. There is almost no turnover among the audit staff. DCAA auditors are assigned responsibility for Kodak's contracts for a few years and then are assigned to another contractor for a similar time period without moving from our facilities. Some of the auditors, especially the supervisory auditors, have been resident at Kodak for more than 20 years. Kodak also has two full-time ACO's resident in its plant to administer CAS.

I present these numbers because they illustrate a somewhat unique situation. Our business unit has reduced staff by almost 20% over the past two years. In the past 10 years, our total Government business has declined by about 40%. However, there has not been any corresponding downsizing of the Government presence at Kodak. More auditors leads to more audits and more opportunities to find issues. At present there are more than 100 open issues at Kodak, many of which date back to the 1980's. This is not to imply that Kodak does not have some real issues, but given the same level of scrutiny for several years, any other company may likely have a similar number of issues.

Many of the CAS issues at Kodak are implementation related issues which seem to depart from the original purpose of the CAS which was to achieve uniformity in cost accounting. The reality of CAS administration, at times, is that it is used to reduce cost to the government by disallowing otherwise allowable cost or placing such a burden on a contractor that cost is withdrawn.

In some cases, otherwise allowable costs are questioned due to somewhat arbitrary interpretations of CAS. We often find CAS issues raised when the Government alleges that there is some "better" allocation method which happens to allocate less cost to the

government. We seldom find the issue raised when the alternative will allocate more cost to the government. We also never hear that our method is unreasonable; only that some other method is "better." This is a very serious problem in a company which is 99% commercial because the allocation methods are usually chosen because they are simple and economical and not because of CAS.

Another reality of CAS administration is that it may place such a burden on a contractor that the contractor will withdraw the cost. We have had instances where when we complain that the cost to comply is too high and the cost impact is immaterial, we are told we should withdraw the cost if we do not want to comply. Another aspect of this burden is that some contractors do not allocate certain costs to the government in order to refrain from having to comply with a standard. Kodak does this with regard to allocated IR&D costs under CAS 420.

CAS can have other negative impacts on a contractor. We recently settled an impact of cost accounting practice changes made in 1990 by agreeing to pay the government over \$60,000. The settlement agreement stipulated that Kodak did not agree that it owed anything, but made a business decision to settle the issue. The only reason there was any alleged cost impact, i.e., increased cost to the government in the aggregate caused by the changes, is because the ACO did not offset increased costs due to one change against decreased costs due to another change. The changes were made effective the same day, by the same business unit, and affected the same contracts. The ACO would not offset the costs because Kodak only provided a few days advance notice of the changes instead of the 60 days notice per the CAS clause. It did not matter that the government was not prejudiced by the short notice. DCAA did not even review the changes for almost 2 years. Under the CAS, Kodak's only recourse was to appeal the determination to the ASBCA under the Contract Disputes Act.

Another problem which we face is that the government does not seem particularly motivated to settle CAS issues. I mentioned earlier that Kodak has a number of outstanding CAS issues dating back to the early 1980's. Some involve alleged non-compliances where Kodak does not agree that the accounting practices are non-compliant. In some instances Kodak will agree to change the practice to one which is "better", but this seldom settles the issue. The current CAS administrative system seems more geared toward finding fault and recovering cost rather than improving cost accounting.

A good example of CAS administration problems is an alleged CAS 405 non-compliance. The DCAA audit report cites our division for this non-compliance primarily because of lack of formal written policies and procedures for screening for unallowable costs. It should not be an issue because CAS 405 does not require written policies and procedures. CAS 405 only requires unallowable costs to be identified and excluded from any billing, claim, or proposal. We believe our process adequately meets this standard as evidenced by our record. It isn't perfect but there are few problems and most of these are caused by human error.

As justification for the CAS 405 non-compliance, the DCAA identified some costs which they believed were unallowable and which were not removed from an incurred cost submission. However, Kodak does not agree that all the costs were unallowable. The result is a sort of circular compliance problem. The DCAA alleges a cost to be unallowable and then cites the contractor for a CAS non-compliance because the alleged unallowable cost wasn't screened out of the incurred cost.

Unfortunately, this story does not stop here. In October 1997, the ACO unilaterally reduced Kodak's G&A billing rates by one percentage point to withhold money to force Kodak to resolve the CAS 405 issue and negotiate cost impacts. The withheld amount quickly exceeded \$1 million. We vigorously protested and filed a certified claim which apparently forced the ACO to rescind his decision. It did not seem to matter that neither the DCAA nor Kodak had ever identified a cost impact resulting from the alleged lack of formal documented procedures. As our outside counsel stated: "Normally the Government has to be owed money before it can withhold money."

Another issue at Kodak which relates to excessive CAS administrative bureaucracy is the Government's insistence on updating old Disclosure Statements. We are spending considerable time and effort on revising a Disclosure Statement for Optical Products, a separate unit which is part of Kodak Equipment Manufacturing Division (KEMD). This unit was awarded two firm fixed price, CAS covered, contracts in September 1989 and completed work on them in 1990. An initial Disclosure Statement was submitted in May 1989 which, shortly after contract award, was found to be inadequate. A revision dated July 1991 was found to be inadequate. Another revision was submitted in November 1994. The ACO is currently requesting a cost impact, but there is no cost impact since no accounting changes were made and no non-compliance has been alleged. Once the government is satisfied as to adequacy, the disclosure statement will be discarded because it hasn't been required since the contracts were completed in 1990. A recent review of the CAS requirements in effect at the time indicates that the disclosure statement was never required, but the issue will not die.

We are going through the same routine on an older Disclosure Statement for our own Division. It too was found to be inadequate. One of the critical issues we have to address stems from when Kodak changed the name of C&GS's parent organization from Kodak Apparatus Division (KAD) to Kodak Equipment Manufacturing Division (KEMD). The audit report states "We recommend the name be changed back ..." All told, the audit report cited several "nits" as the basis for finding the revised disclosure statement inadequate. Many of them relate to organizational changes and name changes which are frequent occurrences in commercial companies.

Although these types of changes are not accounting practice changes, the audit report recommended that Kodak should submit a cost impact proposal identifying all contracts containing the CAS clause and the effect on cost or price for these discretionary changes. The ACO apparently agrees with Kodak because he followed up with a letter stating that

he was requesting a meeting to discuss the matter and that he was seeking legal advice to see if pen and ink changes can be made to implement these changes, without recertification by the controller. Currently, the only cost involved is the on-going administrative cost incurred by Kodak to respond to the government as it pursues this issue. The cost is fully allowable and is charged to current government contracts - another reason that our G&A rate is higher than it should be.

One of the more troubling areas for a company such as Kodak which is primarily commercial is the demand for corporate information to support CAS compliance audits. The time and expense to gather the data to support these audits is often unreasonable when compared to the allocated dollars, and the contractor is not compensated for the extra cost. As an example, on 8/1/96 Kodak was notified that the DCAA was performing a CAS 416 (Insurance) compliance audit which covers EK's fiscal years 1988 through the present. Requested information included: (which I will not read in detail)

1. Completion of the attached Insurance Summary Schedule for your Fiscal Year 1995. (The form requires, among other things, a list of all policies by Carrier, Policy number, Expiration date, premium rate and base, Internal allocation of base, premium, premium expensed in FY 1996 and the allocation to segments.)
2. Identification of records maintained to substantiate the amounts of premiums, refunds, dividends, losses, and self-insurance charges. The records also needs to show the frequency, amount, and locations of actual losses by major type of risk.
3. Identification of any memorandum records which reflect differences between costs determined in accordance with CAS 416 and those included in EK financial statements prepared in accordance with Financial Accounting Standards Board Statement 5.
4. Identification of efforts to determine risk exposure differences or anomalies between commercial and government operation and products.
5. Identification of the basis for establishing and adjusting premiums, and any provisions for deposits and reserves.
6. Identification of any financial interest in or other controls over the various insurers.
7. Identification of the primary accounts, journal vouchers, etc. used to accumulate and allocate insurance costs.
8. Identification of all direct allocations of premium costs to final objectives.
9. Identification of the company policy and procedure for assigning premiums, refunds, and assessments to and among cost accounting periods.

Your written response is requested by August 12, 1996.

Kodak is primarily self-insured. On 8/20/96 the auditor was notified that a total of \$39,275 was allocated to my division for the various types of automobile, general liability, Worker's Compensation, and other liability insurance costs originally at issue. We had hoped that because the costs were so small (the amount is immaterial under almost any interpretation of the CAS standard) that the audit would be called off. It seemed unreasonable for the Government to require all the data for the \$15 Billion commercial company because less than \$40,000 was allocated to CAS covered contracts. The effort to respond might cost more than \$40,000. The government responded that insurance costs included dental and health insurance costs amounting to several million dollars so the amount at issue was not immaterial.

However, the audit was not limited to dental and health insurance costs, and on 9/9/96 Kodak received a follow-up request: (which I will not read in detail)

In addition to the information requested in my memo of 8/1/96, all of which has not yet been provided as requested, the following additional information is requested:

- a. Identification of the specific cost accounting treatment for government contracts in accordance with CAS 416, Accounting for Insurance Costs and for financial reporting purposes in accordance with FASB Statement 5, Accounting for Contingencies.
- b. Actual insurance losses for EK for all types of self-insurance by period for 1996.
- c. The actual self-insurance losses for EK fiscal years 1988 through 1995.
- d. A copy of the written EK policy which specifically identifies the method of estimating projected average losses from actual loss data.
- e. Identification of any analysis completed to compare the cost of self-insurance with the cost of comparable purchased insurance (i.e., feasibility study).
- f. Evidence of Contracting Officer approval of all self-insurance programs.

Your written response is requested by September 12, 1996.

Kodak continued to question the need for the data and did not provide a timely response. The result was that we were provided a draft copy of a letter charging us with obstruction of audit. In the end, we provided a large amount of data, but the cost has been high.

Recommendations:

Based on our experience and the specified goal of the government to move toward more commercial like practices, we question the need for full CAS coverage for commercial companies, including those with current CAS covered segments. If a company has 90% or more commercial sales, we believe that the government is better served by utilizing standard commercial practices throughout the company. We believe that the savings would far exceed the current administrative cost particularly when both the government's and the contractor's costs are totaled.

For cost reimbursement contracts at such firms, we would support use of consistency requirements along the lines of CAS 401/402 to provide consistency in estimates and measurement of costs. We also support some type of screening for unallowables in direct charges to contracts but suggest that estimates and decrement factors could be utilized rather than the more onerous requirements for specific identification of CAS 405. We only hope that the regulations would lead to realistic factors which are fair to both parties. As the regulations are currently administered, contractors must overcompensate in order to get government approval for use of any such decrement factor.

A less revolutionary change would be to simplify and relax the CAS waiver requirements. Waivers should be available for a contract, a standard, or for all contracts and all standards. For example, it might be desirable to exempt a company such as Kodak from CAS 420, Accounting for IR&D/B&P. Kodak does not allocate corporate R&D to government contracts although it could under CAS 420. One reason is that we do not want our corporate R&D effort to be adversely impacted by subjecting it to government oversight and audit. Another is that the corporate allocation method is non-compliant. Recoverable IR&D expense is limited to projects performed by or for our division. However, the government still performs CAS 420 audits and continues to question the accounting methods we use even though the government is charged less than it would under CAS 420.

Another simple change would be to put the burden on the government to demonstrate by clear and convincing evidence that a contractor's practice is non-compliant and that the government is being significantly harmed. After all, we are concerned here with the contractor's accounting system and accounting practices. Most companies are subject to SEC and IRS regulation which assures that they are performing reasonable accounting in accordance with GAAP. If a contractor is using a reasonable method which works for the 99% of the business that is commercial, then there should be some hurdle for the government to overcome to force a change.

Thank you for the opportunity to present our views to this distinguished panel. Are there any questions?

My name is Paul Lindahl and I am employed by 3M Company, St. Paul, MN in their Government Controllers Department. I appreciate the opportunity to provide you a 3M perspective relative to government Cost Accounting Standards (CAS) requirements. Studies have indicated that over ninety per cent (90%) of research oriented commercial firms participate in limited or no government research and development. Many of these companies, rich in leading edge technology, are reluctant to contract with the government because of the burdensome requirements associated with such business. 3M is one of those research oriented commercial companies that has tremendous research and development capability and commitment which could offer significant benefit to government defense and civilian agencies. Our company, with \$ 15 billion in annual sales, spends over \$ 1 billion, nearly 7% of sales, on research and development, however, consistent with statistics cited above, spends far less than 5% of the \$ 1 billion on government R&D.

The Federal Acquisition Streamlining Act (FASA) and the Clinger-Cohen Act were enacted to create fundamental changes in the federal government acquisition process. A basic principle of these new laws was to encourage the increased reliance on the acquisition of commercial items and the use of commercial technologies. With government transitioning to more commercial contract terms, acceptance of more commercial accounting practices could eliminate some of the barriers currently deterring commercial companies from participating in government acquisition.

3M is one of the IDCC member companies categorized by Mr. Marquardt as complying with CAS, but finding the requirements very costly, administratively burdensome, and inconsistent with a primarily commercial company. We ^{are} nearing our tenth year of doing a limited amount of business in government research and development complying with CAS accounting requirements. To ensure the government benefits from extensive technology transfer within corporate, market, and division research, government work is done in commercial laboratories rather than in a separate government unit. The limited government activity, in relationship to total company, eliminates any reasonable logic to establish separate government accounting system. Therefore, in a commercially driven accounting system, compliance with CAS requirements has added significant administrative and system efforts which add indirect costs to government contracts, reducing direct research and development the government can procure with available funding. CAS Disclosure Statements, cost accounting change proposals, and cost impact analysis create significant effort for 3M in preparation, submission, discussion, and issue resolution. In addition, government oversight agencies spend considerable time reviewing contractor proposals, conducting CAS audits, and discussions necessary to bring issues to resolution.

Our experience has been that in many findings of noncompliance, analysis of the specific circumstances has demonstrated immaterial impact resulting in a technical noncompliance determination. The technical noncompliance, however, requires us,

on an annual basis to analyze costs and submit impact proposals to demonstrate continued immaterial impact resulting from the technical noncompliance. These annual submissions also require involvement of government oversight personnel in review of contractor analysis and determination that impact remains immaterial. There have been instances in which CAS technical noncompliances have been monitored annually for five years after initial finding of noncompliance, determining each year that cost impact to government contracts is immaterial and ultimately the decision is made that noncompliance does not warrant continued monitorship, pending change in existing situation. In certain instances where noncompliance has resulted in more material impact to government contracts and our commercial accounting system would not reasonably allow us to comply, we have, reimbursed government for negative impact and/or through extended review and discussion with oversight personnel, negotiated advance agreements to document an "acceptable" accounting practice. The acceptable practice resolves the specific noncompliance, however, implementing these advance agreements obviously requires time, creates additional cost, and negates CAS consistency objectives.

Although we have complied with CAS requirements, we currently have no full CAS covered contracts. As indicated, compliance with such requirements have been burdensome and were we to evaluate award of a full CAS covered contract in the future,

compliance may be extremely difficult. 3M, like our competitors, is re engineering various processes to enhance global success in a very competitive marketplace. We are re engineering many of our financial processes, and in commercial terms, transitioning to less costly, simpler, less detailed, faster processing of financial data. These changes will move us further from detailed cost accounting information necessary to respond to potential CAS related cost allocation issues. Our commercial systems will likely not allow us to comply with requirements of benefit and/or pension cost CAS requirements nor allow us to determine cost impacts to government contracts. Changes necessary to keep us competitive commercially will lessen our ability to comply with CAS requirements and as cited above, deter us from providing valuable research and development to the government.

Reluctance on part of 3M to maintain costly infrastructure necessary to comply with procurement contract requirements has driven our focus toward FAR Part 12, Other Transactions, and Cooperative Agreements to do DoD research and development. These new contracting/agreement vehicles allow commercial companies to participate in government R&D without many of the burdensome regulatory requirements. However, although such arrangements eliminate certain requirements, they provide access to limited government opportunities, limited government funding, and do not achieve government

objective of acquiring research and development from commercial companies in instances where more traditional contracting is identified.

Our comments to this review panel do not address whether or not a regulatory body is necessary to govern cost accounting issues in the defense industry. We are responding to expressed desire of the government to do business in a more commercial fashion and eliminate barriers that prevent government from acquiring important research and development from commercial companies. As indicated above, for several years, 3M has been involved, at some level, in government R&D business and has taken various steps to comply with regulatory requirements. However, as much as we see benefit for 3M and the government resulting from such business, we are a commercial company and must make business decisions based on success of that commercial entity. Our accounting practices comply with generally accepted accounting practices and those practices are scrutinized by independent accounting review. Marketplace forces impose stringent controls on our commercial costs/prices and creation of separate accounting procedures and systems enabling us to account for specific detailed cost allocations is costly, administratively burdensome, unwarranted, and counter to our company objectives of achieving success in that marketplace.

We have voiced our concern relative to CAS requirements before. In January of 1992, we provided information, through IDCC, to a public session of the CAS Board. At that time we suggested that threshold for full CAS coverage be increased from the then \$ 10 million to \$ 30 million and that CAS applicability exemption threshold for negotiated contracts and subcontracts be increased from \$ 100,000 to \$ 500,000. In addition, we proposed that categories of contracts and subcontracts exempt from all CAS requirements be expanded to include commercial companies that meet following criteria:

- 1) Commercial companies with at least ninety percent (90%) sales priced competitively in the commercial marketplace and
- 2) company has accounting practices which conform with generally accepted accounting practices (GAAP) and which have been accredited by an independent certified public accountant and is found to be in conformance with GAAP

We are pleased that since 1992, changes have been implemented to increase applicability thresholds, however, for many commercial companies to enter, or 3M to continue in government R&D business in a meaningful way, thresholds must be further increased or exemption from CAS be identified.

Perhaps criteria for full coverage could be increased to \$ 100 million. As defense company acquisitions and mergers decrease number of contractors, it is likely that increasing applicability threshold would have little effect on large defense contractors, where application of CAS requirements were intended. A higher threshold would however, allow large commercial companies to participate at some meaningful level, in government business.

Exemption from CAS for commercial companies with less than ten per cent (10%) sales to the government continues to be a viable alternative that would allow government to benefit from technology rich commercial companies without burdening those companies with costly infrastructures that are not practicable when government business, while important, is a small part of the company. Market driven forces will ensure fair and reasonable prices to the government and additional CAS administrative costs will also be eliminated. Small businesses are exempt from CAS requirements and although firms like 3M are large commercial companies we are small government businesses.

Imposing administrative burdens of CAS increases our cost and reduces opportunities to participate in government business. In addition, companies attempting to integrate commercial and government business, to achieve optimal efficiencies and effectiveness,

see potential that costs of unique government requirements will negatively impact their ability to compete successfully in global commercial markets. In this situation, the government either does not have access to important technological research and development, or if research is acquired, government pays for unnecessary administrative costs, thereby reducing research and development it receives with available funding, and the unique government costs can place the company in a less competitive position in their primary business, the commercial marketplace....definitely a lose/lose/lose situation. Exemption from CAS, or increased applicability thresholds, would be a large step in achieving government desire to increase willingness of these commercial companies to offer readily available, state of the art dual use technology, at fair and reasonable price, to government as well as their commercial customers obviously a win/win/win situation.

Testimony of Lynn Saylor
Director of Corporate Government Finance
General Electric Company

before the CAS Board Review Panel

June 17, 1998

June 17, 1998

Remarks at the GAO Review Panel on the CAS Board

Good Afternoon! I'm Lynn Saylor from General Electric Company, where I serve as the Director of Corporate Government Finance for the Company Comptroller, Phil Ameen, and the Corporate Finance Staff. GE is a member of various industry associations with headquarters in the Washington area, and I am personally involved as the current Chairman of the AIA Procurement & Finance Council Executive Committee and Vice Chairman of the Manufacturers Alliance Government Contracts Council. I am also a member of the Financial Executives Institute Government Business Council.

Chart 1

You can learn more about GE and our twelve businesses in our 1997 annual report by visiting the GE Homepage at the Internet address shown here. The GE Company financial data I will be sharing with you during the next few minutes is available on the GE Annual Report Homepage.

Chart 2

Those twelve businesses generated more than \$90 billion in consolidated revenues during 1997, up more than sixty percent since 1993, and we're headed toward \$100 billion in 1998.

Government contract sales represent a little more than two percent of the 1997 consolidated revenues, a decline of more than thirty percent since 1993, even after excluding the GE Aerospace business we transferred to Martin Marietta Corporation. Some of the decrease is due to the declining government market, but some is also due to avoiding doing business in a complex regulatory environment, that has become increasingly criminalized since the late 1980s.

Chart 3

This Industry Segments data from the 1997 Annual Report shows that each one of GE's twelve businesses is a multi-billion dollar business by itself. It is also common knowledge that our Aircraft Engine business is the only major GE business with significant government contract sales and their business mix has shifted from a reliance on government contracts in the early 1980s to predominately commercial contracts in the 1990s (including some government contracts for commercial items).

Chart 4

GE believes that the Cost Accounting Standards Board (CASB) should provide an appropriate forum for establishing government contract costing practices for non-

commercial item transactions. However, we also believe that this Panel's review of possible CAS Board reforms, including membership requirements, is timely, and that those reforms should be aimed at reducing some burdens on the government contractor through elimination and simplification of the Cost Accounting Standards (CAS).

GE employees believe fervently in three defining cultural traits --- self confidence, simplicity and speed. Self-confident people, and organizations, don't need complexity and clutter that passes for sophistication in communications, standards or regulations. We know that elimination of such complexities and clutter results in faster, smarter decision making, cost avoidance or elimination and an organization that crackles with energy and excitement.

Chart 5

CAS Board action to eliminate unnecessary CAS Standards and utilize Generally Accepted Accounting Procedures (GAAP) or Financial Accounting Standards (FAS), in certain limited circumstances, combined with increasing CAS thresholds and regulatory exemptions, just might generate an infusion of self-confidence, simplicity and speed into government contracting.

Certainly this panel should re-evaluate the roles and responsibilities of the CAS Board including the membership structure, to ensure that it is an independent accounting policy setting board separated from the myriad of potential political and procurement decisions of Government agencies.

Since the mid 1980s several primarily commercial GE operating components reporting to some of the twelve GE businesses mentioned earlier made decisions to curtail government contracting. Changing those commercial operating components to CAS compliant segments was viewed by management as an unnecessary expenditure of precious resources. Why spend resources to change your accounting system or add infrastructure to comply with complex CAS and FAR regulations, solely to obtain marginal incremental sales, when those resource expenditures will have to be subsidized by the segment's commercial business? We think it was a simple decision!

If a goal is to increase competition to supply goods and services to the Government, the CAS Board should increase exemptions for primarily commercial companies or primarily commercial operating segments of large corporations. Exempting commercial items, and goods and services that are competitively priced or parametrically priced, from CAS and FAR regulations, may be an answer to increasing competition and simplifying the procurement of goods and services.

Since the passage of the Federal Acquisition Streamlining Act and the Clinger-Cohen Act, with an improved definition of commercial items contracting, a few managers at GE operating components have re-visited doing business with the Government, especially in

those instances when we acquired a commercial business with some Government contracts.

In addition, many of the parts used to assembled our commercial and military aircraft engines are identical. GE believes situations like this represent opportunities for the CAS Board to also evaluate ways to exempt primarily commercial companies or operating components of large corporations from this complex regulatory environment.

We believe that the CAS Board could immediately eliminate some of the regulatory environment complexities by reducing the number of CAS Standards. Some of the nineteen CAS Standards do offer good guidance for measuring, assigning and allocating costs. Some do not have an exact parallels in the Financial Accounting Standards (FAS). We believe those CAS Standards should be retained. However, CAS Standards that are redundant to FAS, such as capitalization and depreciation of tangible assets (CAS 404 and 409), or CAS Standards that no longer serve a useful purpose, such as accounting for unallowable costs, cost accounting period, use of standard costs and IR&D/B&P costs, to name a few, (CAS 405, 406, 407, 408, 411 and 420), should be eliminated immediately. Simplifying the complex regulatory environment should result in faster, smarter procurements.

Even when there is a FAS equivalent, there may still be a need for a CAS Standard. For instance, in the pension and post employment benefit areas, FAS 87 and 106 rely on short term interest rates that tend to be volatile and not conducive to longer term contract pricing and costing techniques demanded by government contract accounting. We believe retention of Standards on pensions and insurance (CAS 412, 413 and 416) is appropriate, even though recent changes to the pension Standards rendered them essentially useless. It is rumored within the defense industry that a number of contractors are spending unnecessary resources explaining and defending previously acceptable and approved pension accounting techniques because of these revised pension Standards.

Chart 6

GE believes that the CAS Board should be a contract accounting board of experts that functions independently, providing appropriate accounting decisions and guidance to preserve the integrity of Government contracting. It is conceivable that other pressures or influences prevent the current CAS Board from acting like an independent, objective accounting policy setting board, as expected by the private sector. Those pressures may have created the inconsistencies and inequities in the revised CAS 412 and 413 promulgations on pensions, or the increased administrative burdens, that don't add any perceived value, as demonstrated in revised Disclosure Statements forms, especially Part VII, and the recently recommended definition of a cost accounting practice change.

To address these concerns, we believe that the current mix and number of CAS Board members should be re-evaluated to eliminate any appearance of potential conflicts between setting contract accounting policy and subsequently implementing that same

policy. This Review Panel should consider recommending membership and voting guidelines similar to the FAS Board. The FAS Board has seven members --- three from public accounting, two from industry, one from academia and one from the buy side analyst perspective, generally from the public sector, --- and requires a "super majority" of five votes for rulemaking purposes. A similarly sized CAS Board with the same voting criteria might eliminate some of the negative perceptions about the current CAS Board.

To accomplish this change, we recommend seven members on the CAS Board consisting of --- three from public sector (government), two from the private sector (industry), one from academia and one from public accounting.

Two of the Government representatives should represent the major customer stakeholders that use CAS covered contracts --- such as DoD and DoE --- and the third Government representative should be from the office responsible for establishing accounting policy for the government -- GAO. These representatives should be senior people, perhaps presidential appointees, confirmed by the Senate.

One industry representative should be from a company with contract sales ranking in the top five or ten government contractors and the second industry representative should be from a contractor in the top 100, preferably from the services sector.

I hope my comments will help this Review Panel evaluate ways to enhance the CAS Board's effectiveness, improve the quality of their promulgations and eliminate any continuing negative perceptions of the Board. Thank you for listening to me. Since this is a public meeting, we prefer that you provide written questions and we will respond at a later date.

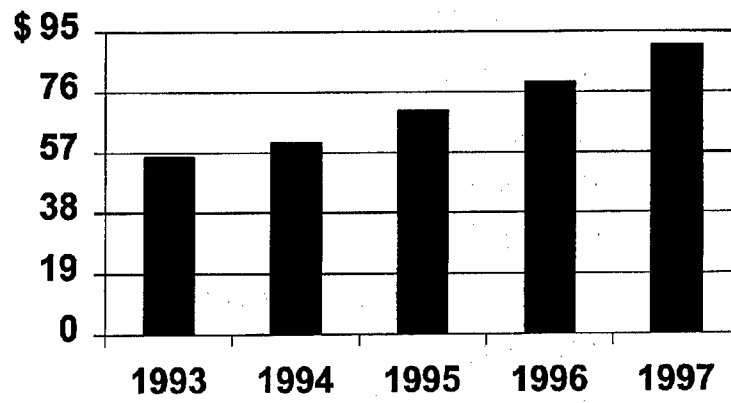
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<http://www.ge.com/annual97/>

- **Aircraft Engines**
- **Appliances**
- **Capital Services**
- **Electrical Distribution & Control**
- **Industrial Control Systems**
- **Information Services**
- **Lighting**
- **Medical Systems**
- **NBC**
- **Plastics**
- **Power Systems**
- **Transportation Systems**

1

**GE Consolidated Revenues
(In billions)**



GE Consolidated Revenues

(In billions)	<u>1997</u>
Aircraft Engines	\$ 7.8
Appliances	6.7
Broadcasting	5.2
Capital Services	39.9
Industrial Products and Systems	10.9
Materials	6.7
Power Generation	7.5
Technical Products and Services	4.9
Corporate items and eliminations	<u>1.2</u>
Total	\$ 90.8

3

CASB Reforms

- **Non-commercial Item Transactions**
- **Membership**
- **Elimination and Simplification**

4

CASB Actions

- **Increase Thresholds and Exemptions**
- **Eliminate Standards**

5

CASB Membership

- **Parallel FASB Seven Members**
- **“Super Majority” for Rulemaking (5)**
- **Government (3)**
- **Industry (2)**
- **Academia (1)**
- **Public Accounting (1)**

6

Presentation to the GAO CAS Board Review Panel
by Patrick J. Gnazzo, Vice President, Business Practices
United Technologies Corporation
June 17, 1998

Good afternoon. I am Patrick Gnazzo, Vice President-Business Practices at United Technologies Corporation. My responsibilities include compliance and business ethics as well as the government contracts program.

Thanks for this opportunity to speak on behalf of United Technologies about the future and the mission of the Cost Accounting Standards Board.

As I was preparing my comments, I recalled a story my dad once told me. He was in the construction business, and had done a lot of work on a house for a couple who had a son fighting in Vietnam. Because of injuries suffered in Vietnam, the couple's young son returned home in a wheelchair. The soldier's parents asked my dad to build a ramp for the house to accommodate their son's wheelchair. They said the Veterans Administration would pay for the ramp and asked my dad to get in touch with the agency.

As my dad began the project, he realized he would have to climb a mountain of paperwork to complete this small job. In fact, he concluded the ramp would cost 25 percent more than he'd normally charge because of VA regulations and procedures. My dad could not bring himself to charge the artificially inflated price. He refused the job, even though the family was a good customer and wanted him to do the work.

In a nutshell, my dad's dealings with the federal government illustrate the essence of my comments. Many good commercial companies are avoiding government business as if it were some dreaded disease. And long-time government contractors have spun off their government businesses -- Litton, Honeywell and Emerson Electric just to name a few.

Existing and potential suppliers are being driven away by government regulatory impediments and by the government's enforcement regime. Although the changes adopted under the leadership of Secretary Perry have brought much needed rationalization to the procurement system, the need for acquisition reform is far from over. The efforts of Secretary Cohen and Under Secretary Gansler in seeking to remove barriers to integrating the civil and military production base are right on target.

I am here today to address the regulatory thicket generated by the Cost Accounting Standards Board -- an organization that was appropriately created 25 years ago but which today adds needless complexity and distorts accounting in order to achieve cost control. Before elaborating on CAS, just to provide context for my remarks, I should tell you that I consider CAS to be the number two problem remaining with the acquisition system. In case you are curious, the number one problem and principal barrier to achieving the objectives of acquisition reform is the "Russian Roulette" operation of the civil False Claims Act. It magnifies the problems that otherwise exist in what one federal judge described as the "infrangible mass" of government contracting rules. But that's a matter for another forum.

I hope today to shed some light on the issues associated with the CAS and CASB, speaking from the perspective of a corporation spanning both government and commercial businesses.

United Technologies has been doing business with the government since the mid-1920s. Pratt & Whitney developed the powerful, air-cooled aircraft engines that helped win World War II. Igor Sikorsky, the founder of the helicopter industry, grew his business into a major supplier to the Armed Forces. Hamilton Standard, a pioneer in aviation systems, is an integral part of NASA programs, from Mercury to the International Space Station.

The corporation, originally called United Aircraft, was 100 percent aerospace/defense until diversifying in the 1970s. Changing its name to United Technologies, the corporation acquired Otis Elevator Company, Carrier and a number of industrial companies that evolved into United Technologies Automotive.

These commercial/industrial units now generate almost 60 percent of UTC's revenues of 25 billion dollars. Otis and Carrier, each with six billion dollars of sales, account for almost half of the total.

Of course, the aerospace/defense units serve commercial and government customers. Government sales, which at one time brought in the lion's share of United Aircraft's revenues, today provide only about 15 percent.

United Technologies' presence in both the government and commercial sectors gives us a different perspective on the subject we are addressing today. On the aerospace/defense side of our business, we understand what it's like to supply the government.

A government contractor as big as UTC can adapt to the arcane requirements of the Cost Accounting Standards Board, the Federal Acquisition Regulations (FAR) and other laws and regulations. But many smaller companies don't have the resources to deal with the twists and turns of CAS. And many commercial companies -- even large ones like our Otis and Carrier operations -- don't want to expend major resources or redesign their companies in order to do business with the government.

What are some of the issues we have with the CASB? Let me start with the fundamental issue of accounting.

CAS requirements often conflict with Generally Accepted Accounting Principles. Therefore, we have to maintain separate financial records for GAAP and CAS -- two sets of books, as it were. And who pays for this unique government requirement? -- the taxpayer!

UTC is burdened by a conflict with regard to writing off non-performing assets. GAAP accounting requires a company to take an immediate write-off when it recognizes that it will not be able to recover the value of certain assets during the conduct of its business. In contrast, CAS prohibits this kind of a charge.

Another conflict appears in pension regulations. Federal pension law and GAAP accounting require five-year amortization of gains and losses in pension plans. CAS requires 15 years!

The cost of maintaining multiple accounting systems is considerable. Actuarial fees plus the resources expended to keep dual pension records surpass a quarter of a million dollars annually for United Technologies. Now, think of that expense repeated at many, many companies, and, to paraphrase a former U.S. senator, now you're talking real money!

CASB regulations also can impede a company's ability to take action that's good for employees and general business objectives. This is clear at a United Technologies subsidiary that is a supplier to NASA. In the context of NASA's efforts to consolidate its supplier base, United Technologies determined it would be better for both parties if this subsidiary were sold to the other NASA supplier, the prime contractor, before contract termination. The sale route was deemed preferable for a number of practical business concerns, including retention of the work force during the two-year-long transition period.

In attempting to negotiate this sale, however, we have encountered a number of roadblocks. CAS regulations are preventing a timely resolution of this matter. In fact, they are making a sale unlikely. Meanwhile, the uncertainty is causing valued employees to leave the company. This is making it difficult to fulfill our commitments to NASA.

What are the reasons for these dual accounting requirements? Actually, no good reason can be found in accounting theory and practice. The reasons must be

understood in terms of impact. The CAS is driven by factors extraneous to good accounting principles.

CAS was supposed to deal with measurement, allocation and assignment of costs. The board, however, has evolved into an instrument for determining and controlling cost allowability.

And how do these problems reveal themselves?

First, the CASB, as currently constituted, is not an independent agency. It is government-controlled -- three votes to two, with nominal private sector representation. It's led by the Administrator of OFPP -- the person responsible for procurement policy and not an accounting expert. What's more, one of the board members of CASB is the head of the Defense Contract Audit Agency. In our view, this an inadequate separation of functions in establishing a control system. The DCAA, as an auditing agency which monitors compliance, should not be represented on a board determining policy. Because other government members of the CASB are not accountants, the views of the DCAA member are very influential in practice.

To see how the CASB should function, consider the Financial Accounting Standards Board. In the world of the FASB, the same people do not set policy and audit compliance with policy. The separation of policy-making and auditing functions is a universally accepted business concept -- everywhere except at the CASB.

Second, the CASB modifies its standards to overturn unfavorable results of litigation. This can occur when contractors, disagreeing with contracting officers' interpretations of CAS, take their case before the Boards of Contract Appeals.

For example, when a contractor (Gould) filed a law suit over an interpretation of pension requirements, the CASB revised CAS 412 and 413 to make the standards conform to the government's position in the law suit. A coincidence? Hardly, but they have added new meaning to the term "home field

advantage!" Although changes in the rules are clothed in accounting jargon, the changes are made in order to reduce costs.

The Cost Accounting Standards, as they exist today, are inconsistent with the interests not only of government contractors but the government itself. We are currently wasting a lot of time battling with government auditors over this issue.

A case in point, in accounting for fixed assets, companies generally tie their depreciation methodology to that of the Internal Revenue Service. Sounds logical, right? Wrong!

That was the procedure three United Technologies business units followed. However, the Defense Contract Audit Agency said the companies were not complying with cost accounting standards in that actual asset lives were longer than the IRS guideline lives.

Our business units acknowledged that they were not using asset lives in accordance with CAS regulations. They pointed out that the government was actually benefiting substantially because cost of money calculations would more than offset the faster depreciation. Nonetheless, the DCAA has continued to pursue this issue.

We suspect that eventually we will be able to reach agreement with the contracting officers -- as we have on several occasions over the past 10-plus years. Such regulations make no sense, but they cost time and money not only for corporations but for the government as well.

Complexities of the Cost Accounting Standards are a major spawning ground for government enforcement actions, including the civil False Claims Act. A few years ago, Litton was accused under the False Claims Act of improperly accounting for certain overheads. Although Litton believed its accounting was proper and that the government had suffered no harm, the threat posed by enormous penalties and treble damages forced the company to settle. Following the settlement, Litton spun-off its defense business.

Otis Elevator Co. also had first-hand experience with a CAS dispute that turned into an enforcement action in the mid-1980s. Although Otis does business almost everywhere and is the world's market leader, Otis has a policy prohibiting almost all business with the U.S. Government.

Decades ago, Otis supplied elevators for many buildings erected by the General Services Administration (GSA). Today, other companies maintain these elevators. The GSA has asked Otis from time to time to submit proposals for servicing these elevators, but Otis says, "No thank you!"

Fear of the leverage of an enforcement regime with high penalties and low standards of liability is the principal factor that keeps Otis on the sidelines. The changes brought by acquisition reform for commercial products do not adequately cover the construction and services industries. CAS remains a looming threat.

The government also wants to integrate civil and military production in common facilities. There are very few such plants in the United States. United Technologies has two of them. If the government is truly intent on fostering more civil/military integration, we must move from cost-based contracting and all its attendant regulations to price-based contracting.

CAS also inhibits integration by imposing obvious additional compliance costs on contractors, such as added staff. Less readily apparent, however, are costs associated with the government's right to supply government furnished material (GFM). Under government interpretation of CAS, this process (the supply of significant amounts of GFM by the government) results in skewed overheads with greater allocations of costs to commercial products. This is because no overhead can be applied or allocated to zero-value GFM when 'total cost input' is used as an allocation base. As a result, with higher costs allocated to commercial items, it's not surprising that contractors are reluctant to create a single integrated production facility.

The government makes the rules for procurement of its needs. We understand that. We also understand that the CASB changes the rules when it suits them. We are used to keeping different books to meet varying requirements. Our aerospace companies have unfortunately grown accustomed to fighting with contracting officers and the DCAA and going to the Boards of Contract Appeals. We've been doing this a long time. But our commercial companies, Otis and Carrier, don't agree that it's worthwhile from a cost-benefit analysis standpoint for them to get into the government business.

I have shared with you some of the highlights of our experience with the CASB at United Technologies. Based on this experience, what do we recommend?

For starters, we favor abolishment of the Cost Accounting Standards Board. The imposition of a unique set of cost accounting standards is extremely expensive to business and government -- without any appreciable benefit to anyone, save the CASB.

The CASB's time has passed. It was created as principles of cost accounting were being developed but is no longer necessary. In theory, the idea was fine. But its structural flaws have become magnified over time. Board actions are motivated by the intent to control government costs rather than adopting good accounting practices.

Responsibility for developing accounting requirements, including any cost accounting standards that should be necessary, should be placed exclusively with the FASB. This will assure independence and a focus on accounting matters rather than procurement policy. Should the FASB require additional funding to take on this responsibility, financial support could come from industry and government.

The responsibilities of FASB should be limited to dealing with measurement, allocation and assignment -- not saving the government money, and not setting procurement policy under the guise of establishing "best practices" for

accountants. Moreover, the Defense Contract Audit Agency should be confined to the audit function. The DCAA should be determining compliance with policy, not setting and interpreting policy.

The government can elect to control costs through its contracts, but let's not do it under the pretext of accounting. If you don't want to abolish or reform the Cost Accounting Standards Board, at least change its name to the Cost Allowability Standards Board. You won't even have to change the acronym.

In conclusion, I ask you to compare the vast majority of business operating in the American economy with the government procurement sector. Mainstream industry follows Generally Accepted Accounting Principles with great success. In contrast, the government contracting sector is plagued with litigation. We waste a staggering amount of resources in lawsuits over interpretations of CASB rules that are at odds with GAAP.

We do not have to continue to do business this way. Experience over the past 25 years has demonstrated the effectiveness of GAAP. Abolishing the CASB will free business to serve the public interest more effectively. At the same time, it will enable the federal government to respond more efficiently to taxpayers and citizens.

Thank you for this opportunity to speak on behalf of United Technologies, and good luck in your deliberations.

* * *



**STATEMENT OF DANIELLE BRIAN,
EXECUTIVE DIRECTOR,
PROJECT ON GOVERNMENT OVERSIGHT (POGO)
TO THE COST ACCOUNTING STANDARDS (CAS) BOARD REVIEW PANEL**

Thank you for the opportunity to appear before the CAS Board Review Panel. POGO is a nonprofit, nonpartisan organization that has, for over 17 years, investigated, exposed and worked to remedy abuses of power, mismanagement, and subservience to special interests, by the federal government. I want to add that it is particularly symbolic that we should be meeting here in the Elmer Staats' Room of the General Accounting Office. General Staats served with distinction not only as Comptroller General, but as Chairman of the CAS Board for ten years. More recently, he served as Chairman of the Federal Accounting Standards Advisory Board. General Staats was a fearless and tireless advocate for the CAS Board, and the need for Cost Accounting Standards. I hope this Panel serves in the tradition and spirit that he established for the CAS Board, and more importantly for the general public interest.

In June 1996, when establishment of the CAS Board Review Panel was requested by the former Chairman of the House Committee on Government Reform and Oversight and the Chairman of the Committee on National Security, POGO became concerned that this action would be another attack on the need for Cost Accounting Standards and the CAS Board. We remain concerned. Over the years since establishment of the original CAS Board, the Government contracting industry has generally opposed many of the accounting standards-setting activities of the Board. In other cases, industry has sought to restrict the application of CAS in Government contracting. This is understandable. The purpose of CAS is to increase the uniformity and consistency with which cost accounting data is supplied by contractors to the Government for the purposes of assisting in either negotiation, pricing or administration of contracts. Such increased uniformity and consistency necessarily restricts contractors in the accounting methods and techniques used to measure costs, assign costs to accounting periods, or allocate such costs to cost objectives when estimating, accumulating or reporting contract costs.

In our view, the stated Congressional basis for this Panel's review of CAS and the CAS Board in many ways "places the cart before the horse." For instance, recent acquisition reform initiatives have sought to increase the Government's reliance on commercially available goods and services.

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1900 L Street, N.W., Suite 314 • Washington, DC 20036-5027 • (202) 466-5539
Fax: (202) 466-5596 • E-mail: pogo@pogo.org • www.pogo.org

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Similarly, other aspects of acquisition reform have sought to lessen the Government's need for cost accounting data when purchasing non-commercial (military or Government unique) goods and services. The Panel has talked extensively about commercial products as though their existence is relevant to this debate. In truth, I would love to talk about how the government has gone back to buying \$76 screws, as well as the absurdity of negotiating "commercial" prices, but that is not at issue here. To the extent that the Government does purchase commercial items, such contracts are by definition, exempt from CAS coverage. Even when purchasing Government unique goods and services, CAS only applies when cost data is provided by the prospective contractor; and even then only when significant dollar thresholds are satisfied. Thus, POGO is somewhat mystified at what this Panel is seeking to review. Whether a contract may be subject to CAS seems to us to be an issue relative to the contracting method deemed appropriate for use under the circumstances. If cost accounting data is required, then CAS applies. If such data is not required, then CAS obviously does not apply. It is the Government's need for, or requirement to provide cost data, in its various contracting strategies, that triggers application of CAS, not vice versa. Why would the government want to enter into a contract that requires cost data, but not want that data to comply with CAS standards? Since CAS is by definition only used when cost-based pricing arrangements are used in government contracting, we have to question whether this Panel is in fact responding to contractor complaints regarding the substance of the CAS Board decisions.

At this point, I would like to address the specific issues for which comments were requested via the General Accounting Office (GAO) world wide web page.

(1) The Cost Accounting Standards Board's mission in a rapidly evolving integrated civil-military industry.

Whether the Government's supplier base is "rapidly evolving" into an "integrated civil-military" industry is in our view not particularly germane. Rather, stripped to its core, the real issue is the future role of cost-based contracting methods in the Government's procurement process.

According to information from the Federal Procurement Data System and the Department of Defense (DOD) Inspector General (IG), at present, cost-based Government contracting accounts for approximately 70% (\$125 billion +) of all contracts let by the Government. Roughly 60% of these contracts are cost-reimbursement, and another 40% are fixed-price, but involve the submission of cost data for contract pricing, payment or incentive purposes.

If, in the future, there is a large shift to price-based contracting, then any CAS issue will automatically become moot. This brings us to POGO's chief concern. If CAS applicability is dependent upon the use of cost-based pricing or contracting techniques to purchase non-commercial items, then the only real CAS issue seems to us to be the specific content of the CAS Board's Standards, disclosure requirements or contract price and cost adjustment provisions. This is very troubling.

Without cost accounting principles, as embodied in the Standards, how will contract prices, target costs and estimated cost ceilings, including fees or profit, be determined? What will Government payments for contractor reimbursement claims be based upon if the Government will no longer rely upon CAS for the determination of actual contract costs accumulated in a contractor's cost accounting records? We are already seeing signs that although much new "acquisition reform" terminology is often being used, only the names have changed, the underlying contracting concepts have not changed at all. A good example of this is the use of so-called "other transactions." Such "other transactions" blur the distinctions between financial assistance instruments (grants and cooperative agreements that are generally used to support an entity's independent research and development efforts) and acquisition contracts where the Government acquires research and prototypes. To date, such "other transactions" have generally been placed in the form of cost-type contracts by another name, but without the traditional audit and cost allowability/allocability provisions. We are told that "other transactions" are designed to bring new firms into the defense industrial base. Yet, recent DOD IG testimony reveals that over 80% of such "other transactions" are being awarded to traditional defense firms. In these circumstances where research or prototype units are "acquired" by the Government, we would ask, how will cost sharing under the new "other transactions" concepts be validated? To what extent are projected or actual cost accumulations relied upon? How is such reliance different from the traditional cost-reimbursement contracting process?

Cost-Based Contracting in the Federal Acquisition Streamlining Act/Federal Acquisition Reform Act Era

While acquisition reform as embodied in the Federal Acquisition Streamlining Act and the Federal Acquisition Reform Act has unfortunately decreased cost data submission requirements, it has not significantly changed the ratio of commercial or price-based contracting methods to cost-based contracting methods. A recent GAO report showed that only about \$10 billion of goods and services purchased by DOD in FY 1997 were classified as "commercial" and conducted pursuant to Federal Acquisition Regulation Part 12. As previously mentioned, if at some point in the future, the Government were to significantly shift to price-based contract pricing techniques, then any CAS issues would automatically dissipate. Again, the question is not CAS, but rather the Government's continuing use of cost-based pricing. That is not a CAS issue. CAS exists to provide meaningful accounting conventions in a cost-based contract pricing environment.

Thus, in a cost-based contract environment where civil and military products or services are provided to customers from a common work force or production line, there is a clear need for an agreed-to set of rules governing a contractor's cost accounting practices, particularly when the projected or actual costs of contract performance are a factor influencing the negotiation of a contract price or the payments to be made for allowable costs. This is because the total costs of the contractor's overall operations have to be accounted for. Then, the portion of the total costs of operation to be identified with individual orders, Government contracts, and other direct or indirect activities need to be identified in an equitable manner. CAS is designed to accomplish this objective by requiring cost-

based contractors to apply their cost accounting practices consistently when estimating, accumulating and reporting the costs of performing individual contracts. CAS also specifies how costs are to be "allocated" to intermediate and final cost objectives. It is my understanding that for selected items of costs, certain CAS either constrain or modify the period cost assignment principles applied for financial statement reporting purposes under Generally Accepted Accounting Principles (GAAP).

- (2) **Costs, benefits, and risk assessment in the application of cost accounting standards to government contractors (including differences based on industry, segment, type of cost, character of goods or services, contract type, and so forth),**

CAS rules address such issues as disclosure and consistent application of accounting practices, and the methodology for the allocation of indirect costs. Because of CAS and the associated disclosure requirements, less auditing effort is required because the range of acceptable accounting alternatives is understood by both contracting parties. Selective audit review can be limited to a compliance check rather than an open debate on the judgmental interpretations between the Government and the contractor regarding what is acceptable accounting for costs. Smaller samples can provide adequate assurance levels to conclude that contractor accounting methods are compliant.

Costs and Benefits of CAS

In 1978, a distinguished panel of accountants and economists reviewed the costs and benefits of the CAS Board and its rules, regulations and standards. It concluded that CAS have had a significant and desirable influence on defense contracting. In particular, the panel concluded that CAS reduced the level of misunderstandings, increased the level of reliance on contractor cost data representations and increased auditor productivity.

More recently, in late 1996 (post-acquisition reform) the DoD gave a strong endorsement of CAS and concluded that CAS was critical in protecting the government's interests:

Without rules to require consistent treatment of costs, the government could not rely upon a contractor's cost representations and would bear significant risks of inequitable contract prices and cost allocation. Since the GAAP are not equipped to address these concerns, the CAS play a vital role in protecting the government's interests.

"Commercial" Companies

POGO has heard an increasingly loud shrill sound emanating from some Government contractors that they should be exempt from CAS because they are "commercial." POGO believes that these

claims are a smoke screen for the real issue -- not being held reasonably accountable to the taxpayer when engaged in cost-based pricing or contracting. Perhaps a more objective review of these "commercial company" claims would suggest that the Government should not consider such firms for cost-based pricing or contracting arrangements. In POGO's view, a firm that cannot comply with CAS when engaged in large dollar cost-based pricing with the Government should be considered ineligible for contract award. Companies should not be allowed to avail themselves of the advantages of cost-based pricing and contracting with the Government, without also being required to step up to the responsibilities this imposes. Sadly, some have seized on "acquisition reform" to shirk those responsibilities -- at least insofar as accountability to the public for their contract cost representations and claims for reimbursement.

Other groups or companies, for instance, colleges and universities, health insurance carriers, and so-called Integrated Dual Use Commercial Companies (IDCC), are also hoping to be exempted from CAS. Although these three groups all have unique claims to make, they are not unique to the extent that cost-based pricing or reimbursement is used in their dealings with Federal contracting agencies. For instance, we have seen claims that so-called IDCC firms should be relieved from CAS coverage because these companies are "commercial." However, our review of the record indicates that what is really sought is relief from cost accounting requirements that have been carefully considered and developed for use in cost-based pricing situations. Similarly, colleges and universities have lobbied for CAS exemptions based on their "uniqueness," but fail to mention that like their commercial counterparts, they receive reimbursements from the Government based on actual costs claimed. This was recognized by GAO in its 1993 recommendation to the CAS Board that CAS application be extended to college and university contracts (and grants) with the Government.

- (3) **The relationship of cost accounting standards to generally accepted accounting principles, activity-based cost systems, and cost allowability principles (including levels of complexity, overlap, duplication, conflict, and so forth).**

CAS vs. GAAP

This is perhaps the most misunderstood aspect of CAS. Simply put, the purposes of GAAP and CAS are different. GAAP applies to the reporting of an entity's annual results of operations and financial condition at the end of a year. GAAP is intended to guide stockholders, potential investors and creditors. CAS, on the other hand, is concerned not only with the assignment of costs to particular cost accounting periods, but also with the allocation of the assigned direct and indirect costs to contracts and to other cost objectives.

As I mentioned above, the 1996 DoD study dispelled the notion that GAAP could in any way replace CAS in protecting the government's interests. The DoD opinion further stated:

GAAP provides guidelines for financial reporting, but are inadequate for contract costing purposes . . . GAAP cannot provide reasonable assurance that such procurements will be fairly priced or will receive equitable cost allocations. In contrast, CAS contain criteria that provide the necessary assurance.

The original GAO Feasibility Study Report clearly concluded that GAAP does not serve contract costing purposes or address the identification of direct and indirect contract costs. This continues to be the case today in current accounting literature. This situation was recognized as recently as the "Report of the Section 800 Panel," and the Department of Defense response to the TASC/Coopers & Lybrand Report. The American Institute of Certified Public Accountants' (AICPA) most recent edition of "Audits of Federal Government Contractors" stresses this point. Is this panel going to reverse the accounting profession's long-standing conclusion?

Those who argue that GAAP may be used in lieu of CAS misunderstand both the nature of CAS and GAAP. CAS are the exclusive authoritative guidance for the cost accounting principles and practices used to estimate, accumulate, and report the costs of **individual contract** performance. Thus, the underlying purpose of CAS differs from GAAP in that CAS is concerned with the identification and allocation of an entity's costs to individual contracts, as either a direct cost or an indirect cost.

Some companies have also claimed that CAS imposes "new" or "burdensome" accounting requirements, or that it requires companies to "change" or establish separate accounting systems. In its 1996 opinion, the DoD also dismissed this myth:

CAS evolved from sound commercial cost accounting concepts that are compatible with GAAP, consequently there should be no need for new or separate accounting systems, and extensive changes to existing systems generally should not be necessary to comply with CAS.

CAS is simply different than GAAP, because it serves a different purpose. CAS does not require a company to replace or modify its financial accounting system utilized for reporting the results of its overall operations. It only requires companies to utilize a cost accounting system that is adequate to record and allocate direct and indirect costs to particular jobs in an equitable manner. Obviously, CAS does require a company to establish a compliant cost accounting system. However, in our view, companies that have trouble with this fundamental concept have no business receiving or performing cost-based contracts.

CAS and the Contract Cost Principles

Over the years, a recurrent theme has been periodically raised that CAS and the contract cost principles in FAR Part 31 are in conflict with one another in various areas. To some extent this is

true. The cost principles, of course, govern what costs are allowable (based on public policy considerations) under Government contracts. By contrast, CAS is concerned with the measurement, assignment and allocation of costs to contracts. Rather than eliminating CAS, we would suggest that one solution would be to combine authority for both allocability and allowability under the CAS Board in an effort to maintain these standards government-wide. I understand this approach was already suggested by the National Security Industrial Association in their response to the "Section 800 Panel," as well as by several academics.

During the debate on CAS, POGO has heard a number of complaints about Government "cost accounting rules" (for instance those of the IDCC member companies). Upon closer examination, however, it would appear that many of these "complaints" stem from, or more accurately relate to, the contract cost principles in FAR Part 31 -- particularly those relating to unallowable costs. Still other Government "cost accounting problems" more properly appear to be a matter of debate and/or interpretive disputes between the Defense Contract Audit Agency and various contractors. In our view, perhaps more rather than less specificity may be needed in the CAS in order to resolve these various ambiguities. We think that as this debate evolves, the various parties need to more specifically state what parts of CAS (or the contract cost principles) are in issue, rather than relying on generic broad brush statements.

We have also heard it said on occasion that the CAS Board has gotten itself into matters concerning the allowability of costs. We think these statements tend to come from quarters that are disappointed with the outcome of specific CAS Board rulemakings -- such as the ones that resulted in the changes to the pension costing standards, or the rule requiring that depreciation be based on original acquisition cost rather than a "stepped-up" basis following a merger or a business combination. We have also heard the reverse, that the cost principles frequently get into matters of allocability that are reserved for the CAS Board. Although reasonable people may disagree concerning these technical matters, POGO believes that we should leave these accounting issues to the people best qualified to assess their merits -- the Members of the CAS Board.

CAS and Activity-Based Costing

Activity-based costing or ABC, is a relatively new term designed to reflect increased emphasis on cost management techniques in business process reengineering. While the term is relatively new, the basic concepts are not. We have heard accusations that CAS is an impediment to those firms seeking to implement ABC. We respectfully disagree. We can find no provision in CAS that would prohibit use of any particular cost driver (indirect cost pool structure or cost allocation base) in an ABC environment. To the contrary, the CAS are quite conceptual in nature. The only basic CAS requirement is that there be a causal or beneficial relationship between the particular cost and its allocation to specific cost objectives, e.g., contracts. Perhaps the real reason why some firms have raised ABC as an issue, is that in their desire to implement an ABC system, they are unwilling to comply with the "no increased cost" to the government provision of the CAS contract clause. We

see nothing wrong with the "no increased cost" prohibition in the CAS contract clause. If a contract was negotiated on the basis of one set of accounting conventions, a decision to switch to a different set of accounting conventions should not place the buyer — the taxpayer — in a worse off position. This is the basic reason why CAS was established in the first place.

CONCLUSION

POGO is very concerned by the direction of the current debate concerning CAS and the CAS Board. The arguments against CAS being heard today are no different than the ones that were espoused in 1970 in opposition to the creation of the original Board, or again in 1980, when contractors succeeded in cutting off funding to the Board. These arguments are as hollow now as they ever were. Even the buzz phrases remain unchanged, "use GAAP," "don't apply CAS to commercial companies or commercial items," "you need to change your whole accounting system for CAS." Even the "civil-military integration" argument has been made before. All of these make for great sound bites, but they mask the underlying issues. The real issue is: What cost accounting conventions or principles should apply to cost-based pricing arrangements used between the Government and many of its contractors? What is wrong with disclosure of a company's major cost accounting practices when dealing with the Government under cost-based pricing arrangements? I have heard a number of generalizations concerning CAS and the CAS Board these past few days, but little that is specific. I am inclined to ask: Where's the beef? If the beef is that the Government needs to review its procurement policies regarding the use of cost-based pricing — fine. I would love to have that debate. But, that is not a debate about CAS. However, if the debate concerns the contents of the CAS Board's rules, presumably after a decision to use a cost-based contract pricing arrangement has been made, then this Panel is going down a road in which it substitutes its judgment for that of a responsible accounting standards setting body established for that purpose. I respectfully suggest this is not the body to review the decisions made by the CAS Board.

GAO has always been supportive of the work of the CAS Board. Indeed, the Comptroller General chaired the original Board, and GAO, by statute, continues to play a vital role in the current Board's standards-setting process. In 1994, GAO issued a supportive report about the current Board which stated that its work is very important, and that the Board's biggest failing was that it was too short-staffed to timely complete projects on its agenda. Not surprisingly, this GAO report did not please some of the contractor critics of the Board. Thus, we find ourselves in a very curious situation where the Acting Comptroller General is the Co-Chairman of a Review Panel concerning CAS and the CAS Board that is not being conducted by GAO. Perhaps the requestors of this review were concerned that if GAO itself undertook to perform the current review, it would have reached a conclusion not too different from its 1994 report — CAS is very important and the work of the CAS Board should be supported, not denigrated or politically attacked.

In 1996, at the close of Comptroller General Bowsher's term, GAO issued a landmark report on the independence of the accounting profession and its standards setting bodies. Although that report generally related to the work of setting accounting standards for financial reporting, its conclusions apply equally to the CAS Board's work. The independence of accounting standards setting bodies needs to be strengthened, not decimated. The establishment of accounting standards should be done in an environment that fosters objectivity and neutrality, sound principles and theory, logic and creativity; not in one dominated by politics, or a concern for specific outcomes. POGO hopes that GAO's involvement in this study will serve to enhance the CAS Board's independence, not make it subservient to special interests at the expense of taxpayers and the public interest.

**Alfred M. King
11102 Fawn Lake Pkwy
Spotsylvania, VA 22553**

June 15, 1998

Mr. Ralph Dawn, Executive Director
CASB Review Panel
GAO
441 G. Street NW
Washington, DC 20548

Dear Sirs:

I am Chairman of the Management Accounting Committee of the Institute of Management Accounting (IMA). The IMA has approximately 70,000 members, primarily in industry but also with strong representation in academia and public accounting. We are a 501 (c) 3 non-profit educational organization. We do not represent any particular industry; rather we try to develop the best practices for management accounting.

The Management Accounting Committee (MAC) is authorized to speak on behalf of the Association on matters dealing with internal financial reporting. A separate Financial Reporting Committee of IMA deals with external financial reporting matters affected by the FASB and SEC. I happen also to be a member of that Committee. Members of MAC come from industry, government, consulting, academia and public accounting. A listing of our current members is attached.

The Management Accounting Committee has developed authoritative pronouncements on a wide variety of topics. We refer to these as Statements of Management Accounting (SMA). Since they deal with internal accounting issues, companies do not have to follow them. On the other hand they have stood the test of time. Attached to this letter is a listing of all of the SMAs issued over the last 15 years.

The basic point we would like to make is that Cost Accounting systems should be designed to provide information for decision-making. The allowability of costs for reimbursement on cost-type contracts is probably an appropriate function of Government. The Government can determine what types of expenses they will pay for, and what they will not pay for,

relative to cost-reimbursement contracts. These policy matters, e.g., country-club dues, can be encompassed in regulations and incorporated in contracts between suppliers and the Government.

Cost Accounting Standards, however, should not be used to try and reduce the level of costs assigned to Government Contracts. The allocation of costs between government and private sector work, or among government contracts, should be determined by companies on a basis that helps make the best decisions. Consistency is important, and it is my understanding that the initial impetus for Cost Accounting Standards came some 30 years ago because of a perception that certain firms were 'playing games'. Consistency between cost estimating and cost reporting is essential. Treating similar expenses consistently over time, and among products and customers, is important. Again, these concepts can be incorporated in contracts between the Government and suppliers.

Where we think that the Government should not get involved is in telling companies how to allocate costs. Let each firm develop a cost accounting system that allows it to make the best decisions -- -- for its own operations -- -- and not necessarily try to standardize on a 'one-size-fits-all' basis.

Let me give you an example. I was personally involved in some consulting work for the Army Materiel Command. In certain Government-Owned, Contractor-Operated plants, there was tremendous under-utilized capacity. It made sense to try and use the excess capacity for commercial work. However, we ran into severe problems because if the firm took the overall costs of the facility and divided it by the actual volume of current throughput, the resulting overhead rate was excessive.

To compete effectively in the commercial market, it would be necessary for the plant to treat excess costs due to under-utilized capacity as a period cost. The Institute of Management Accounting, in SMA 4Y recommends this approach. The best way of determining the excess costs related to excess capacity, in my professional judgment, is through use of Activity-Based Costing (ABC). In Statement 4T IMA dealt with Implementing Activity-Based Costing and in the recently released Statement 4CC dealt with Avoiding the Pitfalls in Implementing Activity-Based Management.

Yet when the plants attempted to utilize ABC to develop the excess costs of under-utilized capacity and utilize this information so that commercial work could be added to the plant, it appeared to cause severe problems between the contractors and the DCAA relative to Cost Accounting Standards. Adding the commercial work to the plant would have ended up *lowering* costs to the Government, because of the absorption of some of the excess overhead. But in the two cases I was involved in rigid reliance on rules, rather than good

business or common sense meant that taxpayers were prevented from achieving the possible savings.

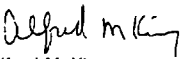
The solution would have been, and still is, to let contractors utilize authoritative Management Accounting principles, applied consistently. If an issue arises that is not covered by authoritative guidelines, I am sure the IMA's Management Accounting Committee would be glad to develop recommended procedures, without any political or economic motivations as to what answer will 'reduce the cost' to the Government.

Companies already have to comply with GAAP for external reporting, and with IRS regulations and the tax law. Throwing in a third set of mandated accounting rules and regulations adds significantly to company costs. I was involved in a study several years ago, whereby utilizing ABC techniques we demonstrated that there was a 20% to 25% increase in costs for a company simply complying with all the regulations required of a Government contractor. Cost Accounting standards were a significant cost driver in the excess costs.

In short, while it may be wishful thinking, I personally would like to see Management Accounting principles set in the private sector, just as GAAP is set in the private sector. In the case of GAAP, the Securities and Exchange Commission has ultimate oversight, but effectively lets the FASB develop good financial accounting. In the case of Management Accounting, the IMA is set up to perform the same function, with ultimate oversight through the Federal Acquisition Regulations.

I will be pleased to answer questions during my testimony.

Respectfully submitted,


Alfred M. King



UNIVERSITY OF BALTIMORE SCHOOL OF LAW

Charles Tiefer
Associate Professor of Law

4913 Crescent Street
Bethesda, MD 20816
Tel: (301) 229-0112
Fax: (301) 229-9104

TESTIMONY BEFORE THE
COST ACCOUNTING STANDARDS BOARD REVIEW PANEL
by Associate Professor Charles Tiefer:

**EXEMPTING DEFENSE CONTRACTORS FROM CAS STANDARDS
WOULD GAME THE TAXPAYERS OUT OF \$7 BILLION
THROUGH ACCOUNTING ABUSES REMINISCENT OF THE S&L SCANDAL**

I thank this panel for receiving my testimony. I am Associate Professor of Government Contracts at the University of Baltimore Law School. I was Solicitor and Deputy General Counsel of the U.S. House of Representatives in 1984-95, where I took part in countless Congressional oversight investigations of government contractor abuses. I have written extensively on government contracting issues, including, just last year, a brief on CAS-disclosure issues filed in a case before the Supreme Court.

The proposals under consideration by the CASB Review Panel would exempt defense contractors from CAS coverage, and weaken the independence of the CAS Board. Defense contractors would game the Treasury out of an estimated \$7 billion a year. Weakening the accounting system protecting the Treasury would repeat what gave us the Savings and Loan debacle, namely, crediting a self-interested industry line that a largely noncompetitive "market" substitutes for meaningful auditing standards of its claims on taxpayer funds. As, apparently, the only academic witness you will hear, I urge the CASB Review Panel, and the press and other public watchdogs, not to accept thin justifications offered for a set of self-interested industry proposals.

1. Don't Tamper with the CAS Board's Independence

Some industry elements propose to abolish the CAS Board, or to compromise its independence by moving it to the Pentagon.

Letting those with procurement responsibilities set the accounting standards without an independent check, is not just putting the fox in the sheep meadow, it is telling the sheepdogs that they should report to the fox and that what the fox says, goes.

An independent CAS Board arose for good reason. In 1968, by Act of Congress, the Comptroller General was directed to pave the way for what became the 1970 CAS Act. Congressional Quarterly, *1968 Almanac* 406 (1969). He did so through extensive inquiry, the writing of a classic report, and crucial testimony at the hearings underlying the 1970 Act. Report on the Feasibility of Applying Uniform Cost-Accounting Standards to Negotiated Defense Contracts (Jan. 1970)(B3999995(1)). That report summarizes extensive review of decades of

experience government auditors had with the hopelessness of negotiating with, or auditing, defense contractors not under uniform, independently-set accounting standards. Senator William Proxmire (D-Wisc.) and others recognized that with so many Pentagon contractors getting paid on a cost-plus basis, without consistency about the accounting for government-payable "costs," contractors were taking the Treasury to the cleaners.

That is why the 1970 CAS Act made CASB independent. Conservative estimates at that time put the loss to the Treasury from defense contractor accounting games at 5% of the applicable expenditures. S. Rep. No. 890, 91st Cong., 12d Sess. (1970), reprinted in 1970 U.S.C.C.A.N. 3770, 3772. For all the industry proposals, there has been nothing more than vague anecdotal evidence that only occasionally even gives sources, let alone a single sound analysis providing an alternative number to the classic 5% figure. In today's budget, with almost 40% of the government's contracts obligated under CAS-covered contracts, that 5% estimate means that CASB's standard-setting is needed to save the government at least \$7 billion/year.

Even within industry itself, however much it chafes at uniform cost accounting standards, the more responsible elements, aware of the abuses to which the less responsible elements are prone, praise CASB. The "Section 800 Panel" report cited commentary of one industry association as follows:

NSIA [National Security Industrial Association] agreed that the cost accounting standards and the Board have done much to protect DOD interests and the financial and ethical integrity of the defense procurement process. It also stated that "there is a continuing need for uniformity and consistency in cost accounting for government contracts."

The same report cites a second industry association:

AIA [Aerospace Industries Association] contended that this statute [the CAS Act] is necessary for the financial and ethical integrity of the procurement process.

REPORT OF THE ACQUISITION LAW ADVISORY PANEL TO THE U.S. CONGRESS, Ch. 2, sec. 2.4.3 (Jan. 1993)(quoted in Richard V. Loeb, The "Reassessment" Of the CASB Mission: An Assessment, The Procurement Lawyer, Fall 1996, at 16)(emphasis added).

Turn that around. Without the CAS Board and the CAS Standards, two industry associations admitted, the procurement process's "financial and ethical integrity" is lost. Woe unto those who speak seriously of that. Most of the defense industry itself does not seriously back the extreme proposals to abolish CASB or to move it to the Pentagon with the loss of the process's "financial and ethical integrity"; these proposals serve just to make other audit-weakening proposals seem, by comparison, like thoughtful or moderate compromises. In much the same way, the S&L industry in the early 1980s did not ask the government seriously to abolish the independent auditing function of the S&L regulators, just sought, as a "moderate" reform, what actually was carried out, a weakening of the accounting standards. Unfortunately, that kind of "moderate" weakening of the standards is all it takes, when access to Treasury funds is concerned, to brew an accounting-abuse scandal.

2. Don't Exempt Big Non-Commercial Defense Contracts from CAS By the Back-Door Proposal #1: Exempting "Commercial Companies"

Under cover of the general notion of "civilian-military integration," several back-door proposals would exempt big defense contracts from the CAS standards.

One proposal concerns so-called "commercial companies." The idea is that if a big company sells a great deal in the commercial marketplace, it should not have to follow CAS

standards for its non-commercial government contracts. After all, the justification for this proposal goes, we want such commercial companies to compete for government contracts.

Would anyone accept this argument if offered in the S&L or banking context: that since we want financial competition, we should let entities unwilling to be audited according to uniform regulatory standards have access to the Treasury (in that instance, through federal deposit insurance)? Commercial contracting is already exempt from CAS. By definition, what is at issue is the quest of big contractors for access to non-commercial government contracts without their having to follow sound cost accounting standards. For the contractors, that allows them a windfall by playing accounting games. After all, CAS standards are one of the most important tools of the government auditor. Just look at the DCAA manual. Defense Contract Audit Agency, DCAA Contract Audit Manual (1996) ("DCAAM").

For the Treasury, the benefit in the short-term from any increased competition is quite outweighed by the long-term detriment of awarding big contracts to big companies for which auditing would become as meaningless as it was in the 1960s, in the era of abuses that led to the CAS Act. This quote from Vice Admiral Hyman G. Rickover in the Senate hearings before the CAS Act will call that era to mind:

We negotiate every day with the cards stacked against us. Defense companies are able to hire large numbers of experienced, highly skilled lawyers and accountants; they are faced by a very few, relatively inexperienced people in government who must look after the government's interests.

Extension of the Defense Production Act and Uniform Cost Accounting Standards: Hearings of the Subcomm. On Production and Stabilization of the Sen. Comm. On Banking and Currency, 92nd Cong., 2d Sess. 498, 500 (1970). Exempt big "commercial companies" from CAS, and once again, DOD personnel will deal with those companies with the accounting stacked against the government.

3. Don't Exempt Big Non-Commercial Defense Contracts from CAS By the Back-Door Proposal #2: Exempting Contracts Negotiated Without "Certified" Cost Data

Congress wisely rejected industry proposals during its consideration of FASA and FARA in order to preserve the ability of the Defense Department and other procuring agencies to require reliable cost information for fixed-price, yet noncommercial, contracting. Industry asked Congress to release contractors engaged in fixed-price noncommercial sales from providing cost data. FARA releases contractors in some situations from providing "certified" cost data, but still allows procuring agencies, at their discretion, to require (noncertified) cost data.

Some industry elements will still be asking for release from CAS standards for such required but noncertified cost data. What are the stakes? In 1997, \$55 billion, or 30% of the Government's procurement dollars, were obligated under negotiated firm-fixed-price contracts for non-commercial items, i.e. Government unique items. Under the FAR amendments, government negotiators can, and often do, require the contractor to provide cost representations regarding the costs for such contracts. FARA, and the FAR, make the contractors adhere to CAS standards in figuring those costs.

Exempting contractors means they can play accounting games when providing such data. Among other matters, they can play games with what costs they allocate to pools that may cover a number of government and non-government contracts. To use Pentagon examples familiar from the scandals of the 1980s, suppose a negotiated contract covered such homely items as a toilet seat cover, a coffee maker, or a set of spare parts. Could the contractor, having the

government over the barrel in a noncompetitive situation, justify \$700 for a toilet seat cover? Or, thousands of dollars for a coffee maker? Certainly, if the contractor can allocate costs from an overhead pool, or from the company pension plan, etc., without constraint by CAS standards. When the Pentagon would ask for cost data in negotiating the contract, the contractor would provide data that looked good but was essentially meaningless, because of the lack of uniform accounting standards regarding what are properly allocable costs. The contract may be fixed-price, but since it is noncommercial - it might even be sole-source - the Pentagon contracting officer would end up negotiating in the dark, with the contractor holding all the cards face-down.

Congress enacted FARA by rejecting, not accepting, the legislative proposals with the potential for such abuses. I discussed this last year in a detailed article about the FARA debates. Charles Tiefer & Ron Stroman, Congressional Intent and Commercial Products, The Procurement Lawyer, Spring 1997, at 22. Initially in 1995, the House of Representatives was minded to give industry much of its wish list on this subject. In conference, however, that position was tempered by bipartisan and bicameral compromise, led by Senators Cohen and Levin. Accordingly, the final section 4201 of FARA let contracting officers obtain from vendors "other information" to ensure that the government obtains a "reasonable" price. The proposals now bruited about to strip off CAS standards would mean that such "other information" would be whatever the contractor's "creative" accounting, and that is not a term of praise, produced. In other words, if the contractor decides, being freed from uniform CAS standards, to allocate disproportionate overhead, etc., to the toilet seat cover, the "other information" it would provide the Pentagon would show cost figures justifying \$700 apiece.

Procurement reform works best when offered in a spirit of thoughtfulness, bipartisanship, and balance; the antithesis of sound reform is this back-door methods of stripping CAS off of \$55 billion of procurement. Just how do the proponents of such proposals expect to prevent the Secretary of Defense from thereby acquiring, once again, a \$700 toilet seat around his neck as his permanent ornament when depicted in the press?

4. Don't Exempt Big Non-Commercial Defense Contracts from CAS By the Back-Door Proposal #3: Dropping CAS and Just Having GAAP

Industry evidently offers another perennial proposal, that under some circumstances it suffices for contractors to use "Generally Accepted Accounting Principles" (GAAP) and not CAS. Anyone familiar with the legislative history of the 1970 CAS Act will realize that the defense contractors of the 1960s followed GAAP, and that GAAP did not protect the Treasury, leading to the CAS Act. GAAP simply does not provide standards intended to police cost accounting, such as the allocation of overhead expenses in a company that has several contracts, some cost-reimbursement, some not. So, the estimate of the scale of losses by the Treasury to defense contractor accounting games, namely, that such games cost the Treasury 5%, occurred in a context where GAAP applied.

Nothing has changed in this regard. GAAP has not become, since then, a set of cost accounting standards. Quite the contrary, the Supreme Court comparatively recently considered a similar question, whether HCFA could hold big health providers to stricter standards than GAAP. Shalala v. Guernsey Memorial Hospital, 514 U.S. 87 (1995). The Supreme Court resoundingly said that the government does NOT, repeat NOT, have to trust GAAP to protect the Treasury from accounting manipulations by cost-reimbursement contractors. As the Court said, "GAAP is not the lucid or encyclopedic set of pre-existing rules that [the losing argument-makers] might perceive it to be." 514 U.S. at 101. GAAP's "orientation may be consistent with the objective of

informing investors, but it ill-serves the needs of Medicare reimbursement and its mandate to avoid cross-subsidization." 514 U.S. at 100-101. The contractor's tactic of cross-subsidization - getting the government-reimbursed contract to pay for costs on other contracts - is just as available, if not more so, to defense contractors as to Medicare ones. As the Supreme Court said, GAAP "ill-serves" the government's goal not to pick up the tab for uninvited guests at the all-costs-paid banquets it spreads before cost-reimbursed contractors.

Conclusion

Just like there were some good ways to bring S&L's into the financial marketplace, just not allowing them to play accounting games with the federal government's backing, so there are some good ways to bring civilian companies into competition for military contracts, just not allowing them to play accounting games with the federal government's backing. Don't create ruinous exemptions to uniform cost accounting.

June 9, 1998

Mr. Ralph Dawn
U.S. General Accounting Office
Washington, DC

Re: Statement to the GAO select committee re the Cost Accounting Standards Board

Dear Ralph:

Per our discussion today, I am submitting herewith a summary of my proposal statement relative to the Cost Accounting Standards Board.

Summary

1. Need for a CAS Board

I believe there still exists a need for a Cost Accounting Standards Board to:

- a). Interpret existing Standards.
- b). Revise existing Standards where necessary.
- c). Develop new Standards as needed.

2. Organizational Structure within the Government

- a). It should not be where it is now : under the Offices of Federal Procurement Policy.
- b). It cannot be under the Comptroller General.
- c). It should be established as an independent agency in the Executive Branch of the Government.

3. Staffing

- a). The Board and the Staffing should be staffed with individuals who have expertise in accounting for the costs of government contracts.
- b). People whose background is predominantly of a regulatory nature should not be on the Board or staff.
- c). Staffing should largely be confined to accountants in industry and the government.

4. Example to illustrate how the current CAS Board and Staff went wrong: Revision to CAS 413.

- a). Object of original Standards.

- b). Change in concept from Cost Accounting to regulatory criteria.
- c). Use of non-accountant to revise the Standards.
- d). Failure to expose the most pertinent provision to the public, especially professional accounting organizations.

Sincerely,

Bernie Sacks

Bernard Sacks

**TALKING POINTS OF THE
COUNCIL ON GOVERNMENTAL RELATIONS
BEFORE THE
COST ACCOUNTING STANDARDS BOARD REVIEW PANEL
JUNE 1998**

My name is John Lordan. I am Vice President for Business Affairs at The Johns Hopkins University and I am presenting this testimony on behalf of the Council on Governmental Relations. The Council is an association of more than 140 research intensive universities and concerns itself with the influence of government regulations, policies and practices on the performance of research conducted at these universities.

I wish to thank the panel for inviting me here today.

University interest in the Cost Accounting Standards Board began in 1978 when the Board considered extending its regulations to university contracts. In 1979, the Board determined that OMB Circular A-21, Cost Principles for Colleges and Universities, already provided adequate coverage and that duplicate coverage would amount to overregulation and would be counterproductive to achieving both good management and enhanced accountability. Universities were exempted from the rules of the Board.

University interest in CASB was renewed in 1991 when the Board considered applying the CASB rules to universities as a means to assure greater accountability for the expenditure of public funds. Before the Board acted on the matter, the university cost principles in Circular A-21 were revised. In fact, those cost principles have been revised three times since 1991. Each time they were revised to assure greater financial accountability, either by prescribing uniform accounting practices, capping cost pools or mandating formulae payments instead of reimbursement of costs.

In November 1994 the Board's rules were made applicable to contracts at educational institutions and in May 1996 those rules were extended to grants.

The burden of these duplicative rules is both unnecessary and expensive. The redundancies are confusing and often lead to serious disagreement as to intent. When two regulations cover the same activity, it is inevitable that rules will be interpreted differently. Honest differences in interpretation of regulatory language lead to disputes and charges of noncompliance.

Universities believe that the government is adequately protected by the revised university cost principles in Circular A-21 and application of CASB rules is counterproductive to achieving enhanced accountability.

The following is a summary of changes to Circular A-21 since 1991:

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Page Two

- Made clear that certain costs are unallowable;
- Imposed a cap on reimbursement of administrative costs- a practice at odds with CASB cost-based accounting mandated for commercial contractors;
- Prevented shifting capped indirect costs to uncapped costs;
- Required universities to provide periodic assurance that an amount equal to reimbursement for building amortization was reserved for research facilities expenditures
- Reduced further the administrative cost cap by including student services under the cap;
- Mandated long-term predetermined rates, up to five years - also contrary to CASB practice for other contractors;
- Required that the indirect cost rate remain the same throughout the life of a research grant;
- Introduced additional restrictions on charging interest on acquisition of buildings and equipment;
- Eliminated usage or cost analysis studies - also contrary to CASB practice for other contractors; and
- Applied the rules of the government Cost Accounting Standards Board, including submission of disclosure statements.

OMB has just completed a fourth revision, which will:

- Produce a standard format for submission of indirect cost proposals. This will obviate the need for a DS-2 Disclosure Statement;
- Establish guidelines for reimbursement of building construction costs;
- Use a formula for reimbursement of utility costs; and
- Provide more definition for calculating depreciation and use allowance on facilities.

When we met with the panel staff director several weeks ago, he asked how a university's circumstances were different from an industry's circumstances. Commercial contractors are not burdened with most of these restrictions. The cap on administrative costs, elimination of cost analysis studies and implementation of guidelines for reimbursement of building construction costs are an especially heavy penalty.

Universities also share in the cost of performance under government agreements. That financial contribution to research is very large. For every \$3.00 the government spends on university research, universities spend an additional \$1.00.¹

The research partnership between the federal government and the nation's universities has been extraordinarily productive, and these rules are viewed as not only burdensome but destructive to the partnership.

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Page Three

In summary, we believe that universities should be exempt from application of CASB rules to colleges and universities because:

1. The principles for which the standards are explicit statements are already embodied in OMB Circular A-21, although Board procedures are not and our complaint is with those overly burdensome procedures;
2. Duplicative rules are counterproductive to achieving good stewardship;
3. OMB is developing a standard format for the submission of university indirect cost proposals. This obviates the need for a DS-2 Disclosure Statement;
4. More than one-half of the universities' overhead cost reimbursements are capped or set by formula. Universities are not permitted to use cost analysis studies because of these formulas;
5. Universities are not-for-profit entities and share heavily in the cost of federal grant and contract work at universities; and
6. More than 85 percent of university agreements are in the form of grants. Universities maintain unified accounting systems. By extending CASB rules to university contracts, those rules also cover university grants.

¹ National Science Foundation Data-Brief (NSF 98-303)

MAY 21, 1998

**TESTIMONY OF HELAINE GREGORY
COMPLIANCE OFFICER, GOVERNMENT OPERATIONS
UNITED HEALTHCARE
BEFORE THE COST ACCOUNTING STANDARDS BOARD REVIEW PANEL
JUNE 18, 1998**

UNITEDhealthcaresm

United HealthCare Insurance Company
450 Columbus Boulevard, CT029-05AA
P.O. Box 150450
Hartford, CT 06115-0450

TESTIMONY BEFORE THE COST ACCOUNTING STANDARDS BOARD REVIEW PANEL

UNITED HEALTHCARE

JUNE 18, 1998

Good morning. My name is Helaine Gregory and I am the Compliance Officer for the Government Operations Division at United HealthCare ("UHC"). As I will discuss in more detail in a few moments, the Government Operations Division is a large Medicare contractor whose mission is to process Medicare claims. Together with me is Bruce Shirk, outside counsel to United HealthCare and in the audience is Elise Gemeinhardt, Vice President of Legislative Affairs at United HealthCare. I am appearing on behalf of United HealthCare. The home office of the Government Operations Division is in Hartford, Connecticut.

My testimony today is intended to provide the basis for a determination that the Health Care Financing Administration ("HCFA"), which is the agency responsible for administration of the Medicare program, need not apply full CAS coverage to its Medicare contracts in order to protect the interests of the Government. In fact, we are hopeful that this testimony will serve to convince you that, in terms of controlling both the direct and indirect costs of its contractors, HCFA is doing an outstanding job – and doing so in exact accordance with its statutory mandate and with the basic purpose of the Cost Accounting Standards ("CAS"). In this regard, I am speaking here today solely on behalf of United HealthCare; we have not consulted with HCFA in connection with the preparation or presentation of this testimony.

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UNITED HEALTHCARE AND MEDICARE

The Government Operations Division at UHC is the second largest Medicare Part B claims processor in the country. In FY 97 the division processed 59.4 million Part B claims, and 64.5 million claims overall. Its annual budget for Medicare contract administrative costs for FY 98 is some \$84 million; its total benefit payout for the same fiscal year is some \$4.6 billion.

The history of the Government Operations Division commenced in 1966, when, about a year after initial passage of the legislation establishing Medicare, The Travelers Insurance Company contracted with the Department of Health, Education and Welfare. The division currently performs both Fiscal Intermediary and Carrier work for the HCFA. More specifically, UHC's Government Operations Division holds four contracts, two of which contain provisions which by their terms impose full CAS coverage: the Railroad Retirement Board national carrier contract and the Region A Durable Medical Equipment Carrier contract.¹ The value of these contracts, added together, exceeds the \$25M yearly threshold, and therefore subject the entire division to full CAS coverage under the terms of the CAS regulations.

All Government Operations contracts are for administration of the Medicare fee-for-service program. This program, which is in concept equivalent to the standard third-party payor health insurance with which your parents were familiar, constitutes some 87% of the \$207 billion paid annually in Medicare program benefits. Medicare fee-for-service is divided into two parts, A and B. Generally speaking, hospital and institutional

¹ Both of these contracts were awarded after April 17, 1992. Civilian agency contracts awarded after this date are subject to CAS assuming the necessary thresholds are met.

providers are paid for their services under the Part A benefit; physicians and ancillary providers are paid under the Part B supplementary insurance benefit. Medicare beneficiaries typically receive Part A benefits under their Social Security entitlement and can elect to participate in the Part B benefit, which has a premium cost of \$43.80 a month, automatically deducted from Social Security checks. Please note that the vast majority of Medicare benefits paid by HCFA are under the fee-for-service program although a small but growing number of beneficiaries have elected to enter managed care plans. The subject of today's conversation, however, is the fee-for-service side of the Medicare program.

**CONGRESS MANDATED THE BASIC PROVISIONS
OF MEDICARE INTERMEDIARY AND CARRIER CONTRACTS
WHEN IT ESTABLISHED THE MEDICARE PROGRAM**

Medicare Intermediary and Carrier contracts have been mandated by statute since the establishment of the Medicare program in 1965.² The applicable provisions are quite explicit regarding the Secretary's authority to provide for payment to contractors of so much of the cost of administration of the Medicare program as the Secretary determines to be "necessary and proper." In arriving at the amount of such payments, the Secretary is:

to take into account the amount that is reasonable and adequate to meet the costs which must be incurred by an efficiently and economically operated [contractor] in carrying out the terms of its contract.³

As can perhaps be understood from the above-quoted statutory language, Medicare contractors operate under "pure" cost reimbursement contracts with no fee or profit and in essence function as paymasters with important ancillary responsibilities.

² 42 USC § 1395 h and u.

³ Because of other language in these provisions, Medicare Fiscal Intermediaries and Carriers are typically insurance companies.

Stated otherwise, Medicare contractors are paid for their costs incurred in disbursing the government's money in the form of Medicare program benefits. Thus, unlike, say, a manufacturing contractor, Medicare contractors are not actually paid the government program money – they only pass it on to health care providers and beneficiaries. The difference between Medicare contractors and other government contractors may perhaps best be characterized as the difference between paying a unit price for manufacture of an M-16 and paying the cost of a visit to the doctor. And, because the government pays all of the contractors' costs incurred in disbursing payment for that doctor's visit, any monies expended by the contractor in compliance with regulatory requirements are in fact paid directly by HCFA with taxpayer dollars.

SUBSTANTIAL PORTIONS OF CAS ALREADY APPLY TO MEDICARE CONTRACTS

As this review panel is aware, there are two types of CAS – full and modified. Modified CAS includes four standards. HCFA has for many years incorporated each of these standards into its Intermediary and Carrier contracts, so that those contracts are already subject to Modified CAS coverage. Indeed, HCFA has developed an approach which might be termed "Modified CAS Plus," as discussed below.

All Medicare contracts contain an Appendix B entitled "Principles for Reimbursement of Administrative Costs." Appendix B specifically includes those CAS standards basic to control of indirect costs, including both CAS 401 (Consistency in Estimating, Accumulating and Reporting Costs) and CAS 402 (Consistency in Allocating Costs for the Same Purpose). In addition, the Medicare Carrier and Intermediary Manuals, which are HCFA "General Instructions" specifically incorporated into all

Medicare contracts,⁴ provide that CAS 405 (Accounting for Unallowable Costs) and CAS 406 (Cost Accounting Period/Use of Fiscal Year) are to be followed by contractors, the latter because Medicare contracts have a term of one year which tracks the Federal fiscal year. In addition, Appendix B provides that CAS 412 and 413 (Pension Costs) apply to contractor pension costs.

**HCFA CONTROLS CONTRACTOR DIRECT AND INDIRECT COSTS
FIRST THROUGH THE APPLICATION OF DETAILED INSTRUCTIONS
FOR PREPARATION OF CONTRACTOR BUDGETS**

The GAO has stated that:

"The CASB standards were intended to help assure the government of a fair price in its procurements and at the same time provide uniform rules for contractors to follow in their cost accounting" (italics added).⁵

We submit that the government is getting a "fair price" for the work of its Medicare contractors because HCFA controls contractor costs on a line item or function by function basis. Thus, Medicare contractors perform a variety of functions in performance of their paymaster role, including, among others, claims processing and payment, reconsiderations and hearings, Medical and Utilization review, provider audits and reimbursement and benefits integrity fraud and abuse. Each of these functions is the subject of a separate line item on a document called the Budget and Performance Requirements or BPRs, which HCFA issues to each contractor on an annual basis. The BPRs provide the template for preparation of the annual budget for each contract, with the process or preparation itself being governed by some ninety (90) single-spaced pages of instructions in the Carrier and Intermediary Manuals.⁶ These instructions

⁴ See, e.g., Medicare Carrier Contract, Articles I and IX, respectively entitled "Definitions" and "Compliance With Regulations and General Instructions."

⁵ GAO Report B-255794, GAO/AIMD-94-88 May 25 (Cost Accounting Standards Board - "Little Progress Made in Resolving Important Issues," June 7, 1994).

⁶ See, e.g., Medicare Intermediary Manual, Part 1 - Fiscal Administration, pages 2-1 through 2-92.

provide that each line item of the BPRs includes both direct and allocable indirect costs and is to be separately negotiated with HCFA. The ultimate negotiation target is a bottom line unit cost per claim which includes both direct and indirect costs. This number has, during the twenty years between 1975 and 1995, decreased from \$3.84 per claim to \$1.35 per claim for Intermediaries and from \$2.90 per claim to \$1.11 per claim for Carriers.⁷

In any event, the contractor administrative costs to which full CAS might be applied are minuscule in comparison to the program monies involved to which CAS does not apply. Total Medicare benefit payments are some \$207 billion, while HCFA's Medicare administrative costs, of which contractor costs are a part, total only some \$1.6 billion.⁸ Contractor administrative costs, therefore, constitute less than 1% of the Medicare program monies disbursed by Medicare contractors

The Department of Health and Human Services Office of Inspector General (OIG) has recently identified a number of material weaknesses in HCFA's methods of accounting for those program monies.⁹ These material weaknesses include an estimated \$20 billion in undocumented claims paid each year -- an amount more than ten (10) times the annual administrative costs of all of HCFA's Medicare contractors.

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Table 50
Medicare/claims processing bottom line unit costs

	Unit cost per claim			
	1975	1980	1994	1995
Intermediaries ¹	\$3.84	\$2.96	\$1.51	\$1.35
Carriers ²	2.90	2.33	1.21	1.11

¹Includes direct costs and overhead costs for bill payment, reconsiderations and hearings lines.

²Includes direct costs and overhead costs for the claims payment, reviews and hearings, and, beneficiary/physician inquiries lines.

NOTE: Fiscal year data.

SOURCE: Health Care Financing Administration, Bureau of Program Operations: Data from the Division of Financial Management (<http://www.hcfa.gov/stats/hstats96/blustat4.htm>).

⁸ 1997 HCFA Financial Report, Combined Statements of Operations and Changes in Net Position for the Year Ending September 30, 1997 at pages 50 and 69.

Obviously, weakness of this magnitude must be immediately addressed by HCFA and its contractors. The imposition of the complete CAS with its intricate accounting and disclosure requirements on the relatively minor costs of Medicare contractors would necessarily constitute a distraction from HCFA's efforts to improve accounting for program monies.

HCFA has contract mechanisms in place which assure that the government is not the victim of improper allocations of contractor indirect costs. These costs are well under control. In contrast, HCFA and its contractors are faced with a Herculean task in developing and implementing effective controls over the billions of benefit dollars annually paid on behalf of Medicare beneficiaries to providers. It is these benefits costs that must be the focus of the efforts of HCFA and its contractors.⁹

**THE HEALTH CARE FINANCING ADMINISTRATION LIKELY
HAS AUTHORITY TO APPLY CAS AS IT DEEMS APPROPRIATE
FOR THE EFFECTIVE ADMINISTRATION OF THE MEDICARE PROGRAM**

It appears that HCFA's approach to control of direct and indirect costs, in addition to being effective, is in accord with applicable law. The minutes of an October 17, 1991 meeting of the CAS Board state:

The Executive Secretary [of the CASB] . . . briefed the Members on the legal status of CAS applicability with respect to contracts entered into by the Health Care Financing Administration (HCFA) in support of program administration for Medicare, Parts A and B. He advised the Board that, under 42 U.S.C. § 1395h(c) [provisions of statute addressing Intermediary Contracts], that HCFA has the authority to determine the necessary and proper costs allocable pursuant to these agreements. He also noted that under this statute, the Secretary of Health and Human Services ["H&HS"] appears to have the discretionary authority to apply CAS to these agreements, on either a wholesale or piecemeal basis, as

⁹ See, e.g., OIG Report on the Financial Statement Audit of the Health Care Financing Administration For Fiscal Year 1997.

¹⁰ In this regard, Medicare administrative expenses as a percentage of benefit payments have trended steadily downward over the last 25 years. Part A administrative expenses declined from 3.1% in 1970 to 1.1% in 1995. Part B expenses declined from 11.0% to 2.8% over the same period. *supra*, note 7.

he determines to be appropriate for the effective administration of the Medicare program.¹¹

The statutory provisions authorizing the Secretary of H&HS to enter into Carrier contracts to administer Part B of the Medicare program, like those addressing Intermediary Contracts and cited by the Secretary of the CAS Board, also appear to grant the Secretary of H&HS discretion to apply the CAS "on either a wholesale or piecemeal basis," again as appropriate for the effective administration of the Medicare program. As noted above, these provisions grant the Secretary the authority and, in fact, by the use of the word "shall", mandate the Secretary to determine the costs of performance of Medicare contracts. Thus, in the case of Carrier contracts, the applicable statute provides that the Secretary

*shall provide that in determining a carrier's necessary and proper cost of administration, the Secretary shall, with respect to each contract, take into account the amount that is reasonable and adequate to meet the costs which must be incurred by an efficiently and economically operated carrier in carrying out the terms of its contract.*¹²

We submit that a compelling case can be made from the language of these provisions that the Secretary has sole authority to make determinations regarding the costs of Medicare contract administration. But such an interpretation need not exclude the CAS. As the Secretary of the Board in effect pointed out, the two statutes may be read together, so as to effect both the purpose of both CAS and Medicare by applying those CAS standards which, in the judgment of the Secretary, are appropriate for efficient and economical administration of the Medicare program.

¹¹ CAS Board, Minutes of Meeting No. 8, October 17, 1991.

¹² 42 U.S.C. § 1395u(c).

SUMMARY AND CONCLUSION

HCFA is currently applying CAS to Medicare in accordance with the law and is any event doing so in a manner which protects the interest of government. We see no compelling reason at this time to continue to incur the additional expense that full compliance with CAS entails when, in the Medicare world, the growth in program expenditures stems from the increase in benefit pay out, not administrative costs. We would request that the Panel consider our remarks as it prepares its recommendations regarding CAS applicability to civilian agency government contractors.

We are willing to provide the Board with any further information that it would request regarding the issues discussed during this testimony. I can be reached as follows:

Helaine Gregory
United HealthCare
Government Operations Division
450 Columbus Blvd., CT029-05AA
Hartford, CT 06103-1801
860.702.8864
860.702.6587 FAX
Email: hgregor1@uhc.com

**Presentation
by the
Blue Cross and Blue Shield Association
to the
CAS Board Review Panel**

**June 18, 1998
Stephen W. Gammarino
Senior Vice President
Federal Employee Program**



**BlueCross BlueShield
Association**

**An Association of Independent
Blue Cross and Blue Shield Plans**

**Presentation
by the Blue Cross and Blue Shield Association
to the CAS Board Review Panel
June 18, 1998**

I am Stephen W. Gammarino, Senior Vice President of the Federal Employee Program of the Blue Cross and Blue Shield Association (BCBSA). I am appearing on behalf of the Association and the 56 Blue Cross and Blue Shield Plans that make up the Blue Cross and Blue Shield Government-Wide Service Benefit Plan.

The Blue Cross and Blue Shield Association, among other responsibilities, is the agent for the 56 independent Blue Cross and Blue Shield Plans that contract year to year with the U.S. Office of Personnel Management (OPM) to provide health insurance for federal employees and their dependents through the Service Benefit Plan.

Each Blue Cross and Blue Shield Plan is a prime contractor for this aspect of the Federal Employees Health Benefits Program (FEHBP). Collectively, we comprise the Blue Cross and Blue Shield Government-Wide Service Benefit Plan. Every fall Blue Cross and Blue Shield Plans compete through Open Season with roughly a dozen nationwide carriers and approximately 350 local HMO's. Blue Cross and Blue Shield has consistently retained its position as the most popular carrier. Currently, 44 percent of all federal employees and retirees have chosen the Blue Cross and Blue Shield Service Benefit Plan as their insurance carrier.

We are different in several ways from our competition. One very major distinction is that we are not one single corporate entity as are many of our competitors. We are 57 separate, distinct, and independent companies – 56 local Blue Cross and Blue Shield Plans and the Blue Cross and Blue Shield Association. We band together to provide the Service Benefit Plan in the FEHB Program. This structure, based on participating affiliates, is embodied in the FEHB Act, at 5 U.S.C. § 8903.

As one might imagine, there are distinct advantages to having 56 separate Blue Cross and Blue Shield Plans coordinate activities to deliver a seamless insurance program for federal employees and their dependents everywhere in the world.

The principal advantage is that all Blue Cross and Blue Shield Plans leverage doctors and hospitals in their respective particular geographic licensed areas to discount charges for Blue Cross and Blue Shield members.

This leveraging by each individual Blue Cross and Blue Shield Plan results in very large discounts from the charges doctors and hospitals bill non-Blue Cross and Blue Shield members. The 56 Blue Cross and Blue Shield Plans pass on to the federal government and the federal employees 100 percent of the cost savings achieved from these negotiated discounts. Nationally these discounts, in the aggregate, total more than \$2 billion each contract year.

This discount leveraging is just one example of the benefits accruing to the government from the integration of the Federal contract with the local Plans' commercial business. The government also benefits from many other activities performed by the Local Plans, including local claims pricing and processing, and medical and utilization review.

Both the discount arrangements and the other services provided by the local Plans are advantages that arise out of the unique organization of having 56 distinct companies each negotiate individual contracts with local doctors, hospitals and other health care providers. No single competitor of Blue Cross and Blue Shield is able to achieve this result on a nationwide basis, and no one Blue Cross or Blue Shield Plan could do it either.

Unfortunately, for purposes of applying the Cost Accounting Standards ("CAS") this structure creates significant problems. As one might expect with 57 separate companies, coordinating and overseeing CAS implementation is an extremely complex and time-consuming task. The difficulties of implementation are harder to accept when you consider the following factors:

- (1) The Service Benefit Plan is only about 5 percent of all Blue Cross and Blue Shield business. In some areas the

Service Benefit Plan is less than 1 percent of the Plan's business. For a Plan to change 100 percent of its accounting system to accommodate CAS, for a federal contract which may represent only 1 percent of its business, makes no economic sense. Pricing and other elements critical to the operation of the Service Benefit Plan are common to both the local Plan's commercial business and government business. Many Plans will find it economically infeasible to segment the Service Benefit Plan business because it is such a small percentage of total business. Thus, any CAS compliant accounting system would have to apply to all of a Plan's commercial business as well.

- (2) As I will explain further, there is little or no value added for the federal government, to carriers, or the ultimate end user – the Federal employee – by imposing CAS unnecessarily on a Program, which is at its very roots commercial.

There are a number of reasons why CAS should not apply to the FEHB Program, which I will develop in detail. In a nutshell, we have five major observations:

- (1) The carrier contracts arising from the FEHB Program fit within the statutory definition of a commercial item acquisition, and are therefore intended by Congress to be exempt from CAS;

- (2) The CAS Board's regulatory exemption for commercial item contracts is unduly restrictive, and should recognize the FEHB contracts as being exempt from CAS;
- (3) For the FEHB Program, CAS provides little or no benefit to the government, nor is there a problem that CAS would solve;
- (4) Specific CAS standards are incompatible with FEHBP carriers' accounting systems; and
- (5) The overall cost of CAS to the government, to the carriers and to the ultimate end-users, the Federal employees, will be significant, and completely out of proportion to the benefits, if any.

1. COMMERCIAL ITEM EXEMPTION

As can be seen from the foregoing description of the FEHB Program and the operation of the Service Benefit Plan, the type of health insurance product provided to the federal government is indistinguishable from the health benefits coverage offered and sold competitively to private sector employers. Indeed, the foundation of the FEHB Program from its inception to today is that the government is purchasing commercial insurance for its employees, and that is no

more true than with the Blue Cross and Blue Shield Service Benefit Plan.

Each of the 56 Blue Cross and Blue Shield Plans underwriting the Service Benefit Plan provides subscribers (whether federal or private sector employees) with the benefit of the considerable discounts that they have been able to negotiate with local health care providers (hospitals and physicians) due to the sheer volume of their commercial business. Coverage under the Service Benefit Plan is priced in the same manner for both the federal government and the private sector. Moreover, Plans' accounting systems reflect the commercial nature of their business.

In 1994, in the Federal Acquisition Streamlining Act, and again in 1995, in the Clinger-Cohen Act, Congress exempted commercial item acquisitions from the application of both the Truth in Negotiations Act (TINA) and CAS. The health benefits coverage acquired by the federal Government under FEHBA contracts squarely meets the statutory definition of "commercial item."¹

However, to date OPM has not recognized the commercial item nature of the FEHBA contracts. Since CAS became applicable to

¹ In pertinent part: "any item of a type customarily used for non-Governmental purposes" that has been "sold, leased or licensed to the general public" or "offered for sale, lease or license. . . ." The definition also includes modifications of a type customarily available in the commercial market place or minor modifications made to meet federal government requirements.

civilian agency contracts in 1992, OPM refrained from applying CAS to FEHBA contracts and sought exemptions and/or deferrals from the CAS Board. However, early in 1998, following a meeting with the CAS Board staff, OPM informed the FEHBA carriers that experience-rated carriers must begin to implement CAS. On the other hand, OPM has no current plans to apply CAS to community-rated FEHBA contracts. Yet OPM has paved the way for CAS application to community-rated contracts by determining that these contracts are not commercial item contracts.² The American Bar Association Section of Public Contract Law has gone on record saying that OPM is wrong and that community-rated FEHBA contracts are commercial item contracts.

OPM's reluctance to recognize the commercial item nature of the FEHBA contracts and to implement the statutory exemptions from TINA and CAS seems to be driven by a concern that OPM will lose the well-established audit and oversight powers that it has exercised with respect to the FEHB Program. If this is a concern, it is groundless. The very Act of Congress that established the FEHB Program in 1959, to bring to federal employees the benefits of commercially available health insurance coverage, gives OPM all of the authority it needs to conduct audits of the carriers.³ We in no way

² OPM regulations issued September 10, 1997. 62 Federal Register 47569

³ See FEHBA, 5 U.S.C. § 8910, requiring each FEHBA contract to contain clauses authorizing OPM (and the GAO) to audit and otherwise examine the records of carriers "as may be necessary," and requiring the carriers to submit such reports as OPM may deem necessary to carry out its functions.

seek to challenge OPM's audit authority; quite the contrary, we believe it essential to the FEHB Program. We simply wish to emphasize that OPM does not need CAS to exercise its audit authority.

**2. THE CAS BOARD'S OVERLY RESTRICTIVE
INTERPRETATION OF THE EXEMPTION FROM CAS**

OPM's difficulties in implementing the statutory exemption in some respects follow from the fact that the CAS Board has not fully implemented the statutory exemption from CAS for commercial item acquisitions. It is not apparent that OPM has received any assistance from the CAS Board in its quest for ways to avoid or, at least, defer the application of CAS to the FEHB Program. Moreover, the CAS Board's regulatory implementation of the commercial item exemption is unduly narrow. It extends the exemption only to firm fixed-price contracts (and subcontracts) and fixed price contracts (and subcontracts) with economic price adjustment.⁴ The Clinger-Cohen Act's exemption from CAS is not limited to these contract types. The CAS Board's unduly narrow exemption operates to complicate the granting of the exemption to contracts, such as those under the FEHB Program, that are clearly for commercial items but, because the product is insurance, may have features (such as

⁴ The CAS Board's justification for this is that FAR 12.207 allows only these two types of contracts to be used to acquire commercial items. FAR 12.207 is itself in conflict with FASA, which required only that these two types of contracts be used "to the maximum practicable."

reserves) not found in traditional firm fixed-price contracts, such as those in the defense industry.

3. CAS PROVIDES LITTLE OR NO VALUE

BCBSA, as agent for the Plans, prices its contract using the same pricing information that is used for pricing commercial programs. Accordingly, prices are set by the market place, and because of this the government gains the full value of the significant discounts Plans have negotiated with health care providers. In addition, federal employees have the ultimate say by choosing each year among hundreds of carriers during the Open Season. Therefore, the government is assured competitive prices for health care benefits. This is the result that Congress intended in defining commercial items and providing for their exemption from the application of CAS.

Payments to health care providers represent more than 93 percent of the costs charged to the government. Application of CAS would not change the amount of the payments to providers. It could affect only costs incurred by the insurance carriers (that being, the Blue Cross and Blue Shield Plans) to administer the claims. The administrative costs represent less than 7 percent of total contract cost.

4. SPECIFIC STANDARDS ARE NOT COMPATIBLE WITH THE CARRIERS' ACCOUNTING SYSTEMS

Specific standards are incompatible with the way FEHB Program carriers' accounting systems are structured. Blue Cross and Blue Shield Plans use accounting systems similar to many other insurance companies. They are cost center based, rather than the job order cost basis prevalent with the typical defense contractor. In a cost center based accounting system, costs are accumulated by cost center rather than by job. A typical cost accounting system will have from 500 to 1,000 cost centers, rather than the relatively modest number of overhead pools and multiple job orders typical in a job order cost accounting system. The cost center based systems are more analogous to activity based costing, except that where activity based costing is used in manufacturing environments there is still a general overhead pool and a General and Administrative pool. These pools generally are not found in the typical Blue Cross and Blue Shield Plan cost accounting system. Cost center based systems provide Plan management with cost data for management control as well as for pricing products.

The concept behind a cost center based cost accounting system is that all products sold are similarly processed, while in a job order cost accounting system each job is expected to be performed differently. CAS are oriented towards a job order cost accounting system. Thus, the cost accounting systems used by the Blue Cross and Blue Shield Plans, in a number of ways, are incompatible with the requirements of CAS.

As an example, under the cost accounting systems used by the Plans, there are no direct or indirect costs as contemplated by CAS, making their systems incompatible with the requirements of CAS 402 and CAS 418.

Also, under the cost center based cost accounting systems, there may not be either overhead pools or G&A pools, which is inconsistent with the requirements of CAS 410. These are only two examples of incompatibility; there are a number of others.

5. THE SIGNIFICANT COST OF CAS TO THE GOVERNMENT, CARRIERS AND FEDERAL EMPLOYEES

Finally, the cost of applying the CAS to the FEHB Program will be substantial to everyone. To comply with CAS will require the relinquishing of existing cost accounting systems and the design and adoption of new systems compatible with the requirements of CAS. This effort will be expensive and time consuming. It is also a less desirable accounting system for Blue Cross and Blue Shield management, since it will deny management cost information that is now available.

Blue Cross and Blue Shield Plans' participation in the FEHB Program range from 50 percent to less than 1 percent. For the typical Plan, FEHBP represents 5 percent or less of its total business. Therefore, many Plans, or even the entire Blue Cross and Blue Shield system, may conclude that they cannot afford to participate in the FEHB Program if implementation of CAS is required. If some Plans (or the entire system) withdraw, the government

will lose the local discounts the Plans have negotiated with health care providers, roughly \$2 billion annually.

SUMMARY AND CONCLUSION

In summary, the Blue Cross and Blue Shield Association and the Plans operate the Service Benefit Plan as contemplated by the FEHB Act. The government is able to acquire health care insurance identical in all material respects to that available to commercial clients at commercial rates. The application of CAS will not decrease prices, but will substantially increase administrative costs. It may result in losing existing insurance carriers, which in turn probably will result in increased health care costs. For those local Blue Cross and Blue Shield Plans that choose to continue in the FEHB Program there will be increased administrative costs to restructure cost accounting systems and comply with CAS Board requirements.

We have been a major contracting party with the government since the start of the FEHB Program in 1959. We value both our relationship with federal employees and our contribution to the Program. The circumstances we have described are a primary example of a major concern expressed by Congress when it enacted both the original CAS legislation and the current law.

Both the original and current CAS legislation requires the CAS Board to assure that individual standards meet a basic cost/benefit analysis: in other

words, the benefits of implementing the standard will exceed the cost of implementation. The CAS Board has acknowledged the importance of this test in its Statement of Objective, Policies and Concepts, as well as in each individual action taken to promulgate or amend specific standards.

What has been overlooked in the CAS Board regulations is the need to apply the same cost-benefit test to the entire body of the standards as they apply to different Federal programs, classes of contractors, or contracting situations. If the concern of benefit over cost is important with respect to individual standards, it is even more important when the entire CAS is applied to a whole set of programs or contractors.

Our circumstances are such that the cost-benefit test yields a clear result: the costs to the government, to carriers, and ultimately to Federal employees of implementing CAS far outweigh the minor or nonexistent benefits. In addition, the Congressional intention of allowing the acquisition of commercial items without the imposition of CAS is thwarted in this circumstance, and by the current CAS Board regulations. We urge this panel to consider these concerns in setting forth its recommendations for the CAS Board going forward.

**Frank D Titus
Assistant Director for Insurance Programs
U.S. Office of Personnel Management**

**Statement on Cost Accounting Standards
in the Federal Employees Health Benefits Program**

I am Frank Titus, the Assistant Director for the Office of Insurance Programs at the Office of Personnel Management (OPM). OPM is responsible for administering the Federal Employees Health Benefits (FEHB) Program for Federal employees and annuitants and their dependents.

The Federal Employees Health Benefits (FEHB) Program is the largest employer-sponsored health benefits program in the world. It is a \$16 billion program that currently contracts with 355 health carriers. Thirty-five are fee-for-service carriers and experience-rated HMOs, and 320 are community-rated HMOs. While the community-rated HMOs comprise the largest number of FEHB Program contracts, the experience-rated carriers represent approximately 75% of overall Program dollars. It is the experience-rated segment of the FEHB Program where cost allocation schemes affect enrollee and Government costs.

Over ninety percent of FEHB Program outlays represents benefits payments. Administrative expenses represent only seven percent. Given the magnitude of the Program, however, that seven percent amounts to \$1.1 billion dollars annually. Because they are direct pass-through costs, it is not clear that benefit costs are subject to the Cost Accounting Standards.

A description of the nature of experience-rated FEHB contracts will underscore the importance of allocation schemes and for standards to gauge their reasonableness. As their name implies, experience-rated contracts are based on the individual health plans' claims experience. The premiums we pay are based on a plan's actual costs for claims and administrative expenses adjusted for expected cost increases. The contracts renew automatically and any gains or losses are carried forward. Thus, plans with multiple lines of business have an opportunity to maximize the indirect expenses assigned to the FEHB contract to reduce the burden on their other lines of business which are competitively bid at fixed prices. In most instances, the FEHB line of business will be the only line of business that provides for the reimbursement of allocated indirect expenses on a cost incurred basis.

As the office responsible for the administration of the FEHB Program management, my office enters into and administers the contracts with participating health benefit plans, and terminates them when a plan no longer meets the requirements of the FEHB law. We are responsible for ensuring performance of all necessary actions for effective contracting, ensuring compliance with the terms of the contract, ensuring the FEHB and other laws and regulations and procedures are met, and safeguarding the interests of the United States in our contractual relationships. Our interest from the financial point of view is solely to ensure the Government is paying the right price for the health care services it purchases for enrollees.

The Government, as purchaser, is entitled to cost data relating to the self-renewing, experience-rated FEHB contracts. We need to ensure that the FEHB Program is being treated fairly with respect to the carriers' other lines of business. The Cost Accounting Standards can add to the integrity of the process of ensuring that costs we bear are allocated equitably to the FEHB Program and are reasonable. Where the Cost Accounting Standards are inappropriate or duplicative, we believe that they would not add value and would prefer not to use them. Our effort since we were notified that CAS applies to the FEHB contracts has been to look for ways to retain the CAS philosophy while tailoring and adapting the standards to the insurance industry and the needs of the FEHB Program. To the degree that other standards further that objective, or that the GAO concludes that the Federal Acquisition Regulation (FAR), Generally Accepted Accounting Principles (GAAP), cost and pricing data, or some combination of these, will insure that our needs are met, we would find those standards acceptable as well.

OPM as the administrator of the FEHB Program has a fiduciary responsibility under the FEHB law to both the taxpayers, since the Government pays the largest portion of the premium, 72% on average, and to FEHB enrollees, to ensure that premiums "reasonably and equitably reflect the cost of benefits provided." Further, there is considerable interest in both the Executive and Legislative Branches in how well OPM controls and monitors FEHB Program costs. Program reviews reveal genuine vulnerability. Over the last four years, more than \$6 million in experience-rated contract charges have been disallowed, with decisions pending on an additional \$48 million for recently issued audit reports.

In the past, the auditors have utilized the FAR and GAAP, and have looked to certain CAS standards as an established basis for measuring reasonableness. Because of differences between CAS requirements and standard insurance industry accounting practices, we have experienced difficulty in applying certain CAS requirements. Our carriers have objected that the cost to comply with CAS will be enormous, and these costs will be charged back to the FEHB Program to be paid for, in large part, with government monies.

We have been working collaboratively with the experience-rated carriers to implement new financial reporting and auditing requirements. These requirements are set forth in the Audit Guide for Financial Audits, Internal Controls and Compliance Audits, and Agreed Upon Procedures. This Audit Guide can be expanded to require more allocation data as a possible way to avoid the costs applying the full CAS, while satisfying ourselves that we receiving reasonable and equitable treatment from the carriers.

Our office does not perform audits. We have an independent Inspector General at OPM and it is the responsibility of that office to audit the insurance carriers. We rely on their expertise to identify and question inappropriate or unreasonable costs. However, my office is responsible for the resolution of questioned costs. Accepted standards can, at once, reduce the incidence of questioned costs and facilitate the resolution of those that are questioned. I am glad that Sanders Gerson, Deputy Assistant Inspector General for Audits, Office of Inspector General, could be with me today to give you the auditor's point of view.

Sanders P. Gerson
Deputy Assistant Inspector General for Audits
U.S. Office of Personnel Management
Office of the Inspector General

Statement on the Application of the Cost Accounting Standards
to the
Federal Employees Health Benefits Program

My name is Sanders Gerson, and I am the Deputy Assistant Inspector General for Audits in the Office of Personnel Management's (OPM) Office of the Inspector General (OIG). As Frank Titus previously indicated, OPM is responsible for administering the Federal Employees Health Benefits Program. The program makes group health insurance available to federal employees, annuitants, and other eligible people. Insurance benefits are provided by private-sector health insurance carriers who contract with the OPM. Historically, except to the extent referenced in the FAR cost principles, these contracts have not incorporated the requirements of the Cost Accounting Standards Board. What I would like to discuss is whether OPM's health program contractors should be subject to cost accounting standards, and if so, to what extent.

But first, some perspective. The OIG is responsible for detecting and preventing fraud, waste and abuse in OPM programs. We are also responsible for promoting economy, efficiency, and effectiveness in the administration of OPM programs. With regard to implementing cost accounting standards as presently required, we find that these responsibilities pull us in two different directions. As auditors, we believe the standards are necessary to prevent fraud, waste and abuse. But, we also see them as a burden to the economy and efficiency of program operations in that it is not clear to us what added value the administrative processes of CAS would bring to the health insurance program.

There are about 355 health benefit contracts in the federal employees' health program. The approximate total annual cost of these contracts is \$16.2 billion. These contracts fall into two categories. The first category is our community-rated, health maintenance organizations or HMOs. This category represents 93 percent of the total number of contracts, but only 25 percent of the total health program costs. The government cost of these contracts is determined on the basis of the price paid by private-sector clients of the contractor adjusted for benefit and demographic differences of the federal group. Neither actual nor projected expenses of the contractor are a factor in establishing either the price or cost of HMO contracts; consequently, cost allocation is not a process that is employed in determining either contract price or costs. Thus, cost accounting standards are not applicable to this category of contracts and should not be arbitrarily applied.

The second category of health benefit contracts are experience-rated or fee-for-service contracts. There are 35 such contracts, with an annual value of \$12.2 billion, representing 75 percent of the total health program costs. Blue Cross Blue Shield is one of these contracts. While Blue Cross Blue Shield is a single contract, its participation in the federal program is

through about 58 separate corporate entities. The government costs for these experience-rated contracts are determined on the basis of actual costs incurred. These annual contracts are automatically renewable with each year's gains and losses being carried forward to the next year. Gains and losses, actual costs incurred, and utilization and economic trends are factors used to determine each year's premium rates for the government and subscribers.

Actual costs incurred include two major elements—health benefit expenses and administrative expenses. Health benefit expenses are the insurance benefits paid to or on behalf of federal subscribers. Health benefit expenses represent approximately 93 percent of contract costs and are direct contract costs. In assessing whether dollar thresholds have been met for disclosure statements and full versus modified CAS coverage, there has been some question as to whether benefit payments should be included in the calculation. Since benefit costs generally do not pose cost allocation issues, and because they are so disproportionate to administrative expenses, which do pose cost allocation issues, we do not believe that under current requirements benefit expenses should be considered in these dollar threshold calculations.

This leaves the administrative expense portion of the experience-rated health benefit contracts. Administrative expenses represent the cost of processing insurance benefits. They are analogous to overhead. In 1996, administrative expenses totaled about \$785 million -- or 6.4 percent of total experience-rated contract costs. This is the only portion of the health benefit contracts that we believe should be subjected to cost accounting standards. Historically, insurance carriers distribute administrative expenses to final cost objectives through multiple cost centers. A typical insurance carrier could have in excess of 250 cost centers. Cost accounting standards provide a sound, consistent and reasonable basis for allocating costs to cost centers and then to final cost objectives. Cost accounting standards serve the same purpose for contract costing as GAAP does for financial statement reporting. We see no reason why, as a body of generally accepted principles, these cost accounting standards should not represent a reasonable basis for contract cost allocations. Further, except for the general rules of materiality, all costs which are allocated to a contract should be subject to these principles. As cost accountants gather together in their various companies to decide how they are going to allocate any of these multiple cost centers to their government contracts, they should have available a set of guiding principles they can follow. That does not seem to be an unreasonable expectation. Absent such principles, there is always a strong financial incentive to shift costs from private-sector fixed-price contracts to government cost-reimbursable contracts.

With regard to disclosure statements, we do not believe that these statements add value to the federal program. They are onerous to prepare and onerous to manage. Within the insurance industry, they are more onerous than elsewhere, since each of the 250 or more cost centers becomes a pool of expenses whose allocation methods must be disclosed. Further, they must be initially reviewed and audited and any changes must be reviewed. As a small audit organization, we do not have the resources to devote to this additional workload. We have had 38 years of experience with the carriers in the federal employees health benefits program and have been able to adequately deal with cost allocation issues without the need for disclosure statements. We deal with these issues in much the same way we deal with the contract cost principles and generally accepted accounting principles. We have not needed disclosure statements to enforce

these other requirements and do not see the need for disclosure statements to enforce cost accounting standards. Any standards that are not complied with and result in increased cost to the government could be handled pursuant to the contract disputes clause.

In summary, by applying the basic cost accounting principles to all situations that require the allocation of costs to multiple-cost objectives and eliminating the disclosure statements, the government burden of administering the standards is eliminated and the contractor burden is reduced.

This concludes my statement.

**PRESENTATION TO THE COST ACCOUNTING STANDARDS BOARD
REVIEW PANEL**

by Margaret M. Worthington, Partner, Price Waterhouse LLP

June 18, 1998

I APPRECIATE THE OPPORTUNITY TO ADDRESS THE COST ACCOUNTING STANDARDS BOARD REVIEW PANEL AT THIS PUBLIC MEETING AS A REPRESENTATIVE FROM THE ACCOUNTING PROFESSION.

MY NAME IS MARGARET WORTHINGTON. I AM A PARTNER WITH PRICE WATERHOUSE LLP AND HAVE BEEN ACTIVELY ENGAGED IN THE FEDERAL CONTRACTING PROCESS FOR OVER 30 YEARS. AT PRICE WATERHOUSE I CONSULT WITH CLIENTS ON A BROAD ARRAY OF MATTERS RELATING TO CONTRACT PRICING AND COST ALLOWABILITY AND ALLOCABILITY, INCLUDING COMPLIANCE WITH COST ACCOUNTING STANDARDS (CAS). PRIOR TO JOINING PRICE WATERHOUSE, I WAS EMPLOYED BY THE DEFENSE CONTRACT AUDIT AGENCY (DCAA) FOR OVER 15 YEARS, INCLUDING THREE YEARS AS A PROGRAM MANAGER IN THE COST ACCOUNTING STANDARDS DIVISION OF DCAA HEADQUARTERS. DURING THAT PERIOD I ALSO SERVED FOR MORE THAN A YEAR AS THE AGENCY'S REPRESENTATIVE ON THE DEPARTMENT OF DEFENSE CAS WORKING GROUP.

I AM THE AUTHOR OR CO-AUTHOR OF NUMEROUS PUBLICATIONS ON FEDERAL CONTRACT PRICING AND COSTING MATTERS, INCLUDING A BOOKLET ENTITLED "COST ACCOUNTING STANDARDS", PUBLISHED BY THE NATIONAL CONTRACT MANAGEMENT ASSOCIATION, AND A TEXTBOOK ENTITLED *CONTRACTING WITH THE FEDERAL GOVERNMENT*, PUBLISHED BY JOHN WILEY & SONS.

MY REMARKS TODAY ADDRESS THE RELATIONSHIP OF COST ACCOUNTING STANDARDS TO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) AND THE FEDERAL ACQUISITION REGULATION (FAR) COST PRINCIPLES.

I WOULD LIKE TO EXPRESS MY STRONG CONVICTION THAT THE CAS BOARD NEEDS TO ADOPT A MORE COMMERCIAL FOCUS. THE PROCUREMENT REFORM INITIATIVES THAT HAVE BEEN ADOPTED IN THE LAST FEW YEARS BY THE CONGRESS AND THE EXECUTIVE BRANCH HAVE SIGNIFICANTLY STREAMLINED THE PROCESS BY WHICH THE FEDERAL GOVERNMENT ACQUIRES COMMERCIAL ITEMS AND OTHER PRODUCTS AND SERVICES THAT ARE ACQUIRED THROUGH A COMPETITIVE CONTRACT AWARD PROCESS. HOWEVER, THE ENVIRONMENT IN WHICH THE FEDERAL GOVERNMENT PROCURES PRODUCTS AND SERVICES THAT ARE NEITHER COMMERCIAL IN NATURE NOR AWARDED THROUGH A

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COMPETITIVE PROCESS CONTINUES TO BE INORDINATELY COMPLEX AND BURDENSOME. THIS COMPLEX AND BURDENSOME PROCESS, ATTRIBUTABLE IN LARGE MEASURE TO THE FAR COST PRINCIPLES AND CAS, CAN CLAIM NO WINNERS. THE GOVERNMENT LOSES BECAUSE THE COSTING AND PRICING INFRASTRUCTURES THAT CONTRACTORS MUST IMPLEMENT IN ORDER TO ENGAGE IN COST-BASED CONTRACTING ARE COSTLY TO DEVELOP AND MAINTAIN. SUCH COSTS, OF NECESSITY, MUST BE PASSED ON TO THE GOVERNMENT THROUGH HIGHER PRICES FOR THE ACQUIRED PRODUCTS AND SERVICES. INDUSTRY LOSES BECAUSE IT IS FORCED TO DEVOTE SCARCE RESOURCES TO DEVELOP AND MAINTAIN THIS INFRASTRUCTURE. FURTHERMORE, THE COSTLY INFRASTRUCTURE IMPEDES A CONTRACTOR'S ABILITY TO DEVELOP DUAL-USE TECHNOLOGIES AND COMPETE AGAINST U.S. AND FOREIGN ENTITIES THAT MAINTAIN "LEAN AND MEAN" INFRASTRUCTURES DESIGNED ONLY TO MEET MANAGEMENT AND EXTERNAL FINANCIAL REPORTING REQUIREMENTS.

THE NEED FOR THE CAS BOARD TO MOVE TO A MORE COMMERCIAL FOCUS IS DIRECTLY PERTINENT TO A DISCUSSION OF THE RELATIONSHIP OF CAS, GAAP AND THE FAR COST PRINCIPLES. THE CURRENT CAS BOARD'S TENDENCY TO ADOPT POSITIONS ESPOUSED IN THE FAR COST PRINCIPLES, WHICH HAVE A DECIDEDLY GOVERNMENT FOCUS, RATHER THAN ACCOUNTING TREATMENTS PRESCRIBED IN GAAP, WHICH HAVE A COMMERCIAL FOCUS, IS A SOURCE OF CONCERN TO ME BOTH AS A FEDERAL CONTRACTS PROFESSIONAL AND A CERTIFIED PUBLIC ACCOUNTANT. THE BOARD'S DEPARTURE FROM GAAP HAS BLURRED THE DISTINCTIONS BETWEEN CAS PRONOUNCEMENTS AND FAR COST PRINCIPLES AND HAS GENERALLY SLOWED OR REDUCE THE RECOVERY OF COSTS THAT ARE LEGITIMATE COSTS OF DOING BUSINESS.

IN THEIR STATEMENTS OF OBJECTIVES, POLICIES AND CONCEPTS, BOTH THE ORIGINAL AND CURRENT CAS BOARDS RECOGNIZED THE DISTINCTIVE ROLES OF THE CAS BOARD AND THE PROCUREMENT OFFICIALS RESPONSIBLE FOR PROMULGATING THE FEDERAL COST PRINCIPLES, SUCH AS THE DEFENSE ACQUISITION REGULATORY COUNCIL. THE ROLE OF THE CAS BOARD WAS TO DEFINE, MEASURE, ASSIGN AND ALLOCATE COSTS TO CONTRACTS AND OTHER COST OBJECTIVES IN A COST ACCOUNTING PERIOD. THE ROLE OF THE PROCUREMENT OFFICIALS WAS TO ISSUE REGULATIONS, BASED ON REASONABLENESS AND/OR PUBLIC POLICY CONSIDERATIONS, THAT ADDRESSED THE EXTENT TO WHICH FEDERAL DEPARTMENTS AND AGENCIES WOULD REIMBURSE CONTRACTORS FOR THOSE DEFINED, MEASURED, ASSIGNED AND

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ALLOCATED COSTS. STATED MORE SUCCINCTLY, THE ROLE OF THE CAS BOARD WAS TO ESTABLISH A CONTRACT'S COST, WHILE THE COST PRINCIPLES WERE TO ESTABLISH HOW MUCH OF THAT COST WOULD BE REFLECTED IN THE CONTRACT PRICE PAID BY THE GOVERNMENT.

THE STATEMENTS OF OBJECTIVE, POLICIES AND CONCEPTS OF BOTH THE ORIGINAL AND CURRENT CAS BOARDS ALSO SOUGHT TO AVOID DIFFERENCES WITH OTHER PRINCIPLES AFFECTING ACCOUNTING FOR FINANCIAL PURPOSES, WITH THE CAVEATS THAT OTHER ACCOUNTING PRINCIPLES WOULD BE TAKEN INTO ACCOUNT TO THE EXTENT THAT THE BOARDS COULD DO SO AND STILL ACCOMPLISH THEIR OBJECTIVES.

THE PHILOSOPHY OF THE ORIGINAL CAS BOARD WAS SUCCINCTLY SUMMARIZED IN ITEM 7 OF PREAMBLE A TO THE ORIGINAL PUBLICATION OF CAS 404, PUBLISHED IN DECEMBER 1973, WHICH STATED:

THIS BOARD WILL CAREFULLY CONSIDER ALL AUTHORITATIVE STATEMENTS OF ACCOUNTING PRINCIPLES TO THE EXTENT THAT IT CAN DO SO WHILE MAINTAINING PROGRESS TOWARD ITS OWN PRIMARY GOAL OF INCREASED UNIFORMITY AND CONSISTENCY IN COST ACCOUNTING FOR CONTRACTS.

IN MY OPINION, THE ORIGINAL CAS BOARD'S PROMULGATIONS REASONABLY ADHERED TO THOSE OBJECTIVES. MANY OF US TODAY ARE CONCERNED, HOWEVER, THAT RECENT PRONOUNCEMENTS OF THE CURRENT CAS BOARD HAVE NOT.

THE DIFFERENCE IN PHILOSOPHIES BETWEEN THE ORIGINAL AND CURRENT CAS BOARDS IS PARTICULARLY ILLUSTRATED BY COMPARING THE ORIGINAL AND REVISED CAS 404 PROMULGATIONS.

- THE ORIGINAL CAS BOARD CONFRONTED THE ISSUE OF HOW ASSETS SHOULD BE VALUED IN THE CONTEXT OF BUSINESS COMBINATIONS AND CONCLUDED THAT GAAP, AS EMBODIED IN ACCOUNTING PRINCIPLES BOARD (APB) OPINION NO. 16 PROVIDED THE PROPER ACCOUNTING TREATMENT. THE PURCHASE METHOD OF ACCOUNTING OUTLINED IN APB 16 PROVIDES THAT THE BEST DETERMINATION OF THE VALUE OF THE ASSETS ACQUIRED IS THEIR FAIR MARKET VALUE AT THE TIME OF THE BUSINESS COMBINATION. THE ORIGINAL CAS BOARD SIMPLY CONCLUDED THAT, FROM AN ACCOUNTING PERSPECTIVE, THERE WAS NO COMPELLING REASON TO DEPART FROM GAAP. IN FACT, THE ARMED SERVICES BOARD OF CONTRACT APPEALS

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OBSERVED IN A 1983 DECISION (GOULD DEFENSE SYSTEMS, INC., ASBCA NO. 24481, JUNE 10, 1983, 83-2 BCA 16,676), THAT NEITHER THE COST PRINCIPLES NOR CAS 404 CONTESTED THE GENERAL PROPRIETY OF USING THE GAAP PURCHASE METHOD OF ACCOUNTING FOR CONTRACT PRICING AND COSTING PURPOSES.

- IN SHARP CONTRAST, THE CURRENT CAS BOARD REVISED CAS 404 IN A MANNER THAT CONFLICTS WITH GAAP AND IS INTERNALLY INCONSISTENT. PARAGRAPH 50 (D) (1) OF THE STANDARD ESSENTIALLY FREEZES THE ASSET VALUES AT NET BOOK VALUE, WHEREAS PARAGRAPH 50 (D) (2) FOLLOWS APB 16. THE ONLY DIFFERENCE IN CIRCUMSTANCES WHICH CAUSES THESE DIFFERING ACCOUNTING TREATMENTS IS THAT IN PARAGRAPH 50 (D) (1) SOME AMOUNT FOR DEPRECIATION OR COST OF MONEY WAS CHARGED TO FEDERAL CONTRACTS BY THE SELLER IN THE FISCAL YEAR PRECEDING THE BUSINESS COMBINATION; PARAGRAPH 50 (D) (2) APPLIES ONLY IF NO DEPRECIATION OR COST OF MONEY WAS CHARGED TO FEDERAL CONTRACTS BY THE SELLER DURING THAT PERIOD. IN MY VIEW, THIS REVISION TO CAS 404 IS INDEFENSIBLE FROM AN ACCOUNTING PERSPECTIVE BECAUSE IT DOES NOT REFLECT THE ECONOMIC TRANSACTIONS WHICH OCCUR AS A RESULT OF A BUSINESS COMBINATION. THE BOARD JUSTIFIED ITS POSITION, IN PART, BY CITING "THE CURRENT ECONOMIC AND BUDGETARY ENVIRONMENT WHERE FURTHER REDUCTIONS IN THE DEFENSE BUDGET CAN BE EXPECTED TO LEAD TO ADDITIONAL MERGERS AND BUSINESS COMBINATIONS AMONG DEFENSE CONTRACTORS". THE BOARD WAS CLEARLY SWAYED BY CONTINUING ASSERTIONS FROM FEDERAL PROCUREMENT OFFICIALS THAT THE FEDERAL GOVERNMENT SHOULD NOT, OR COULD NOT AFFORD TO, REIMBURSE CONTRACTORS FOR INCREASED DEPRECIATION COSTS THAT RESULTS FROM ASSET STEP-UPS. WHETHER THE FEDERAL GOVERNMENT WANTED TO REIMBURSE CONTRACTORS FOR THE COSTS SHOULD HAVE BEEN IRRELEVANT TO THE CAS BOARD'S DELIBERATIONS. UNFORTUNATELY, IT WAS NOT. THUS, THE EFFECT OF THE CAS 404 REVISION WAS TO NO LONGER RECOGNIZE A GAAP COST THAT HAD BEEN RECOGNIZED BY THE ORIGINAL CAS BOARD BUT HAD BECOME UNALLOWABLE UNDER THE PROVISIONS OF FAR 31.205-52 IN 1990.

**ANOTHER AREA OF GRAVE CONCERN IS THE CURRENT CAS BOARD'S
RETREAT FROM ACCRUAL ACCOUNTING TO CASH BASIS ACCOUNTING.**

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THE CONCEPT OF ACCRUAL ACCOUNTING IS FUNDAMENTAL TO GAAP BECAUSE, FROM A FINANCIAL REPORTING PERSPECTIVE, ACCRUAL ACCOUNTING IS VIEWED AS PROVIDING A BETTER INDICATION OF AN ENTITY'S ASSETS, LIABILITIES, AND PERFORMANCE THAN DOES INFORMATION ABOUT CASH RECEIPTS AND PAYMENTS. ACCRUAL ACCOUNTING IS DESCRIBED IN PARAGRAPHS 139 AND 140 OF THE FINANCIAL ACCOUNTING STANDARDS BOARD'S STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 6 AS FOLLOWS:

ACCRUAL ACCOUNTING ATTEMPTS TO RECORD THE FINANCIAL EFFECTS ON AN ENTITY OF TRANSACTIONS AND OTHER EVENTS AND CIRCUMSTANCES THAT HAVE CASH CONSEQUENCES FOR THE ENTITY IN THE PERIOD IN WHICH THOSE TRANSACTIONS, EVENTS, AND CIRCUMSTANCES OCCUR RATHER THAN ONLY IN THE PERIODS IN WHICH CASH IS RECEIVED OR PAID BY THE ENTITY. ACCRUAL ACCOUNTING IS CONCERNED WITH AN ENTITY'S ACQUIRING OF GOODS AND SERVICES AND USING THEM TO PRODUCE AND DISTRIBUTE OTHER GOODS OR SERVICES. IT IS CONCERNED WITH THE PROCESS BY WHICH CASH EXPENDED ON RESOURCES AND ACTIVITIES IS RETURNED AS MORE (OR PERHAPS LESS) CASH TO THE ENTITY, NOT JUST WITH THE BEGINNING AND END OF THAT PROCESS. IT RECOGNIZES THAT THE BUYING, PRODUCING, SELLING, DISTRIBUTING, AND OTHER OPERATIONS OF AN ENTITY DURING A PERIOD, AS WELL AS OTHER EVENTS THAT AFFECT ENTITY PERFORMANCE, OFTEN DO NOT COINCIDE WITH THE CASH RECEIPTS AND PAYMENTS OF THE PERIOD.

THUS, ACCRUAL ACCOUNTING IS BASED NOT ONLY ON CASH TRANSACTIONS BUT ALSO ON CREDIT TRANSACTIONS, BARTER EXCHANGES, NONRECIPROCAL TRANSFERS OF GOODS OR SERVICES, CHANGES IN PRICES, CHANGES IN FORM OF ASSETS OR LIABILITIES, AND OTHER TRANSACTIONS, EVENTS, AND CIRCUMSTANCES THAT HAVE CASH CONSEQUENCES FOR AN ENTITY BUT INVOLVE NO CONCURRENT CASH MOVEMENT. BY ACCOUNTING FOR NONCASH ASSETS, LIABILITIES, REVENUES, EXPENSES, GAINS, AND LOSSES, ACCRUAL ACCOUNTING LINKS AN ENTITY'S OPERATIONS AND OTHER TRANSACTIONS, EVENTS, AND CIRCUMSTANCES THAT AFFECT IT WITH CASH RECEIPTS AND OUTLAYS. ACCRUAL ACCOUNTING THUS PROVIDES INFORMATION ABOUT AN ENTITY'S ASSETS AND LIABILITIES AND CHANGES IN THEM THAT CANNOT BE

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OBTAINED BY ACCOUNTING ONLY FOR CASH RECEIPTS AND
OUTLAYS.

THE CURRENT CAS BOARD'S STATEMENT OF OBJECTIVES, POLICIES AND
CONCEPTS STATES THAT ACCRUAL ACCOUNTING GENERALLY PROVIDES
FOR THE BEST MATCHING OF COSTS TO THE PRODUCTION OF GOODS AND
SERVICES THAT GIVE RISE TO THE THOSE COSTS. FURTHERMORE, THE
COMPENSATION STANDARDS THEMSELVES HISTORICALLY EMBRACED
ACCRUAL ACCOUNTING.

- ITEM 3 OF PREAMBLE A TO CAS 408 ACKNOWLEDGED THAT: "UNDER
GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, LIABILITIES ARE
USUALLY RECORDED WHEN OBLIGATIONS TO TRANSFER ASSETS OR
PROVIDE SERVICES IN THE FUTURE ARE INCURRED". CAS 408
FOLLOWED GAAP BY CONCLUDING THAT THE PROPER MEASURE OF
THE LIABILITY AND THE CRITERION FOR COST RECOGNITION OF
COMPENSATED ABSENCES WAS THE AMOUNT PAYABLE IF THE
EMPLOYER WERE TO TERMINATE THE EMPLOYMENT FOR ANY REASON
OTHER THAN DISCIPLINARY ACTION.
- CAS 412, PRIOR TO BEING REVISED IN MARCH 1995, PROVIDED THAT
PENSION COSTS WERE ASSIGNABLE TO THE EXTENT THAT THEY WERE
FUNDED OR FUNDING COULD BE COMPELLED. THUS, THE COSTS OF
UNFUNDED, NONQUALIFIED PENSION PLANS WERE ASSIGNED AND
ALLOCATED TO GOVERNMENT CONTRACTS ON AN ACCRUAL BASIS, TO
THE EXTENT THAT A VALID LIABILITY WAS DEEMED TO EXIST. ITEM 11
OF PREAMBLE A TO THE ORIGINAL PROMULGATION OF CAS 412
SPECIFICALLY NOTED;

THE BOARD BELIEVES THAT ASSIGNING PENSION COSTS TO COST
ACCOUNTING PERIODS ON A CASH BASIS IS INAPPROPRIATE FROM
AN ACCOUNTING VIEWPOINT AND COULD LEAD TO IMPROPER
ASSIGNMENT OF PENSION COSTS AMONG PERIODS...

THE UNDERLYING CONCEPT OF THE STANDARD IS THAT WHEN A
VALID LIABILITY EXISTS, THE CORRESPONDING COSTS MAY BE
ACCRUED IRRESPECTIVE OF WHEN THE LIABILITY IS LIQUIDATED...

- UNDER CAS 415, THE COST OF DEFERRED COMPENSATION IS
ASSIGNABLE AS A CONTRACT COST IN THE PERIOD THE CONTRACTOR
INCURS AN OBLIGATION TO PAY SUCH COST.

**PRESENTATION TO THE COST ACCOUNTING STANDARDS BOARD
REVIEW PANEL**

by Margaret M. Worthington, Partner, Price Waterhouse LLP
June 18, 1998

IN DIRECT OPPOSITION TO THE PRINCIPLES STATED IN ITS STATEMENT OF OBJECTIVES, POLICIES AND CONCEPTS, THE CURRENT BOARD IGNORED THE CONCEPT OF ACCRUAL ACCOUNTING WHEN IT PROMULGATED THE REVISION TO CAS 412. THIS REVISION WAS CLEARLY AN ACCOMMODATION BY THE BOARD TO GOVERNMENT CRITICS WHO VIGOROUSLY ASSERTED THAT FUNDING WAS THE ONLY ACCEPTABLE PROOF OF A CONTRACTOR'S PENSION COST OBLIGATION. WHILE FEW WILL ARGUE THAT CASH BASIS ACCOUNTING EASES THE TASK OF COST VERIFICATION, IN MOST INSTANCES IT VIOLATES THE PRINCIPLE OF MATCHING COST WITH THE BENEFITTING ACTIVITIES. THIS IS PARTICULARLY TRUE WITH REGARD TO PENSION COSTS BECAUSE OF THE EXTENDED DELAY BETWEEN THE PERIOD THAT THE PENSION BENEFIT IS EARNED AND THE ACTUAL PAYMENT OF BENEFITS.

I AM FURTHER CONCERNED THAT THE BOARD MAY BE MOVING IN THE DIRECTION OF CASH BASIS ACCOUNTING WITH REGARD TO THE PENDING ADVANCED NOTICE OF PROPOSED RULEMAKING ON POST-RETIREMENT BENEFIT PLANS OTHER THAN PENSION (PRB) PLANS. TOPIC G OF THE STAFF DISCUSSION PAPER DATED SEPTEMBER 20, 1996 OBSERVED THAT, BECAUSE PRB PLANS ARE MORE COMPARABLE TO NONQUALIFIED PENSION PLANS THAN TO QUALIFIED PENSION PLANS, "... THE BOARD MAY HAVE TO ADDRESS MANY OF THE ISSUES THAT AROSE IN THE PENSION CASE IN THE CASE OF POST RETIREMENT BENEFIT COSTS AS WELL." IF THE BOARD PRESCRIBES THE SAME ACCOUNTING FOR PRB COSTS AS WAS PRESCRIBED FOR NONQUALIFIED PENSION PLANS IN THE REVISION TO CAS 412, THE RESULT WILL BE CONSISTENT BUT BAD ACCOUNTING FOR BOTH TYPES OF PLANS.

IN CONCLUSION, I WOULD LIKE TO RESPOND TO TWO QUESTIONS:

- SHOULD CAS BE MORE CLOSELY ALIGNED WITH GAAP?
- SHOULD CAS BE MORE CLOSELY ALIGNED WITH THE FEDERAL COST PRINCIPLES?

WITH REGARD TO THE RELATIONSHIP OF CAS AND GAAP, MY ANSWER IS YES. CAS SHOULD DEVIATE FROM GAAP ONLY ON AN EXCEPTIONAL BASIS WHERE THERE ARE PARTICULARLY COMPELLING REASONS TO DO SO, SUCH AS WHERE THE VOLATILITY OF COSTS COMPUTED UNDER GAAP IS COUNTERPRODUCTIVE TO CONSISTENCY BETWEEN PERIODS AND THEREFORE TO PREDICTABILITY FOR FORWARD PRICING PURPOSES.

**PRESENTATION TO THE COST ACCOUNTING STANDARDS BOARD
REVIEW PANEL**

**by Margaret M. Worthington, Partner, Price Waterhouse LLP
June 18, 1998**

WITH REGARD TO THE RELATIONSHIP OF CAS AND THE FAR COST PRINCIPLES, MY ANSWER IS A RESOUNDING NO. ACTIONS BY THE DEFENSE AND CIVILIAN ACQUISITION REGULATORY COUNCILS AND DEPARTMENT OF DEFENSE PROCUREMENT POLICY MAKERS SUGGEST THAT THE PROCUREMENT POLICY CHARTER IS INEXORABLY AT ODDS WITH WHAT I BELIEVE SHOULD BE THE FUNDAMENTAL FOCUS OF CAS, I.E., THE PROMULGATION OF STANDARDS WHICH REFLECT SOUND ACCOUNTING CONCEPTS.

THANK YOU FOR THE OPPORTUNITY TO PRESENT MY VIEWS TODAY AT THIS IMPORTANT PUBLIC MEETING.

**PRESENTATION TO THE
COST ACCOUNTING STANDARDS BOARD
REVIEW PANEL**

**BY RODNEY W. MATEER
NATIONAL PARTNER
GOVERNMENT CONTRACTING SERVICES GROUP
DELOITTE & TOUCHE LLP**

JUNE 18, 1998

**CAS BOARD ACTIVITIES THAT ARE
INCONSISTENT WITH ITS FUNDAMENTAL
OBJECTIVES AND GENERALLY
ACCEPTED ACCOUNTING PRACTICES**

I. BACKGROUND

A. Legislative Mandate

The current Cost Accounting Standards Board (CAS Board) legislation (PL 100-679), included in an amendment to the Office of Federal Procurement Policy (OFPP) Act, provided the Board with the "authority to make, promulgate, amend and rescind cost accounting standards and interpretations thereof." The law explained that the purpose of such actions were "designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment and allocation of costs to contracts with the United States."

The Board acknowledged this responsibility in its Statement of Objectives, Policies and Concepts. The CAS Board stated that:

The primary objective of the Board is to promulgate, amend, and revise Cost Accounting Standards designed to achieve (1) an increased degree of uniformity in cost accounting practices among Government contractors in like circumstances, and (2) consistency in cost accounting practices in like circumstances by individual Government contractors over periods of time.

The actions by the new CAS Board, however, have been inconsistent with the law and the intent expressed by the Board. It appears that the Board, in its current activity, has not evaluated its actions against the very clear objectives set for its operation.

B. CAS Board Objectives

1. Cost Accounting Standards

The law requires the CAS Board to promulgate Cost Accounting Standards. The Board, in its Statement of Objectives, Policies, and Concepts describes a Cost Accounting Standard as:

... a statement formally issued by the Cost Accounting Standards Board that (1) enunciates a principle or principles to be followed, (2) establishes practices to be applied, or (3) specifies criteria to be employed in selecting from alternative principles and practices in estimating, accumulating and reporting costs under contracts subject to the rules of the Board.

Therefore, under the authority of the law and the Board's interpretation of the law, Standards cover cost, whether used for estimating, accumulating, or reporting purposes.

Furthermore, the Board explained that the measurement, assignment, and allocation of costs--or allocability--is an accounting concept involving the ascertainment of contract costs. The Board stated that its objective in issuing "fair" Standards was to provide to the contracting parties "accounting data that are representative of the facts." It is fair to say, therefore, that the Board's stated objective is to devise a set of accounting rules to define and measure costs, to assign such costs to accounting periods, and, finally, to allocate cost to individual contracts. The accounting rules are definitive as to the allocable relationship between the cost as incurred and the benefiting contracts. While the Board has acknowledged that its Standards may not always agree with accounting rules written for other purposes, such as financial or tax accounting, the Board has not stated that it will deviate from accounting concepts, nor does its authorizing legislation appear to permit such deviations.

2. Uniformity and Consistency

The objective to increase uniformity and consistency is the sole mission given to the Board by its authorizing legislation. Going back in history to the GAO study that led to the legislation to establish the first CAS Board and to the legislation itself, the objective of uniformity and consistency was singled out as the Board's sole mission.

3. Consistency in Cost Accounting Practices

The Board expressed an objective for consistency in like circumstances by individual government contractors over a period of time. This notion of consistency should also apply to the use of consistent concepts in the development of Standards. The need for each Standard to be consistent in the accounting concepts used is not established by law or stated as a Board objective. Nevertheless, for the Board to issue a coherent set of Cost Accounting Standards, this objective must be met. The Board has expressed the need for consistency within Standards and explained in its Statement of Objectives, Policies and Concepts that "No one section of a Standard stands alone, and all sections must be read in the context of the Standard as a whole." One should expect that not only should Standards be internally consistent, but that consistency in accounting concept should be expected among all Standards.

II. CAS BOARD ACTIVITIES

A. CAS 412 and 413

1. Accrual vs. Cash Accounting. The first amendments to Standards promulgated by the new Board were the substantial amendments to the pension accounting Standards CAS 412, Cost Accounting Standard for Composition and Measurement of Pension Cost, and 413, Adjustment and Allocation of Pension Cost. The amendments contained several concepts for cost determination not previously used by the CAS Board.

One concept introduced into CAS 412 was the concept of cash-based accounting. The Board had stated in its redrafting of the Statement of Objectives, Policies and Concepts that the use of cash-based accounting might be used. Cash-based accounting is generally unacceptable

for financial accounting (FAS 87, Employee Accounting Pensions). Therefore, to use it for cost accounting should be limited to circumstances where protection of the Government interest is more important than the accurate determination of contract cost.

Even more important to the mission of the CAS Board, as established in the law and adopted in the Board's operating statement, is the need to increase uniformity and consistency in the cost accounting for Government contracts. By its very nature cash-based accounting attributes cost incurrence to the accounting period in which payment is made to acquire assets or for incurred expenses, rather than to the accounting period in which the assets are used or the expenses incurred. The resulting mismatching of cost with accounting periods, and the products produced in those periods, will assure that different contractors making the same product at the same cost will reflect different cost values for Government contract costing purposes. Similarly, within a single entity the attribution of cost to products when a payment is made rather than when the cost is incurred will result in inconsistencies in results from one accounting period to another. Therefore, the basic purpose for which the CAS Board was established is not achieved, and, instead, such proposed accounting will only serve to decrease uniformity and consistency in cost accounting for Government contracts.

Finally, the action by this Board to use cash-based accounting reverses actions by the previous Board to move to accrual accounting. The change in CAS 412 to cash-based accounting makes the accounting concepts used in that Standard in conflict with the changes from previous cash-based procurement regulations to accrual accounting in CAS 408, Accounting for Costs of Compensated Personal Absence, and CAS 415, Accounting for the Cost of Deferred Compensation, two other Standards which similarly deal with labor related costs. It also makes CAS 412 inconsistent with CAS 404, Capitalization of Tangible Assets, 409, Depreciation of Tangible Capital Assets, and CAS 411, Accounting for Acquisition Cost of Material. In fact, these five Standards are all the other Standards dealing with accrual accounting, so that the change to CAS 412 isolates it as inconsistent with the general concepts used in the other Standards.

2. **Cost Determination vs. Repricing.** The other significant change in cost accounting concepts was the guidance promulgated in CAS 413.50(c)(12). While the change to cash-based accounting appears to be from a generally acceptable method of accounting to one which is generally unacceptable, the changes in this area have nothing to do with accounting or accounting concepts. While contract cost accounting has been described by the CAS Board and others as dealing with contract cost determination, this section of the Standard effectively deals with the repricing of contracts performed in previous accounting periods by a direct credit or by the readjustment of contract prices in the current period. Pricing of contracts has never been considered in the law, by the Board's published statements on operations, or by the previous CAS Board. Pricing of contracts is considered the domain of the procuring agencies and the CAS Board's legislation, and operating statements always have limited the Board's scope to cost determination. Accounting practices provide for readjustment of prior period cost estimates as increases or decreases in cost in the current and future periods, such estimating errors are reflected as additional profit or loss in the period in which the error occurred.

This concept is illustrated in several other Standards which cover adjustments in a current cost accounting period for estimating errors in previous accounting periods. All such Standards treat the adjustment as an adjustment to cost, not an adjustment to the customer or the repricing of contracts. Examples in other Standards include CAS 409.50(j) on the adjustment of cost as a result of the disposition of fixed assets, CAS 415.50(d)(7) and (8) on the adjustment of deferred compensation earned in previous periods for forfeitures occurring in the current period, and CAS 416.50(a)(1)(i) for refunds, dividends or additional assessments of insurance premiums.

3. Actuarial Assumptions. In addition to the issue of repricing versus cost adjustment posed by CAS 413.50(c)(12), CAS 413.50(c)(12)(i) provides that:

The actuarial assumptions employed shall be consistent with the current and prior long term assumptions used in the measurement of pension costs.

This provision is contrary to Generally Accepted Accounting Principles (GAAP) which require that accounting estimates represent the best information available for the circumstances existing at the time the estimates are made. As APB 20, paragraph 10, provides:

Thus accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.

This provision also conflicts with CAS 412.40(b)(2) which provides that:

Each actuarial assumption used to measure pension costs . . . shall represent the contractor's best estimate of anticipated experience under the plan. . . .

It also conflicts with guidance in other Standards dealing with changes in estimates for changed circumstances. For example, CAS 409, in a number of sections, requires estimates to reflect both historic information and future expectations and both asset life and method of depreciation must change when changed circumstances indicate the need. CAS 414, when treating with projected cost of capital rates, requires the use of current treasury rates. CAS 415 requires that current interest rates be used to adjust deferred compensation amounts in the current period. And, finally, CAS 416, in dealing with self-insurance, requires that loss experience shall be evaluated regularly, and self-insurance charges for subsequent periods shall reflect such experience.

B. CAS 404 and 409

The CAS Board recently promulgated two changes to CAS 404 on capitalization of tangible assets and 409 on depreciation accounting. The first of these changes was to change the treatment of accounting for fixed assets in a merger or acquisition. GAAP requires that the seller reflect the gain or loss between the selling price of the fixed assets and their net book value upon a sale or merger, and that the buyer capitalize the acquired fixed assets at their fair value not to exceed the purchase price (APB 16). The changes to CAS 404 and 409 essentially ignore the transaction, precluding recognition of the gain or loss by the seller, and requiring use of the previous owners net book value for the assets, rather than its cost to the buyer. This approach is

contrary to GAAP, it is not an alternative accounting approach, and may be outside the scope of activity authorized by the CAS Board's legislation.

This approach will likely decrease uniformity in accounting among contractors. For example, the provisions of the Standard preclude a business which has previously used the fixed assets on government contracts from recognizing and recording the fixed assets at their cost to the new owners, while a business which has not previously used the fixed assets on Government contracts can record the fixed assets at their acquisition cost. Another example of circumstances leading to a decrease in uniformity will occur when a company, wishing to expand its business, chooses to acquire another business, while another company in the same circumstances might choose to purchase additional facilities. The different approaches to achieve the same objectives results in different fixed asset cost to produce similar products in like circumstances. These results are diametrically opposed to the basic purpose for which the CAS Board was established.

The second change made to CAS 404 was to increase the minimum acquisition cost criterion for capitalization of fixed assets. The change was made from a previous minimum criterion of \$1,500 to a revised criterion of \$5,000. While this change may be beneficial in decreasing the expense of administering fixed assets, the change was inserted after the publication of the NPRM. This action effectively precludes external review of the change.

CONCLUSION

The various amendments to Standards promulgated to date have consistently moved the cost accounting practices required by the Standards from those recognized as generally acceptable to practices that are not generally acceptable or are outside the purview of cost accounting practice. The conclusion reached is that the CAS Board is making policy decisions rather than cost accounting practice decisions. Such policy decisions may have supportable rationales, however, the legislation establishing the Board intended a cost accounting principles and practices Board, not a procurement policy maker. The procurement agencies have traditionally been given the responsibility for policy decisions and the CAS Board had recognized this in its *Statement of Objectives, Policies and Concepts*. It should continue to recognize its role in the process of amending existing Standards and issuing new Standards.

The new practices prescribed will decrease uniformity and consistency in the cost accounting for Government contractors. This result is opposed to the designed purpose of reestablishing the Cost Accounting Standards Board and brings to question whether the actions by the CAS Board are appropriate. In addition, the result of the Board's recent efforts have produced conflicting policy and accounting concepts and are resulting in a set of Standards that can no longer be depended upon to be internally consistent. The result is a less than coherent set of rules.

CALDWELL & BODENHEIMER, LLC
Certified Public Accountants and Consultants

Andrew V. Caldwell, Jr, CPA, Chrd.
Jerrold Bodenheimer, CPA, Chrd.

June 5, 1998

Mr. Ralph Dawn
U.S. General Accounting Office
441 G Street, N.W. - Room 4A53
Washington, DC 20548

Dear Mr. Dawn:

Because of scheduling conflicts, we regret that we will be unable to make an oral presentation at the public hearing of the Cost Accounting Standards Review Panel on June 16 and 17, 1998. It would be appreciated if the panel would take these written comments into account.

I am currently a partner in a public accounting which emphasizes audit, accounting, and consulting services to government contractors. We have frequently been consulted by both government contractors and government agencies on questions of contract cost allowability and allocability generally, and the application of CAS and FAR cost principles specifically. We have participated as consultants and expert witnesses in numerous contract cost disputes. Before entering public accounting, I was on the staff of the first Cost Accounting Standards Board. For a number of years I was also a member, and later chairman, of the ASPR (now FAR) Cost Principles Subcommittee.

The charter of the Cost Accounting Standards Review Panel requests it to "focus on" five broad issues. These issues include

401 Washington Avenue, Suite 200
Baltimore, Maryland 21204
(410) 337-2900 - FAX (410) 337-0541

(i) the viability of the CASB's original mission after "major changes in the procurement laws"; (ii) the extent to which a board is advisable to regulate contractor cost accounting practices; (iii) the relationship between contract cost allowability and allocability; (iv) the structure of a Board; (v) the staffing of a Board; and (vi) any other relevant issues. (June 25, 1996 letter from William F. Clinger, Jr. and Floyd Spence to Comptroller General Bowsher) Brief views on each of these issues are set forth below.

My views on the first five issues to be considered by the Panel follow.

(i) The viability of the CAS Board's original mission after major changes in the procurement laws. The mission of the current CASB appears to be defined in Section 26 of the Office of Federal Procurement Policy Act (P.L. 100-679) as follows:

(f)(1) The Board shall have the exclusive authority to make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States.

Similarly, the first CASB was required to "promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost accounting principles followed by defense contractors

and subcontractors under Federal contracts."

It is assumed that the "viability of the original mission" refers to a continued need for a Board and the "major changes in procurement laws" are those aimed at reducing cost based pricing. Based on these assumptions, any question concerning a continued need for the mission, if not the CASB, is vastly premature. As long as there are cost based contracts, the need will continue for "cost accounting standards governing measurement, assignment, and allocation of costs to contracts."

The problems created by the lack of an authoritative standard setting body is clearly evident from the problems encountered in the 1980's during the hiatus between the first and second Cost Accounting Standards Boards. Without an authoritative Board, there is no practical way to change existing standards, disclosure requirements, applicability thresholds, and other regulations. Unless the Panel is willing to cancel all Standards, disclosure requirements, and related regulations, a Board - or at least some other responsible organization - is indispensable.

(ii) The extent to which a board is advisable to regulate contractor cost accounting practices. The obvious, if somewhat facetious, response to this question is "compared to what?" If the choice is between an independent board and full time employees of an appropriate federal agency, a board appears to be preferable.

While there may be those who question the need for CAS, or those who disagree with the existing CAS, there are few who could argue with the promulgation process. In large part this process is enhanced by the broad and diverse experience brought by an ostensibly independent board. The use of such a board to "regulate contractor cost accounting practices" assures consideration of multiple interests, has withstood the test of time, and should be continued (but see iv below).

(iii) The relationship between contract cost allowability and allocability. This has been a nagging issue since the early days of the first CASB. Having been extensively involved in the development of both Cost Accounting Standards and contract Cost Principles, I believe that the dichotomy of cost allocability and allowability is unnecessary and counterproductive. The existing FAR Cost Principles are replete with allocability rules posing as allowability issues, while CAS contain allowability issues posing as allocability issues. The line between allowability and allocability is too blurred to successfully separate these issues. Under these circumstances a single organization should be entrusted with what is now divided into Cost Principles and Cost Accounting Standards. For the reasons stated under (ii) above, a Board is deemed to be a superior mechanism for the combined functions.

iv. The composition, membership, terms, and structure of the board. The current law provides for two "representatives" from

each government and industry. This composition presumably provides some experience with contract accounting issues, but also seems to lead to advocacy, rather than independence. Ideally, board member should be able to decide issues on their merit and equity, not as an "advocate" of either industry or government. Perhaps an alternative to the existing board composition, it may be desirable to include members from academia, the accounting profession without any significant connection with government contract accounting, or companies without significant government contracts.

(v) The staffing of a board. The woefully inadequate staffing of the existing CASB has been amply recognized. (See, for example, GAO Report B-255794, May 25, 1994). An understaffed board serves neither the government nor government contractors. Even if the Board is to continue in its existing mission, additional staffing is required. Obviously this deficiency would be exacerbated if the Board were to assume an expanded role, as contemplated under (iii) above.

In summary, the mission of the CASB is required as long as cost based contracts exist. The presumably unattainable goal of eliminating cost based contracting is not a reason to abandon the mission at this time. A board type structure continues to be the preferable mechanism for accomplishing the mission. A board composition and structure which would tend to avoid "advocacy" should be considered. It would be preferable to combine

responsibility for both cost allocability and allowability in a single organization. The CASB, or a substantially similar organization, is deemed to be preferable organization to achieve both of these functions.

Sincerely,

Bert Bodenheimer/ks

Bertold Bodenheimer

BB:ks

GORDON SHILLINGLAW
115 LIVE OAK LANE
LARGO, FLORIDA 33770-2657
E-MAIL: GSLIVE25@AOL.COM

June 8, 1998

To: Cost Accounting Standards Board Review Panel

Subject: Comments for Consideration by the Panel

I served as a member of the "old" CASB from 1978 to its demise in 1980. With that background, I wish to make a few comments for your consideration. Unfortunately, a scheduling conflict will prevent me from presenting my views in person at the meetings on June 16-18, but I hope you will find these written comments useful. A copy of my resume is attached.

The first issue I wish to address is the suitability of GAAP as a substitute for CAS. Any objective review of GAAP will conclude quickly that GAAP cannot play this role. One reason is that the cost-related sections of GAAP have an entirely different purpose. They are designed solely to determine the period or periods in which costs are to be classified as expenses for financial statement purposes. Except for end-of-period inventory measurement, nothing in GAAP prescribes how the costs of a period are to be assigned to the various contracts and other cost objectives pursued in that period. If a cost is classified as a current expense, that is the end of it as far as GAAP is concerned. *Cost accounting* principles are necessary to implement the next step by providing guidance as to the classification of costs of an individual time period to the cost objectives of that period.

Furthermore, public policy may require that GAAP measurements of period expenses be modified to make them suitable for application to government contracts. A prime example of such a necessary departure lies in the accounting for mergers and acquisitions. When an acquisition is accounted for by the purchase method, GAAP requires that the assets of the acquired business be revalued. If contract costs thereafter are based on the revalued amounts, some procedure must be established to prevent the escalation of the costs of existing contracts. GAAP is silent on this issue because contract costing is not in GAAP's domain.

Gordon Shillinglaw Comments for Consideration by
the Cost Accounting Standards Board Review Panel

The second issue on which I wish to comment is the need for CAS in the current contractor environment. Without CAS, cost measurements of a given contract can be manipulated at will and at the contractor's pleasure. If costs are to be used in the contracting process, the measurement rules should be understood by both parties so that conformance to the rules can be monitored and verified. Opposition to that simple idea can only reflect the position that cost measurement is a private matter that no one in government has the right to oversee or monitor. This position will be valid only if and when cost measurements cease to enter into government procurement decisions. That day seems likely to be far off.

As to the need for the CAS Board itself, experience shows that standards need to be reevaluated from time to time. Without a sitting Board, CAS standards are locked in concrete. For example, when the old CAS Board was terminated, it was actively working on proposals to make CAS 410 more flexible to variations in contractors' situations. That effort could not be completed when the Board went out of existence.

Related to that, someone should have the power to grant full or partial exemptions from CAS. This power doesn't have to be lodged in the CAS Board, but it should be given to some agency or body other than the entity that is negotiating the contracts. Independence is a key requirement.

Finally, I have no problem with the possible increase in the number of industry representatives on the Board, although that would put further strain on the Board's very restricted budget. If that is done, however, neither the representatives of affected government bodies nor the industry representatives should constitute a majority of the Board. During my term on the old Board, the industry representative added useful insights to the standard-setting process and was flexible enough to permit us to get on with our work. Unfortunately, most industry representatives are likely to be hostile to the basic objectives of CAS. Their role is important, but it must not dominate. The Board has a public mission. It cannot be anti-industry, but it must not be a captive of industry, either.

Respectfully submitted,

Statement



STATEMENT OF
ELEANOR HILL
INSPECTOR GENERAL, DEPARTMENT OF DEFENSE
TO COST ACCOUNTING STANDARDS BOARD
REVIEW PANEL ON
THE NEED FOR COST ACCOUNTING STANDARDS

JUNE 15, 1998

Office of the Inspector General
Department of Defense

Mr. Chairman and Members of the Panel:

I appreciate the opportunity to present the Office of the Inspector General (OIG), DoD, view on the importance of the Cost Accounting Standards Board (CASB) and the standards it promulgates. At the outset, I want to emphasize that the OIG, DoD, has been a strong proponent and supporter of acquisition reform. We intend to continue working with the Department and Congress to identify barriers to further reform, develop new processes and approaches, and evaluate the results of the new policies and procedures.

There were 85 major DoD acquisition programs, valued at over \$725 billion, ongoing at the end of FY 1997. There are also several hundred smaller system acquisition programs and huge logistics procurement efforts. Cumulatively, these programs constitute the largest and most complex capital investment effort in the world. The Department must ensure our fighting forces have the most technologically advanced weapons at reasonable, proper costs. Because of these risks, the DoD audit community has given high priority to prudent audit coverage of acquisition programs from requirement determination through contract completion. My comments on the CASB are based on the experience gained in this extensive internal and contract audit effort.

ACQUISITION REFORM

We fully support the identification and implementation of best practices in both Government and industry. We also endorse competitive procurement and commercial purchases whenever feasible. For instance, the Single Process Initiative is an excellent example of working with industry to adopt commercially-used, contractor facility-wide processes instead of the more costly contract-unique requirements of the past. It is important that we identify and buy commercial products whenever they meet contract requirements in order to make best use of our limited funds. Commercial buys are exempt from Cost Accounting Standards (CAS) and other regulations which some contractors view as burdensome.

However, there are still and will continue to be Defense unique items that cannot be bought commercially off the shelf or by competitive bidding. The Government will not be able to obtain the best value if we make sole source procurements without CAS. We must not put programs at risk for overcharging because of unsupported assertions that laws and regulations such as the CAS are preventing many companies from bidding on DoD contracts. Despite the commendable emphasis on decreasing DoD dependence on military-unique items, a certain degree of dependence will always exist. The same holds true for sole-source procurement. In fact, continued consolidation of the defense industry may make competition even less likely in the future.

GENERAL ACCOUNTING OFFICE REVIEW

In 1970, the General Accounting Office (GAO) issued a report to Congress on the feasibility of applying uniform cost accounting standards to negotiated prime contract and subcontracts over \$100,000. In our view, the results of that study are still valid today.

The GAO noted that Government cost principles are generally based on Generally Accepted Accounting Principles (GAAP) and the accounting methods accepted for income tax purposes by the Internal Revenue Service. However, GAAP and accounting treatments for tax purposes were and are still not adequate for contract costing because they were designed for totally different purposes.

The GAAP are concerned with reporting cost information for financial statement purposes and was developed primarily for stockholder use and protection. GAAP do not address allocations between products and services within a fiscal year. Instead, they emphasize proper treatment of cost allocations between fiscal years. Accounting treatment for tax purposes attempts to properly implement existing tax laws and regulations. Tax laws are enacted for a different purpose than addressing concerns about proper contract costs and overpricing.

The GAO also concluded that, when prices are set without competition and the restraints of the market place, cost data play an important role in negotiating, administering, and settling contracts at fair prices. We agree with the GAO and are convinced that properly disclosed and consistently followed cost accounting standards and contractor practices lead to a better DoD/contractor working environment, ultimately resulting in less adversarial conditions.

Except for the CASB, there are no definitive sources for criteria on cost accounting practices for contractors doing business with the Government. The Audit & Accounting Guide for Audits of Federal Government Contractors, issued by the American Institute of Certified Public Accountants, acknowledges that GAAP provide little guidance for cost accounting purposes in Government contracting. In contrast, CAS provides uniformity and consistency in handling Government contract costs. Applying CAS ensures comparability in cost data, in turn providing a reasonable assurance that procurements will be reasonably priced.

ESTABLISHMENT OF THE COST ACCOUNTING STANDARDS BOARD

The first CASB was created in 1970. After issuing 19 standards, the original CASB went out of existence on September 30, 1980. In 1988, the CASB was reestablished under the Office of Management and Budget. At that time, most major contracts and subcontracts were issued for negotiated

procurements and, therefore, subject to CAS. However, contracts and subcontracts were exempt from CAS if they were: awarded under sealed bids; negotiated for less than \$5,000,000; awarded to small business contractors; issued for a price set by law or regulation; or awarded on a firm-fixed price basis for commercial items. Over the years the dollar thresholds have changed. Today, contractors are required to comply with all CASB standards if they have received either a single CAS-covered contract award of \$25 million or more, or received \$25 million or more in CAS-covered contract awards during the preceding cost accounting period with at least one award exceeding \$1 million.

NEED FOR COST ACCOUNTING STANDARDS

The CASB has issued 19 standards to increase uniformity and consistency in the allocation of costs. We do not believe that complying with CASB standards is an unreasonable burden for those covered contractors. In fact, CAS provides a sound foundation for better understanding and communication between the contractor and the Government of cost measurement methods that, in turn, should reduce the incidence of misunderstandings and contract disputes.

It is important to remember that CAS is not applicable to commercial contracts or to "Other Transactions." "Other Transactions" are exempt from the Federal Acquisition Regulation, contract audit, CAS and most procurement statutes. The DoD already has authority to use "Other Transactions" for research and development acquisitions. The DoD can thus use commercial contracts or "Other Transactions" to avoid the use of CAS in special circumstances. In the absence of competition, CAS provides some protection for both the Government and contractor against inequitable or inconsistent cost allocations. The GAAP, Internal Revenue Service rules, and Securities and Exchange Commission regulations do not ensure that costs are allocated to the proper products.

Over the last 5 years, the Government has saved more than \$300 million as a result of audits that question improper contractor accounting changes and other CAS noncompliances. As of March 31, 1998, audit reports involving another \$500 million in cost questioned from CAS noncompliances and accounting changes are open and in the process of being resolved. Therefore, from a taxpayer's perspective, CAS is providing a useful service.

CONTRACTOR PENSION PLANS

One of the most significant items of contractor costs that is passed to the Government through contracts is employee pension cost. Based on a recent evaluation by this office, the estimated pension fund assets for the largest 15 contractors were about \$100 billion. The CASB has issued two very important standards, CAS 412 and 413, that provide the contractors and the Government with badly needed guidance on the proper composition and

measurement of pension costs, as well as criteria for assigning, valuing, and allocating them. In addition, because of the significance of pension-related issues in business combinations, CAS provides the only real means to ensure that charges to Government contracts are appropriate. Government funded pension assets must be properly allocated during restructuring to ensure future contracts do not shift a disproportionate share of future pension costs to the taxpayer.

ACCOUNTING FOR UNALLOWABLES

The CAS 405 facilitates the negotiation, audit, administration, and settlement of contracts by requiring contractors to identify expressly unallowable costs (examples are lobbying, political contributions, golden parachutes and entertainment costs). The Defense Contract Audit Agency has reported that, in fiscal year 1997, over \$2 billion was deleted from claims by major contractors. Without CAS, contractors will not have to identify these unallowable costs and eliminate them from their claims. Attempting to operate without CAS would result in an unacceptable risk that unallowable costs will be passed to the Government.

PROTECTION FOR CONTRACTORS

The CAS requires that major contractors prepare a disclosure statement of their cost accounting practices and have it reviewed by the Government for adequacy. This process ensures that the contractor and the Government use consistent accounting practices when negotiating sole source contracts. Prior to the development of a well structured process, both parties had legitimate reason to fear that practices could be disguised or manipulated. The company could manipulate accounting practices to yield higher prices and Government contracting officials could direct companies to manipulate accounting practices to a particular program's advantage. Proper implementation and enforcement of CAS has stopped this from occurring. In the current environment, because the contractor's cost accounting practices and procedures are disclosed in the CAS Disclosure Statement, neither party can dictate or make deviations to suit their needs.

CONCLUSION

I am concerned with the misperceptions of CAS as an impediment to civil-military integration. Waivers are available that allow for awarding firm-fixed price contracts for commercial items, in which case cost or pricing data are not required. The DoD also already has the authority to use "Other Transactions" to encourage commercial firms to do research and development business with the Department. We have noted in recent reviews that "Other Transactions" are not being awarded very often to new commercial companies who believe that the cost of compliance with procurement regulations far outweigh the potential profits associated with a new customer, even one as large as the Federal

Government. For the period FY 1990 through FY 1997, 85 percent of the funds for "Other Transactions" went to traditional DoD contractors (81 percent) and nonprofit institutions (4 percent) who should already have CAS compliant accounting systems. This result leads us to question the assertions that a large number of companies are deterred from doing business with the DoD because of Government procurement regulations.

In a perfect world, we would not need CAS. We would be able to buy everything either commercially or with adequate price competition. We strongly support further efforts to avoid unnecessary military specifications and increase competition. However, it is unrealistic to assume that Defense contracting will not always involve a large number of sole source procurements. As long as we purchase goods and services from sole sources, CAS will be necessary to protect the Government's interest. Where there is not a true competitive market-place or reasonable commercial comparability, we must have the necessary laws and regulations to ensure that the prices paid for highly complex military weapons systems are reasonable.

I support changes to the CAS that are reasonable and vetted through a rigorous review process. Elements such as applicable thresholds clearly ought to be revisited periodically. To provide flexibility I can also support the DoD having effective and easy-to-use waiver authority for the CAS in specific acquisitions, or for portions of an acquisition when needed for the benefits of National Defense. I urge you to carry out this review with the intention of improving the CASB process, not eliminating it.

NOTE: Tabs referenced in this letter are not included.



Government Electronics & Information Technology Association

2500 Wilson Boulevard, Arlington, Virginia 22201-3834
703-907-7566 • FAX 703-907-7968 • www.eia.org/geia

June 18, 1998

Mr. James F. Hinchman
Acting Comptroller General
U. S. General Accounting Office
441 G Street, N. W.
Washington, DC 20548

Dr. Jacques S. Gansler
Under Secretary of Defense for Acquisition and Technology
3010 Defense Pentagon
Washington, DC 20301-3010

Mr. Nelson F. Gibbs
Vice President and Controller
Northrup Grumman Corporation
1840 Century Park East
Los Angeles, CA 90067

Subject: Issues on the Applicability of Cost Accounting Standards

Dear Co-Chairs of the CAS Board Review Panel:

The Government Electronics and Information Technology Association (GEIA) appreciates the opportunity to contribute to the Review Panel's study of the mission, operation, and structure of the CAS Board. We regret that we were unable to participate in the public hearings held by the Panel during June 16 - 18 but are pleased that we have been allowed to submit written comments.

The GEIA represents the Federal market sector within the Electronic Industries Alliance (EIA), an umbrella organization representing numerous associations and over 2,500 member firms. The GEIA maintains programs in market planning and forecasting, Government relations and acquisition policy, standards development, and many other areas. Our members are dedicated to serving the unique needs of the Government business arena, through both special design and off-the-shelf applications of electronic and information technologies.

While private industry in general has suggested a number of issues for the Review Panel to consider, we wish to offer comments in one particular area - the applicability of CAS to certain contracting circumstances. As you may already be aware, this has been an

A Sector of the Electronic Industries Alliance



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increasing concern to private industry. To further the Review Panel's understanding of this problem, we are providing copies of related correspondence which has been submitted to the CAS Board and other Government officials in recent years. Private industry's frustration (as well as the Government's) with the Board's responsiveness to these problems will be evident.

In private industry's view, the CAS Board was slow to act on the CAS exemptions that were enacted by Congress under the Federal Acquisition Streamlining Act of 1994 (FASA) and the Federal Acquisition Reform Act of 1996 (FARA), later renamed the Clinger-Cohen Act. Moreover, to date, the Board has been apparently unwilling to act on a number of related issues which have surfaced as the Government adopted new pricing rules and contracting approaches. The following is a summary of the principal CAS applicability issues.

CAS and Contracts for Commercial Items

Private industry was disappointed in the CAS Board's efforts to implement Section 8301 of FASA and Section 4025 of the Clinger-Cohen Act. Both Acts installed exemptions from CAS on contracts for commercial items.

The CAS Board never fully implemented Section 8301, except to delegate to agency heads the authority to waive CAS on contracts for commercial items when cost or pricing data were not obtained (see Tab 12). Private industry disagreed with this action: (1) because it was unnecessary for the Board to grant waiver authority to exempt on a case-by-case basis that which was already expressly exempted by Congress under Section 8301 and (2) whether cost or pricing data was submitted was not a qualifying condition imposed by Congress (see Tabs 9, 10, 11).

The CAS Board implemented Section 4025 initially as an interim rule and later as a superseding final rule. While private industry supported the interim rule, it did not entirely support the final rule because the Board limited the exemption created by FARA by prohibiting application to fixed-price contracts with economic price adjustments based on actual costs incurred (see Tab 4). Not only did private industry find the Board's reasoning flawed but also observed that the Board had created a number of practical problems without providing adequate guidance (e.g., was the whole contract CAS-covered or just the economic price adjustment portion?).

Finally, apart from the exemptions, the CAS Board has not yet acted on the issue of hybrid commercial contracts (see Tabs 4 and 9). This might occur, for example, on a firm-fixed price contract for commercial items, which contains a relatively minor provision (e.g., contract line item) for on-site maintenance to be paid on a time and materials basis. Assuming that the time and materials contract line item does not qualify for an exemption,

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is the entire contract CAS-covered or just the time and materials contract line item? In deciding the extent of CAS-coverage and Disclosure Statement obligations is the determining value the entire contract or just the time and materials portion?

CAS and Cost Realism

Another well-known issue that remains unresolved is the Truth in Negotiations Act (TINA) vs CAS conflict. This involves firm-fixed price contracts that have been exempted from TINA but, nevertheless, are CAS-covered contracts because some cost data (uncertified cost or pricing data) was submitted, usually for cost realism analysis purposes (see Tabs 1, 4, 5, 6, 7, 8, 9, 10, 11, 14, 15, 16). This conflict, in private industry's view, underscores the CAS Board's apparent unwillingness to keep pace with the procurement reform efforts which have been undertaken by Congress and the Executive Branch.

For example, the application of CAS for purposes of conducting a cost realism assessment is a growing concern for private industry. In such cases, the cost data submitted is used to establish whether an offeror understands the Government's statement of work (see FAR 15.401 and 15.404-1). The cost data is not used to negotiate contract price or determine the amount of payment for products and services delivered to the Government. CAS in such circumstances serves no practical value to either party, and the contractual imposition of CAS could produce inequities for the contractor. That is, should the Government be entitled to a downward contract price adjustment on such CAS-covered contracts if the contractor changed accounting practices?

This area has not only been a concern to private industry but to the Department of Defense, as well. Private industry strongly concurred with the recommendation offered by the Director of Defense Procurement nearly two years ago to exempt firm fixed price contracts where no certified cost or pricing data was submitted (see Tabs 6, 7, 8, 13). More recently, private industry support the Under Secretary of Defense for Acquisition request for a waiver to exempt such contracts, although private industry believed that a waiver was unnecessary if a more relevant exemption was created by the Board (see Tabs 1, 2, 3).

It is not clear why the CAS Board finds it necessary to perpetuate the TINA vs CAS conflict. The solution appears to be relatively simple, well-justified, broadly supported, and involves minimal risk to the Government - that is, exempt from CAS all firm-fixed price contracts awarded without certified cost or pricing data. Nevertheless, to date, the Board has not responded to the either private industry's or the Government's concerns in this area.

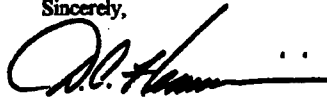
In sum, CAS applicability remains a significant issue for private industry. When combined with other contracting issues, such as the Board's proposals on changes in accounting

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practice and negotiating equitable price adjustments, a question emerges about the Board's ability or willingness to address contracting matters. We believe it is appropriate for the Review Panel to consider limiting the Board's scope of activities to accounting practice matters and giving the Agencies, within the framework of the Federal Acquisition Regulation system, the responsibility for determining CAS applicability and establishing contract administration policies and procedures.

We would be happy to meet with you or the Review Panel to discuss these issues further, if you desire. In the meantime, if you have any questions or need additional information, please do not hesitate to call me at (703) 907-7565.

Sincerely,



Dan C. Heinemeier
President
Government Electronics and Information Technology Association

cc: CASB Review Panel Members

Mr. Larry L. Grow
Mr. Jack M. Hughes
Major General Timothy P. Malishenko, USAF
Dr. Louis I. Rosen
Mr. Michael J. Thibault
Rear Admiral Leonard Vincent, USN
Ms. Karen L. Wilson

LETTER COPY
w/o TABS



AMERICAN BAR ASSOCIATION

Section of Public Contract Law
Writer's Address and Telephone



1900 K Street, N.W.
Washington, DC 20006
PHONE: (202) 496-7559
FAX: (202) 496-7756

Email: david_churchill@mckennacuneo.com

January 26, 1999

Mr. James F. Hinchman
Principal Assistant Comptroller General
General Accounting Office
441 G Street, NW
Washington, D.C. 20548

Re: Cost Accounting Standards Board Review Panel

Dear Mr. Hinchman:

This letter is addressed to you in your capacity as Co-Chair of the Cost Accounting Standards Board Review Panel. The Section of Public Contract Law of the American Bar Association has undertaken its own study of the Cost Accounting Standards Board. This study has generated a white paper examining recent promulgations of the CAS Board in light of limitations on its statutory authority.

The views expressed in the enclosed white paper have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

The Section hopes that the enclosed white paper will prove useful to the Review Panel in its deliberations, and would be happy to provide any other information and assistance as you may require.

Sincerely,

David A. Churchill/mk
David A. Churchill
Chair, Section of Public Contract Law

Enclosure

1998-1999
CHAIR
David A. Churchill
1900 K Street, NW, Suite 100
Washington, DC 20006
(202) 496-7559
CHAIR-ELECT
Rand L. Allen
1776 K Street, NW
Washington, DC 20006
(202) 429-7329
VICE-CHAIR
Gregory A. Smith
1200 19th Street, NW, 6th Floor
Washington, DC 20036-2412
(202) 861-6416
SECRETARY
Norman M. Thorpe
3031 W. Grand Blvd., 8th Floor
Detroit, MI 48201-1046
(313) 574-1628
BUDGET AND FINANCE OFFICER
Patricia A. Mosher
311 California Street, 10th Floor
San Francisco, CA 94104-2602
(415) 356-2828
SECTION DELEGATE
Marshall J. Dole, Jr.
1601 Elm Street, Suite 3000
Dallas, TX 75201
(214) 999-4733
IMMEDIATE AND PREVIOUS
PAST CHAIRS
Martha G. Madison
655 15th Street, NW, 8th Floor
Washington, DC 20005-5701
(202) 626-1468
John T. Ruelbs
1100 Wilson Blvd., 20th Floor
Arlington, VA 22209-2249
(703) 284-4355
COUNCIL MEMBERS
Thomas P. Borletta
1330 Connecticut Avenue, NW
Washington, DC 20036-1704
Hubert J. Bell, Jr.
233 Peachtree Street, NE
Atlanta, GA 30303-1530
Kevin Flanagan
400 Army Navy Drive, Room 1076
Arlington, VA 22202-2885
David C. Lane
2010 Corporate Ridge Road
McLean, VA 22102-7858
Kent R. Morrison
1001 Pennsylvania Avenue, NW
Washington, DC 20004-2595
Frederick E. Moss
6309 Glenholme Drive
Plano, TX 75093
Robert P. Murphy
441 G Street, NW
Washington, DC 20004
Craig Ostermer
200 West Mowry Street, #129
Santa Fe, NM 87501
John L. Proctor
21240 Burbank Blvd.
Woodland Hills, CA 91367-6675
Alexander W. Purdie, Jr.
4225 Legation Avenue, Suite 211
Wright-Patterson AFB, OH 45433
Mary Ellen Carter Williams
18th & T Streets, NW, Room 7023
Washington, DC 20005
Patricia H. Witte
1615 New Hampshire Avenue, NW
Washington, DC 20009
EDITOR, PUBLIC CONTRACT
LAW JOURNAL
Carl L. Vachetta
Washington, DC
EDITOR, THE PROCUREMENT
LAWYER
Barbara A. Pollack
El Segundo, CA
BOARD OF GOVERNORS LIAISON
John W. Clark, Jr.
Dallas, TX
LAW STUDENT LIAISON
Lawrence N. Hill
Chicago, IL
SECTION DIRECTOR
Marilyn Nelson
750 North Lake Shore Drive
Chicago, IL 60611-4497
(312) 988-5596
Fax: (312) 988-5688

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Page 2

cc: Rand L. Allen
Gregory A. Smith
Norman R. Thorpe
Council Members
Lynda Troutman O'Sullivan
Alan C. Brown
Agnes P. Dover
Alexander J. Brittin

January 1999

SECTION OF PUBLIC CONTRACT LAW
WHITE PAPER

THE CAS BOARD'S STATUTORY AUTHORITY

The Section of Public Contract Law of the American Bar Association has analyzed the promulgations of the second Cost Accounting Standards Board over the course of its existence, measuring them against the Board's statutory authority. The Section's conclusions are set forth in this paper. The views expressed herein are presented on behalf of the Section of Public Contract Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

EXECUTIVE SUMMARY

Recent promulgations of the Cost Accounting Standards Board have strayed beyond the Board's charter to regulate matters of cost accounting into areas of procurement policy and contract administration, which are the exclusive province of the procuring agencies. In this era of acquisition reform and streamlining, the Board should be looking to shrink, not expand, its jurisdiction. By straying beyond its charter into areas of procurement policy and contract administration, the Board has done just the opposite. The Section believes that the answer is to re-emphasize that the Board should be concerned strictly with what constitutes good cost accounting.

The current CAS Board has been granted the exclusive authority to "make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States." OFPP Act Amendments of 1988, § 26(f), 41 U.S.C. § 422(f). The Board was also given the authority to promulgate rules and regulations requiring contractors to

agree to a contract price adjustment, with interest, for any increased costs paid to such contractor or subcontractor by the United States by reason of a change in the contractor's or subcontractor's cost accounting practices or by reason of a failure by the contractor or subcontractor to comply with applicable cost accounting standards.

Id., § 26(h); 41 U.S.C. § 422(h).

The legislative history of the OFPP Act Amendments makes clear that Congress considered and rejected the idea of giving the Board jurisdiction over cost allowability as well as allocability.

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Notwithstanding the limitation of the Board's authority to matters of cost accounting, the Board's recent efforts have reflected too great an emphasis on agency policy preferences, often at the expense of sound accounting. Additionally, the Board has in recent years strayed into areas of contract administration. In three recent instances (the March 1995 revisions to CAS 413, the Staff Discussion Paper on PRB costs, and the proposed rulemaking on cost accounting practice changes), the Board has ventured to prescribe (1) contract price adjustments where no statutory authority exists for such prescriptions, and (2) detailed and overly prescriptive rules governing the administration of CAS-covered contracts. The Section believes that this trend may reflect, in part, a belief that if agency preferences are not accommodated, the agencies may negate the Board's rules through amendments to the FAR.

The Section believes that there are valid reasons for maintaining the current distinction between cost accounting, on the one hand, and procurement policy and contract administration on the other. Separating them encourages the consideration and adoption of sound accounting rules, while according greater visibility to agency decisions on procurement policy and contract administration. To the extent it is deemed necessary to better handle the inevitable conflicts between the CAS and agency procurement regulations, the Board's authorizing legislation could be amended to: (1) charge the full Board, not just the OFPP Administrator, with the responsibility for resolving CAS/FAR conflicts; (2) require, instead of authorize, the Board to resolve such conflicts; and (3) allow agencies and contractors to invoke the resolution process by petition to the CAS Board.

DISCUSSION

A. Background

The original CAS Board grew out of the 1968 Defense Production Act hearings. Admiral Hyman G. Rickover testified before the House Banking and Currency Committee that the lack of uniform accounting standards made it nearly impossible for Government auditors and procurement officials to ascertain a contractor's actual cost and profit on a particular contract, because estimates of cost and profit were largely dependent upon the accounting principles used by the contractor.¹ Section 718 of P. L. 90-370 directed the Comptroller General, in cooperation with the Secretary of Defense and Director of the Bureau of the Budget, to study the feasibility of applying uniform cost accounting standards to be used for negotiated defense contracts and subcontracts of \$100,000 or more.

On January 19, 1970, the Comptroller General reported to Congress that it was both feasible and desirable to establish and apply uniform cost accounting standards for negotiated procurement contracts, and that the standards should not be limited to defense cost-type contracts but rather, should be applied Government-wide to both cost-type and fixed price contracts.² The

¹ S. Rep. 1322, 90th Cong., 2d Sess., reprinted in 1968 U.S.C.C.A.N. 2448, 2459.

² Comp. Gen. Report B-39995, Feasibility of Applying Uniform Cost Accounting Standards to Negotiated Defense Contracts (Jan. 19, 1970).

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original CAS Board was established later that year by the Defense Production Act Amendments of 1970, P.L. 91-379. In establishing the Board, Congress noted that:

When a contract is negotiated, an accurate representation of the contractor's cost is necessary in order to arrive at a fair contract price. In the absence of complete and accurate information about the cost of a contract, the Federal Government has no way of knowing whether the contractor's profits are excessively large or whether the final price is a fair price. Negotiation is thus meaningless in the absence of a clear understanding of the actual costs involved.

* * *

The essential problem in cost accounting is to develop methods for allocating expenses to a particular contract. Direct expenses associated with the contract are fairly easy to determine; however, there are a variety of methods for allocating indirect or overhead expenses. Since overhead often represents more than half the cost of a contract, the particular cost accounting method used to allocate overhead charges has a crucial bearing on determining the cost of the contract.³

Accordingly, the CAS Board was directed to "promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost accounting practices followed by defense contractors and subcontractors under Federal contracts."⁴ The Board was also given statutory authority to promulgate regulations requiring defense contractors and subcontractors "to disclose in writing their cost-accounting principles, 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 paid to the defense contractor by the United States because of the defense 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."⁵

The original CAS Board ceased to exist on September 30, 1980, when Congress failed to appropriate funds for it.

B. Current CAS Board's Statutory Authority

The current CAS Board was created by section 26 of the Office of Federal Procurement Policy Act Amendments of 1988, P. L. 100-679. The Section of Public Contract Law supported

³ S. Rep. 91-890, 91st Cong., 2d Sess., reprinted in 1970 U.S.C.C.A.N. 3768, 3770.

⁴ P.L. 91-379, § 719, codified at 50 U.S.C. App. § 2168(g).

⁵ *Id.*, at § 2168(h).

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the establishment of an independent Board in OFPP. The Section, together with others in industry, also recommended that the reconstituted Board have jurisdiction over issues of cost allowability as well as allocability.⁶ However, Congress expressly limited the authority of the current CAS Board, like the authority of original Board, to matters of cost allocability. As the Senate Report explains:

In considering the functions and responsibilities of the Board, the Committee concluded that the agencies, rather than the Board, should be responsible for determining the allowability of specific costs. In his testimony on S. 2215, the Comptroller General stated, "We believe it is important to separate the cost allocability standards and the cost allowability principles. Allocability is an accounting issue and allowability is a procurement policy issue."

The Committee agrees with this distinction. Accordingly, Section 4 assigns only allocability functions to the Board. Allowability and other similar policy issues will be addressed by the Administrator and the agencies outside the purview of the CAS Board.⁷

Hence, although the Board's jurisdiction over cost accounting (allocability) matters is exclusive, it is also limited to those matters, and does not extend to issues of procurement policy. Rather, the statute requires procurement policy issues such as allowability to be addressed by the procuring agencies and the Administrator of OFPP.⁸ Consistent with the CAS Board's statutory grant of authority, the Section in January 1992 urged the Board to adopt a statement of objectives that reflected the following fundamental features of the Board's enabling legislation:⁹

- (1) That Congress intended the CAS Board to be independent of the procuring agencies and, for that reason, located the Board in OFPP;
- (2) That Congress also gave the CAS Board *exclusive* authority to promulgate cost accounting standards governing the measurement, assignment and allocation of costs to government contracts;

6 Reauthorization of the Office of Federal Procurement Policy, 1988: Hearings S. 2215 Before the Subcomm. on Federal Spending, Budget, and Accounting of the Senate Comm. on Governmental Affairs, 100th Cong., 2d Sess. 199 (1988) (Statement of C. Stanley Dees, Chairman, American Bar Association Section on Public Contract Law).

7 S. Rep. 100-424, 100th Cong., 2d Sess. 17 (1988).

8 See 41 U.S.C. §§ 405(b), 421, 422(j)(3).

9 See Letter from John S. Pachter, Chair, Section of Public Contract Law, to Ms. Barbara Diering, Special Assistant, Cost Accounting Standards Board (Jan. 9, 1992).

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- (3) That the standards promulgated by the Board take precedence over conflicting or inconsistent regulations of the procuring agencies; and
- (4) That to effectuate this statutory hierarchy, Congress gave the Administrator of OFPP (and Chair of the CAS Board) authority to ensure that regulations of the procuring agencies are consistent with the cost accounting standards promulgated by the Board.

The CAS Board's May 1992 Statement of Objectives, Policies and Concepts recognizes the limitations on the Board's authority. Specifically, the Statement observes (in language substantially similar to that in the original Board's 1977 Restatement) that:

While the Board has exclusive authority for establishing Standards governing the measurement, assignment and allocation of costs, it does not determine the allowability of categories or individual items of cost. Allowability is a procurement concept affecting contract price and in most cases is established in regulatory or contractual provisions. An agency's policies on allowability of costs may be derived from law and are generally embodied in its procurement regulations. A contracting agency may include in contract terms, or in its procurement regulations, a provision that it will refuse to allow certain costs incurred by contractors that are unreasonable in amount or contrary to public policy. In accounting terms, these same costs may be allocable to the contract in question.¹⁰

The Board's Statement also acknowledges that its Chairman, as Administrator of OFPP, is responsible for ensuring that the executive agencies' procurement regulations are not inconsistent with the Cost Accounting Standards promulgated by the Board.¹¹

C. Consistency of Recent CAS Board Promulgations with the Board's Statutory Authority

Notwithstanding its Statement of Objectives, Policies and Concepts, not all of the current CAS Board's promulgations have been consistent with its statutory authority. Rather, the Board in recent years has increasingly strayed into areas of procurement policy and contract administration. The Section has repeatedly urged the Board to not lose sight of its fundamental purpose and objective as directed by Congress – the independent development of sound cost accounting rules for government contracts. The Section has urged the Board to focus on the accounting issues and not attempt to justify accounting rules on non-accounting procurement policy grounds. The Section has also decried the Board's tendency to impose overly detailed and

¹⁰ Cost Accounting Standards Board, Statement of Objectives, Policies and Concepts (May 1992), 57 Fed. Reg. 31036 (Jul. 13, 1992).

¹¹ *Id.*

prescriptive rules on the administration of CAS-covered contracts. For example, the Section expressed a concern that the Board's Staff Papers on CAS 412 and 413, on CAS 404 and 409, and on post-retirement benefit ("PRB") costs reflect too great an emphasis on accommodating agency policy preferences.¹² The Section also expressed concern that the Board in its proposed rulemaking on cost accounting practice changes was becoming too involved in contract administration, and that the proposed rules would impose additional administrative burdens on both Government and industry.¹³ In addition, the Section has expressed its concern that the Board has not fulfilled its statutory responsibility to ensure that agency regulations on cost allowability do not conflict with the Standards promulgated by the Board.¹⁴

Nevertheless, the Board's recent efforts continue to reflect too great an emphasis on agency policy preferences and contract administration at the expense of sound accounting. We discuss below three examples – the March 1995 revisions to CAS 412 and 413, the Staff Discussion Paper on Post-Retirement Benefit ("PRB") costs, and the proposed rulemaking on cost accounting practice changes – in which the Board has inappropriately premised its ruling on procurement policy considerations, including the provision of additional opportunities to adjust the prices of firm fixed-price contracts, and has inappropriately inserted itself into the contract administration process, in the absence of statutory authority to do so.

1. Changes to CAS 412 and 413

The OFPP Act Amendments of 1988 authorize the CAS Board to promulgate (1) cost accounting standards for the measurement, assignment, and allocation of costs, to be used in estimating, accumulating, and reporting those costs; and (2) regulations requiring contractors to agree to contract price adjustments to protect the Government from the payment of increased costs as a result of the contractor's failure to comply with disclosed and established cost accounting practices or applicable standards or as a result of their voluntary accounting changes. The so-called "segment closing" provision of the new CAS 413 goes well beyond this statutory authorization. It is neither a "cost accounting standard" nor a regulation designed to recover "increased costs" paid by the United States.

Unlike a cost accounting standard, the new segment closing adjustment provision of CAS 413.50(c)(12) does not regulate the measurement, assignment, or allocation of pension costs. In

¹² See Letter from John S. Pachter, Chair, American Bar Association Section of Public Contract Law, to Mr. Robert Lynch, Project Director, Cost Accounting Standards Board (Oct. 18, 1991); Letter from John S. Pachter, Chair, Section of Public Contract Law, to Dr. Rein Abel, Cost Accounting Standards Board (Oct. 25, 1991); Letter from John T. Kuelbs, Chair, Section of Public Contract Law, to Mr. Eric Shipley, Project Director, Cost Accounting Standards Board (Dec. 19, 1996).

¹³ Letter from Marcia G. Madsen, Chair, Section of Public Contract Law, to Rudolph J. Schubauer, Project Director, Cost Accounting Standards Board (Sept. 12, 1997).

¹⁴ See Letter from John S. Pachter, Chair, Section of Public Contract Law, to Ms. Barbara Diering, Special Assistant, Cost Accounting Standards Board (Jan. 9, 1992).

fact, the new provision has nothing to do with costs. In circumstances where surplus pension assets have resulted from unanticipated earnings growth or other rise in asset value, the segment closing provision has, instead, to do with the calculation and recapture of income attributable to previously allocated pension costs. In cases where there is a shortfall of assets in relation to liabilities (for whatever reason), and the Government must therefore make up its "share" of the shortfall, this exercise likewise has nothing to do with the measurement, assignment, or allocation of costs.

The new segment closing provision also exceeds the authority granted by 41 U.S.C. § 422(h), because it requires a contract adjustment in the absence of any noncompliance with applicable Standards or change in accounting practices. A "cost accounting practice" is defined as "any disclosed or established accounting method or technique which is used for allocation of cost to cost objectives, assignment of cost to cost accounting periods, or measurement of cost."¹⁵ A "change to a cost accounting practice" is defined as "any alteration in a cost accounting practice," other than the "initial adoption of a cost accounting practice" or "partial or total elimination of a cost or the cost of a function."¹⁶ The CAS Board's illustrations of changes which do not meet the definition of a change to a cost accounting practice expressly provide that the elimination of a segment is not a cost accounting practice change.¹⁷

Nor would any Government claim under the new CAS 413 be seeking "increased costs paid" as that term is currently defined. Consistent with the underlying Congressional objectives, the CAS Board has interpreted the term "increased costs paid" as follows:

- (a) Increased costs paid shall be deemed to have resulted whenever the cost paid by the Government results from a change in a contractor's cost accounting practices or from failure to comply with applicable Cost Accounting Standards, and such cost is higher than it would have been had the practices not been changed or applicable Cost Accounting Standards complied with.

¹⁵ 48 C.F.R. § 9904.302-1.

¹⁶ *Id.*, at § 99043.302-2.

¹⁷ 48 C.F.R. § 9903.302-4(e). The illustration is as follows:

Description: A contractor eliminates a segment that was operated for the purpose of doing research for development of products related to nuclear energy.

Accounting treatment: The projects and expenses related to nuclear energy products have been terminated. No transfer of these projects and no further work in this area is planned. This is an elimination of cost and not a change in cost accounting practice.

48 C.F.R. § 9903.302-4(e).

- (b) If the contractor under any fixed-price contract, including a firm fixed-price contract, fails during contract performance to follow its cost accounting practices or to comply with applicable Cost Accounting Standards, increased costs are measured by the difference between the contract price agreed to and the contract price that would have been agreed to had the contractor proposed in accordance with the cost accounting practices used during contract performance. The determination of contract price that would have been agreed to will be left to the contracting parties and will depend on the circumstances of each case.¹⁸

Under the new segment closing provision of CAS 413, a contract adjustment is required even though the contractor has fully complied with all applicable Standards and its disclosed and established cost accounting practices, and has consistently estimated and accumulated its pension costs in accordance with those practices. Hence, the adjustment is unrelated to the statutory concept of "increased costs" paid and is not authorized by the statute.

The Board's revisions to CAS 412 were commented on by the Section three times. In response to the Discussion Paper on Accounting for Fully Funded Defined Benefit Pension Plans, the Section expressed its concern that the Discussion Paper reflected too great an emphasis on agency policy preferences because, while recognizing that pension costs are most appropriately accounted for on an accrual basis, the Paper suggested that the assignment of pension costs should reflect agency policy decisions to condition pension cost allowability on funding.¹⁹ The Section reminded the Board that its principal focus should be on the development of sound accounting rules.²⁰

In its comments on the Advance Notice of Proposed Rulemaking, the Section noted that the Board had recognized the desirability of accrual accounting, although the rule still contained significant funding components, and termed the ANPRM a "significant improvement" over the earlier Staff Discussion Paper.²¹ However, the Notice of Proposed Rulemaking that followed veered sharply away from accrual accounting, requiring that pension liability be liquidated (funded) in the current period to be allocable to cost objectives of the period, and incorporating the ERISA full-funding limitation for both measurement and allocation of pension cost.²² The Section noted that in the CAS Board's May 1992 Statement of Objectives, Policies, and Concepts, the Board stated that it would not necessarily adhere to accrual accounting in the assignment of costs to cost accounting periods if to do so showed either bias or prejudice to

¹⁸ 48 C.F.R. § 9903.306(a), (b).

¹⁹ Letter from John S. Pachter, Chair, Section of Public Contract Law, to Robert Lynch, Project Director, Cost Accounting Standards Board (Oct. 18, 1991), at 3.

²⁰ *Id.* at 1.

²¹ Letter from Karen Hastie Williams, Chair, Section of Public Contract Law, to Robert Lynch, Project Director, Cost Accounting Standards Board (Apr. 12, 1993), at 2.

²² 58 Fed. Reg. 5899 (Nov. 5, 1993).

either party to the contract.²³ The Section commented that the Board's departure from accrual accounting in this case did not meet the criteria of fairness and equity because the Board proposed to require contractors to follow the accrual method to assign costs to periods, but to follow a cash basis of accounting in order to allocate costs to cost objectives of that period, thus subjecting contractors to the disadvantages of both the accrual and cash basis methods of accounting and affording the procuring agencies additional bases for disallowing legitimate pension costs.²⁴ These requirements remained unchanged in the final rule.

2. Staff Discussion Paper on Costs of Post-Retirement Benefit Plans

The CAS Board's September 20, 1996 Staff Discussion Paper on the Treatment of Costs of Post Retirement Benefit Plans Other than Pension Plans raised a number of issues related to accrual accounting and to re-opening the prices of fixed price contracts. By letter dated December 19, 1996, the Section commented on the provision for adjusting prior years' costs for unrealized assumptions when a PRB plan terminates or a segment closes, and specifically counseled the CAS Board "against reopening the *prices* of fixed price type contracts, or cost type contracts in years that are closed," noting that:

Limiting the adjustment mechanism to costs only is consistent with sound procurement policy and will secure to the government and the contractor equally the benefit of their bargain. Moreover, the OFPP Act Amendments of 1988 do not provide the CAS Board with authority to adjust contract prices, other than the equitable adjustment mechanism for cost accounting practice changes or noncompliances that result in increased costs to the government. See Pub. L. 100-679, § 26(h)(1), 41 U.S.C. § 422(h)(1). For this reason, we believe that CAS 413-50(c)(12), as amended March 30, 1995, is subject to challenge as exceeding the Board's statutory authority.²⁵

In addition, the Section reiterated its support for accrual accounting, expressing the opinion that accrual accounting is required by the CAS Board's statutory mandate to achieve uniformity and consistency and is consistent with the approach taken in other standards, such as CAS 408, CAS 412, and CAS 415, governing compensation costs.²⁶ The Section advocated that funding should be required only if payment of the benefits cannot be compelled, and noted that

²³ Letter from Donald J. Kinlin, Chair, Section of Public Contract Law, to Richard C. Loeb, Executive Secretary, Cost Accounting Standards Board (Jan. 4, 1994) at 6.

²⁴ *Id.*

²⁵ See Letter from John T. Kuelbs, Chair, American Bar Association Section of Public Contract Law, to Mr. Eric Shipley, Project Director, Cost Accounting Standards Board (Dec. 19, 1996).

²⁶ *Id.* at 3-4.

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funding requirements stem from procurement policy, not cost accounting, considerations.²⁷ The Section entreated the Board to refrain from mandating the actuarial assumptions to be used by contractors, since no single set of assumptions will be appropriate for all contractors.²⁸ Finally, the Section repeated its urging that the CAS Board avoid treating matters unrelated to cost accounting, such as the public policy considerations and the effects of reductions in the Federal budget discussed in the Discussion Paper.²⁹

3. Cost Accounting Practice Changes

The Board has also strayed without statutory authority into areas of contract administration, as demonstrated by its proposed rulemaking on cost accounting practice changes. Despite opposition by both federal agencies and contractors, in its supplemental notice of proposed rulemaking ("NPRM II") published on July 14, 1997, the Board continues to propose lengthy, detailed, and complex new regulations for the notification, cost impact, and contract price and cost adjustment processes for changes made to contractors' cost accounting practices, while at the same time considerably expanding the universe of actions that would qualify as "cost accounting practice changes" necessitating invocation of these complex rules.³⁰ In comments accompanying NPRM II, the Board observed that while it "continues to recognize that responsibility for administering CAS-covered contracts rests with the various Federal agencies," the proposed regulations were necessary because, in the Board's view, the CAS cost impact process is "generally not being accomplished in a timely or efficient manner."³¹ The Board thus rejected comments by both Government and industry opposing the proposed rule:

Comment: A Federal agency expressed concern about the extent of detailed administrative responsibilities and requirements included in the prior NPRM. An industry representative presented a similar view by stating that some of the proposed material was overly prescriptive.

Response: In order to fully and clearly describe the cost impact process, inclusion of certain administrative responsibilities and requirements is unavoidable. ...³²

In its January 22, 1991 comments recommending agenda items for the CAS Board's consideration, the Section noted that one major concern was then-recent DCAA guidance stating that consolidation or separation of business unit indirect pools or bases, or a change in the

²⁷ *Id.* at 4-5.

²⁸ *Id.* at 5-6.

²⁹ *Id.* at 5.

³⁰ *See generally* 62 Fed. Reg. 37654, 37678-692 (Jul. 14, 1997) (proposed new subpart 9903.4).

³¹ *Id.* at 37664.

³² *Id.*

composition of indirect cost pools, constituted a change in accounting practice.³³ The Section urged the CASB to undertake a project clarifying the difference between organizational changes and cost accounting practice changes, revising the guidance to specify that changes may occur in the composition of a cost pool or in the amount of costs allocated to contracts without any change having taken place in allocation methods or techniques.³⁴ Instead, the Board's promulgations on this subject have evidenced its adoption of the DCAA position.

D. CAS-FAR Conflicts

We discuss below three examples of CAS-FAR conflicts, two of which remain unresolved (one despite litigation) and one of which the Board "resolved" by modifying the CAS to conform to the cost principle: (1) the different CAS and FAR definitions of the term "direct cost"; (2) the conflicting FAR and CAS requirements for the allocation of business unit general and administrative (G&A) cost; and (3) accounting for asset revaluation following a business combination.

1. Definition of "Direct Costs"

CAS 402-30(a)(3) defines the term "direct cost" to mean "any cost which is identified specifically with a particular final cost objective."³⁵ By contrast, the FAR cost principles define a "direct cost" as "any cost that *can be* identified specifically with a particular final cost objective."³⁶ The difference is significant. The CAS definition, consistent with the fundamental requirements of CAS 402, recognizes that whether a particular cost is "direct" or "indirect" depends on the treatment of such costs in the contractor's cost accounting system. CAS 402.402-50(b) provides in pertinent part that:

The Disclosure Statement to be submitted by the contractor will require that he set forth his cost accounting practices with regard to the distinction between direct and indirect costs. In addition, for those types of cost which are sometimes accounted for as direct and sometimes accounted for as indirect, the contractor will set forth in his Disclosure Statement the specific criteria and circumstances for making such distinctions. In essence, *the Disclosure Statement submitted by the contractor*, by distinguishing between direct and indirect costs, and by describing the criteria and circumstances for allocating those items which are

33 Letter from Norman L. Roberts, Chair, Section of Public Contract Law, to Richard C. Loeb, Executive Secretary, Cost Accounting Standards Board (Jan. 22, 1991) at pp. 3-5.

34 *Id.*

35 48 C.F.R. § 9904.402-30(a)(3) (emphasis added).

36 48 C.F.R. § 31.202(a).

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sometimes direct and sometimes indirect, *will be determinative* as to whether or not costs are incurred for the same purpose.³⁷

In the absence of a Disclosure Statement, "*the determination of whether specific costs are directly allocable to contracts shall be based upon the contractor's cost accounting practices used at the time of contract proposal.*"³⁸

The FAR definition, by contrast, is not tied to the contractor's disclosed or established cost accounting practices. Rather, it imposes a more objective, theoretical standard – whether a particular cost *can be* identified with a particular final cost objective, irrespective of whether the cost has been so identified – that may conflict with CAS 402's fundamental requirement that all costs incurred for the same purpose in like circumstances be treated the same. The FAR definition can thus lead to disputes, because it permits Government auditors to second-guess the contractor's cost allocation practices by arguing that particular costs can, and therefore should, be allocated directly notwithstanding the contractor's consistent treatment of such costs as indirect costs.

In its January 22, 1991 comments recommending agenda items to the Board, the Section recommended that the Board clarify the appropriate definition of direct costs in light of the *FMC Corp.* decision.³⁹ The ASBCA and the Federal Circuit in that case used the FAR definition of direct cost to determine that legal costs of prosecuting a claim under a subcontract should be charged direct to that subcontract, despite the contractor's practice of classifying legal costs as indirect, because the costs "*can be identified specifically*" with the subcontract. The Section pointed out that this test for defining "direct cost" lacks specificity, and makes it difficult at best for contractors to comply with CAS 401, which requires contractors to estimate and report costs on a consistent basis and thus to estimate as direct costs only those costs that can be specifically identified to the contract at the time of proposal preparation.⁴⁰

The Board has failed to address this conflict.

2. Allocation of Business Unit G&A Expenses

It is a fundamental requirement of CAS 410 that "[b]usiness unit G&A expenses shall be grouped in a separate indirect cost pool which shall be allocated only to *final cost objectives*."⁴¹ The Standard defines a "final cost objective" in pertinent part as "a cost objective which ... in the contractor's accumulation systems, is one of the final accumulation points."⁴² Accordingly,

³⁷ 48 C.F.R. § 9904.402-50(b) (emphasis added).

³⁸ 48 C.F.R. § 9904.402-50(c) (emphasis added).

³⁹ *FMC Corp., Northern Ordnance Div.*, ASBCA No. 30,130, 87-2 BCA ¶ 19,791, *aff'd FMC Corp. v. U.S.*, 853 F.2d 882 (Fed. Cir. 1988).

⁴⁰ Letter from Norman L. Roberts to Richard C. Loeb, *supra*, n.33 at 6-7.

⁴¹ 48 C.F.R. § 9904.410-40(a) (emphasis added).

⁴² 48 C.F.R. § 9904.410-30(a)(5).

CAS 410 does not permit the allocation of G&A expenses to *intermediate* cost objectives, such as service centers or other overhead pools. FAR 31.203(c), on the other hand, provides in pertinent part that: "Once an appropriate base for distributing indirect costs has been accepted, it shall not be fragmented by removing individual elements. 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."⁴³ Thus, the FAR *requires* that indirect costs, including G&A, be allocated to all of the costs, both allowable and unallowable, in the allocation base, notwithstanding the CAS 410 requirement that G&A expenses be allocated only to final cost objectives.

This conflict between CAS 410 and Defense Acquisition Regulation 15-203(c), the predecessor to FAR 31.203(c), was at the heart of *Rice v. Martin Marietta Corp.*, 13 F.3d 1563 (Fed. Cir. 1993). In the proceedings below, the Armed Services Board of Contract Appeals held that DAR 15-203(c) conflicted with CAS 401, and was therefore unenforceable. The Federal Circuit reversed, holding that DAR 15-203(c) was an allowability, not allocability, provision. The Board failed to address this issue prior to the litigation and has failed to address it since.

3. Asset Revaluation

The "purchase method" of accounting, which requires a buyer in a business combination to record the acquired company's assets at their fair market value, has long been required for most types of business combinations by Accounting Principles Board ("APB") Opinion No. 16 (which is encompassed by generally accepted accounting principles ("GAAP")). In promulgating CAS 404 in 1973, the original CAS Board adopted the "purchase method" of accounting, incorporating it by reference in CAS 404.50(d):

Under the "purchase method" of accounting for business combinations, acquired tangible capital assets shall be assigned a portion of the cost of the acquired company, not to exceed their fair value at date of acquisition.⁴⁴

CAS 409, as originally promulgated, required depreciation cost to be calculated by measuring the difference between capitalized cost and residual, thus permitting the buyer to recover the associated depreciation and facilities costs for the purchased company using the "stepped-up" asset basis required by the "purchase method" of accounting. Upon disposition by sale, CAS 409 requires the gain or loss to the seller to be recognized and measured based on the difference between the amount realized and the undepreciated balance, but expressly limits the gain to be recognized for contract costing purposes "to the difference between the original acquisition cost of the asset and its undepreciated balance."⁴⁵

⁴³ 48 C.F.R. § 31.203(c).

⁴⁴ 38 Fed. Reg. 5321 (Feb. 27, 1973) (CAS 404.50(d)).

⁴⁵ 48 C.F.R. § 409.50(j)(1).

However, effective July 23, 1990, the FAR cost principles were amended to add a new principle, 31.205-52, for asset valuations resulting from business combinations:

When the purchase method of accounting for a business combination is used, allowable amortization, cost of money, and depreciation shall be limited to the total of the amounts that would have been allowed had the combinations not taken place.⁴⁶

The new FAR 31.205-52 thus imposed a rule governing cost allowability that was contingent on cost measurement techniques in direct conflict with the requirements of CAS 404 and 409. On January 22, 1991, the Section recommended that this CAS-FAR conflict be included as an item on the Board's regulatory agenda.⁴⁷ The Section also provided comments in response to the Staff Discussion Papers published on August 26, 1991⁴⁸ and November 4, 1993.⁴⁹ In its October 25, 1991 letter, for example, the Section urged the Board to "not lightly consider abandoning the purchase method of accounting or adopting any other practices that differ from GAAP where these current methods have been widely used and relied upon for both Government and financial reporting purposes for many years."⁵⁰ The Section commented that the Staff Discussion Paper overall was too preoccupied with procurement policy, and failed to adequately acknowledge conflicts between the cost principle and longstanding CAS requirements.⁵¹ Many other commenters similarly recognized the conflict between FAR 31.205-52 and the CAS.

Professor Fremgen of the Naval Postgraduate School, like most industry commenters, and contrary to most Government commenters, urged the CAS Board to focus on good accounting in resolving the CAS-FAR conflict. Professor Fremgen's comments are pertinent to some of the issues now facing the Review Panel:

In general, I believe that this Staff Discussion Paper (SDP) is overly concerned with contract pricing and payments by or to the government. These are matters of legitimate concern, but they are properly within the purview of government contracting agencies

46 55 Fed. Reg. 25530 (Jun. 21, 1990) (FAC 84-58, adding new FAR 31.205-52, effective July 23, 1990).

47 See Letter from Norman L. Roberts to Richard C. Loeb, *supra* n. 33.

48 56 Fed. Reg. 42079 (Aug. 26, 1991) (Staff Discussion Paper: "Recognition and Pricing of Changing Asset Values Resulting from Mergers and Business Combinations by Government Contractors").

49 58 Fed. Reg. 58882 (Nov. 4, 1993) (Staff Discussion Paper: "Treatment of Gain or Loss Subsequent to a Merger or Business Combination").

50 Letter from John S. Pachter, Chair, Section of Public Contract Law, to Dr. Rein Abel, Cost Accounting Standards Board, at p. 7 (Oct. 25, 1991).

51 *Id.* at 2.

and the Federal Acquisition Regulation. The SDP states specifically (p. 7) that the "primary goal" of the CASB is "increasing uniformity and consistency in the pricing of Government contracts in accordance with the concept of equity" (emphasis added). And it cites the Board's "Statement of Objectives, Policies, and Concepts" (57 Fed. Reg. 31036) for this assertion. But that is not what the "Statement" says. Rather, it states that the primary objective of the Board is to set standards to achieve "increased ... uniformity ... and consistency in cost accounting practices" (emphasis added). It goes on to recognize that the Board's authority pertains to the measurement, assignment, and allocation of costs, not to allowability. Further, it asserts that a Cost Accounting Standard is considered fair if it provides equitable allocation of costs to contracts, even though the resultant contract pricing may be regarded as fair or unfair by the contracting parties.

Thus, the unanimous opinion of the Government commenters on the earlier SDP that CAS should be brought into line with FAR § 31.205-52 (p. 2) is inconsistent with the recognized differences in the roles of CAS and FAR. Similarly, the Government commenters' belief that "the capital used to execute recent business combinations could have been put to better use" (p. 3) is irrelevant to accounting. Accounting should faithfully reflect what did happen, not what should have been done. If a contracting officer believes that the price paid in a business combination was clearly excessive, he or she can disallow it in accordance with the FAR's "reasonableness" criterion.

There seems to be a persistent underlying theme in the SDP that business combinations are not really legitimate transactions. Thus, cost accounting should be manipulated to offset their undesirable effects. Without regard to the validity of that theme, accounting is not an appropriate means of correcting the implied wrong.⁵²

Despite widespread recognition of the conflict between FAR 31.205-52 and CAS, the Board did nothing to eliminate the conflicting FAR cost principle. Rather, on February 13, 1996, the CAS Board revised CAS 404 and 409 to prohibit the step-up or step-down of assets following a business combination when, during the most recent cost accounting period prior to a business combination, the assets generated either depreciation expense or cost of money charges

⁵² Comments of Professor Fremgen, Naval Postgraduate School, in response to the November 4, 1993 Staff Discussion Paper, reprinted in CCH Cost Accounting Standards Guide ¶ 20,019, at p. 11,596.

that were allocated to Federal government contracts or subcontracts negotiated on the basis of cost.⁵³ Ironically, in amending the CAS to conform to the FAR, the Board acknowledged "that there is an appearance of conflict between the provisions of CAS 9904.404 and FAR 31.205-52," and stated that "the OFPP Administrator will determine whether any changes may be necessary in the FAR cost principles to make them fully compatible with the *amended CAS 9904.404 and 9904.409*."⁵⁴

4. CAS-FAR Conflict Resolution

Although the current Board's enabling statute, like its predecessor P.L. 91-379, provides that the Board has exclusive authority over standards "governing the measurement, assignment, and allocation of costs,"⁵⁵ and that "costs which are the subject of [CAS] ... shall not be subject to regulation ... established by another executive agency that differ with such standards with respect to the measurement, assignment, and allocation of such costs,"⁵⁶ CAS-FAR conflicts persist. As demonstrated by the examples discussed above, the procuring agencies have not been willing to withdraw conflicting cost principles, and the OFPP Administrator has not exercised his statutory authority to eliminate conflicting agency procurement regulations. The persistence of these CAS-FAR conflicts detracts from the underlying purpose of the Board to promote consistency in the costing of government contracts. In addition, the failure or inability to resolve CAS-FAR conflicts administratively will likely continue to lead to time-consuming and costly disputes and litigation.

Section 26(j) of the OFPP Act requires the Administrator, "under the authority set forth in section 6 of this Act . . . to ensure that no regulation or proposed regulation of an executive agency is inconsistent with a cost accounting standard promulgated or amended under this section by rescinding or denying the promulgation of any such inconsistent regulation or proposed regulation and taking such other action authorized under section 6 as may be appropriate." 41 U.S.C. § 422. Section 6 of the OFPP Act authorizes, *but does not require*, the Administrator of OFPP to resolve these conflicts. To ensure that such conflicts are promptly and appropriately resolved, it may be appropriate to modify the statutory language to *require* the Board to resolve conflicts between the CAS and FAR or other agency regulations – by rescinding the offending regulation, not by capitulating to the procuring agencies (as happened in the case of the CAS 404 – FAR 31.205-52 conflict) -- within a stated period of time (e.g., 60 days) after being petitioned to do so by either (a) a contractor with contracts subject to CAS, or (b) a procuring agency. In addition, thought should be given to having CAS-FAR conflicts resolved by the *full Board*, not just the Chair.

⁵³ 61 Fed. Reg. 5520 (Feb. 13, 1996).

⁵⁴ *Id.*, at 5521 (emphasis added).

⁵⁵ 41 U.S.C. § 422(f)(1).

⁵⁶ 41 U.S.C. § 422(j)(3).

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An administrative conflict resolution method could be a preferable alternative to litigating these matters (although that would still be an option for the contracting parties), because it is likely to be faster and cheaper, and lead to more predictable results. The Board, in the Section's view, is better positioned than courts and agency boards of contract appeals to resolve the accounting issues at the heart of CAS-FAR conflicts. For the same reason, giving the Board statutory authority (and responsibility) to resolve CAS-FAR conflicts is more likely to effectuate the statutory hierarchy intended by Congress.

* * * * *

As Congress recognized in reestablishing the Board in 1988, there are valid reasons for maintaining the current distinction between issues of cost allocability, which are assigned to the CAS Board, and cost allowability, which fall within the policy purview of the procuring agencies. The Section, in its February 1988 White Paper, acknowledged that questions of allocability and allowability are often intertwined and that a clear separation is not always possible. Nevertheless, where procurement policy is involved, separating accounting considerations from policy considerations should permit the consideration and adoption of sound accounting rules while according greater visibility to procurement policy decisions. For these reasons, it continues to be beneficial for the CAS Board to confine itself to matters of cost accounting, focusing on its principal mission of achieving uniformity and consistency, as well as fairness and equity, in the measurement, assignment and allocation of cost.

In this era of acquisition reform and streamlining, the Board should be looking to shrink, not expand, its jurisdiction. By straying beyond its charter into areas of procurement policy and contract administration, the Board has done just the opposite. The Section continues to urge that the Board's guiding principle, consistent with its fundamental purpose and objective as directed by Congress, should be the independent development of sound cost accounting rules for government contracts.

AMERICAN BAR ASSOCIATION

Section of Public Contract Law
Writer's Address and Telephone



1900 K Street, N.W.
Washington, DC 20006
PHONE: (202) 496-7559
FAX: (202) 496-7756
Email: david_churchill@mckennacuneo.com

January 28, 1999

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CHAIR

David A. Churchill
1900 K Street, NW Suite 100
Washington, DC 20006
(202) 496-7559

CHAIR-ELECT

Randi L. Allen
1776 K Street, NW
Washington, DC 20006
(202) 429-7329

VICE-CHAIR

Gregory A. Smith
1200 19th Street, NW 8th Floor
Washington, DC 20036-2412
(202) 861-6416

SECRETARY

Norman R. Thorpe
1011 W. Grand Blvd., 8th Floor
Detroit, MI 48201-3046
(313) 974-1628

BUDGET AND FINANCE OFFICER

Patricia A. Meggher
111 California Street, 10th Floor
San Francisco, CA 94104-3602
(415) 956-2828

SECTION DELEGATE

Marshall J. Duke, Jr.
1601 Elm Street, Suite 2000
Dallas, TX 75201
(214) 999-4733

**IMMEDIATE AND PREVIOUS
PAST CHAIRS**

Marcia G. Madson
655 15th Street, NW, 8th Floor
Washington, DC 20005-5761
(202) 626-1468
John T. Kuehls
1200 Wilson Blvd., 20th Floor
Arlington, VA 22209-2249
(703) 264-4355

COUNCIL MEMBERS

Thomas P. Bartlett
130 Connecticut Avenue, NW
Washington, DC 20036-1704
Hubert L. Bell, Jr.
233 Peachtree Street, NE
Atlanta, GA 30303-1530
Kevin Flanagan
400 Army Navy Drive, Room 1076
Arlington, VA 22202-2885
David G. Lane
2010 Corporate Ridge Road
McLean, VA 22102-7838
Kent R. Morrison
1011 Pennsylvania Avenue, NW
Washington, DC 20004-2595
Frederick E. Moss
6109 Glenholme Drive
Palo, TX 75093
Robert P. Murphy
441 G Street, NW
Washington, DC 20054
Craig Ochner
200 West Marcy Street, #129
Santa Fe, NM 87501
John E. Preston
21240 Burbank Blvd.
Woodland Hills, CA 91367-6675
Alexander W. Purdie, Jr.
4225 Logistics Avenue, Suite 23
Wright-Patterson AFB, OH 45433
Mary Ellen Cusler Williams
16th & T Streets, NW, Room 2023
Washington, DC 20405
Patricia H. White
1615 New Hampshire Avenue, NW
Washington, DC 20009

**EDITOR, PUBLIC CONTRACT
LAW JOURNAL**

Carl E. Vaccarella
Washington, DC

**EDITOR, THE PROCUREMENT
LAWYER**

Barbara A. Pollack
El Segundo, CA

BOARD OF GOVERNORS LIAISON

John W. Clark, Jr.
Dallas, TX

LAW STUDENT LIAISON

Lawrence N. Hill
Chicago, IL

SECTION DIRECTOR

Stanley Neborak
750 North Lake Shore Drive
Chicago, IL 60611-4497
(312) 986-5796
Fax: (312) 986-5688

Mr. James F. Hinchman
Principal Assistant Comptroller General
General Accounting Office
441 G Street, N.W., Room 7100
Washington, DC 20548

The Honorable Jacques S. Gansler
Under Secretary of Defense for
Acquisition and Technology
3010 Defense Pentagon, Room 3E933
Washington, DC 20301-3010

Mr. Nelson F. Gibbs
Vice President and Controller
Northrop Grumman Corporation
1840 Century Park East
Los Angeles, CA 90067

Re: Cost Accounting Standards Board Review Panel

Gentlemen:

This letter is addressed to you in your capacity as Co-Chairs of the Cost Accounting Standards Board Review Panel. The Section of Public Contract Law of the American Bar Association has undertaken its own study of the Cost Accounting Standards Board. This study has generated an additional paper concerning the constitutional considerations involved in proposed CAS Board restructuring.

The views expressed in the enclosed white paper have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

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The Section hopes that the enclosed white paper will prove useful to the Review Panel in its deliberations, and would be happy to provide any other information and assistance as you may require.

Sincerely,


David A. Churchill
Chair, Section of Public Contract Law

DAC/LTO/mmk

Enclosure

cc: Officers and Council Members
Alan C. Brown
Lynda Troutman O'Sullivan
Agnes P. Dover
Alexander J. Brittin
Marilyn Neforas

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**SECTION OF PUBLIC CONTRACT LAW
WHITE PAPER**

**PROPOSED CAS BOARD RESTRUCTURING – CONSTITUTIONAL
CONSIDERATIONS**

The Section of Public Contract Law of the American Bar Association has analyzed the constitutional implications of the current organization and location of the Cost Accounting Standards Board. The Section's conclusions are set forth in this paper. The views expressed herein are presented on behalf of the Section of Public Contract Law. They have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the policy of the Association.

EXECUTIVE SUMMARY

The CAS Board consists of five members: (1) the OFPP Administrator, the Board's Chairperson, who is appointed by the President, with the advice and consent of the Senate; (2) one member appointed by the Secretary of Defense; (3) an officer or employee of the General Services Administration ("GSA") appointed by the GSA Administrator; (4) a representative of industry; and (5) one individual who is particularly knowledgeable about cost accounting problems and systems. The latter two members are appointed by the OFPP Administrator. The Board is imbued with the "exclusive authority to make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States."

The Supreme Court has held that administrative functions of an executive agency which "represent the performance of a significant governmental duty exercised pursuant to a public law," such as rulemaking, may only be exercised by persons who are "Officers of the United States" as that term is used in Article II, § 2, clause 2 of the Constitution (the "Appointments Clause"). "Officers" under the Appointments Clause are of two types: "principal officers" and "inferior officers." "Principal Officers" are selected by the President with the advice and consent of the Senate and generally include Supreme Court justices, ambassadors, Department heads and their immediate deputies, executive agency heads, and other similar high ranking officials. "Inferior officers" are appointed by the President, the Judiciary, or the Heads of Departments. Their work is directed and supervised at some level by others who were appointed by presidential nomination with the advice and consent of the Senate. Although the line between "principal" and "inferior" officers is not sharply drawn in every case, the distinction can be important, because "principal officers" clearly have rulemaking authority, while the rulemaking power of "inferior officers" has never been specifically determined.

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The CAS Board unquestionably engages in "administrative functions" which "represent the performance of a significant governmental duty exercised pursuant to a public law" and its actions must, therefore, be performed by "Officers of the United States." The current Board configuration raises constitutional questions that could affect the validity of the Board's promulgations. The CAS Board is located within the Office of Federal Procurement Policy ("OFPP"), which in turn is located within the Office of Management and Budget ("OMB"). The Appointments Clause of the Constitution may require that the Board's cost accounting standards and interpretations be adopted by a "principal officer" in order to have the force and effect of law. Under the current CAS Board structure, only the Administrator of the Office of Federal Procurement Policy ("OFPP") is appointed by the President and confirmed by the Senate. However, the OFPP Administrator is subordinate to the Director of the Office of Management and Budget ("OMB"). Thus, the OFPP Administrator may be considered an "inferior officer." Consequently, to satisfy Constitutional requirements, if the Board is to retain its current structure, it may be necessary to have the Board's cost accounting standards and interpretations adopted by the Director of OMB in order for them to be binding on the executive agencies. If so, the language in the Board's underlying statute should be modified to specifically provide that the Board's standards and interpretations, after being adopted by a majority of the Board, must then be approved by the head of the agency. The Section believes that having the actions of the CAS Board subject to the approval of the OMB Director in this manner would reduce the CAS Board's effectiveness and perhaps create the perception that it is not an "independent Board," as specified in its implementing statute.

Alternatively, the CAS Board could be restructured and take one of three forms: (1) the Board may be established as an independent agency composed entirely of members appointed by the President and confirmed by the Senate; (2) the Board may retain its current composition but its implementing statute should be modified to specifically provide that the CAS Board members are not subject to direction, in the performance of their functions, by any other Government officers or employees; or (3) the current Board structure could be retained with the acknowledgment that its cost accounting standards and interpretations are only advisory in nature. The latter alternative would permit the Board members to be subject to direction by a principal officer while avoiding potential conflicts with the Appointments Clause.

Establishing the Board as an independent agency with members who are appointed by the President with the advice and consent of the Senate would achieve two significant goals of the Board's enabling statute: the Board's pronouncements undoubtedly would have the force and effect of law upon adoption by a majority of the Board members, and the balance of power among the Board members would be ensured. The Board members would be "principal officers" within the meaning of the Appointments Clause and therefore, the Board would possess unequivocal constitutional authority to promulgate standards that are binding upon all executive agencies. In addition, as "principal officers," there would not exist even the appearance that a Board member could be swayed by the procuring agency, as could potentially be the case currently for the members appointed by the Secretary of Defense and the GSA Administrator, respectively, and the two private sector members appointed by the OFPP Administrator.

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If the Board retains its current composition, freeing the OFPP Administrator from the OMB Director's control, at least with respect to CAS Board matters, would minimize questions about compliance with the Appointments Clause. The statutory provision that requires the OFPP Administrator to obtain the OMB Director's concurrence with certain decisions would have to be amended to state expressly that the provision is inapplicable to promulgations of the CAS Board. Neither the OMB Director nor any other individual can direct the Administrator in the performance of his or her duties as Chair of the CAS Board. Under a scheme where the OFPP Administrator would be the only "principal officer" on the Board, however, the Administrator would have to adopt Board pronouncements in order for them to be binding. The Chair's power would therefore be greater than the authorizing statute contemplates, resulting in at least the appearance of undue influence on the workings of the Board.

If language were included in the Board's authorizing statute specifically stating that the Board members are not subject to direction, in the performance of their CAS Board duties, by any other Government officer or employee, the Board could be located within any executive agency. One proposal for the restructuring of the CAS Board is to move the Board from OFPP and place it under the authority of the Comptroller General, who is said to possess a "unique blend of independent accounting and procurement expertise ideally suited to CAS Board services." This alternative would pose a potential violation of the separation of powers principle if the Board were to retain its current composition (particularly if its members are either inferior officers or employees) with the Comptroller General as the Chair, in lieu of the OFPP Administrator, because an officer appointed by the Legislative Branch would control an executive function. If the CAS Board were merely "attached" to GAO for administrative support purposes, however, and the Board retained its independence, the arrangement would have an increased chance of withstanding constitutional scrutiny. Even if all the members of the Board were principal officers, in cases where the Comptroller General was perceived as the "swing vote," separation of powers issues could arise.

DISCUSSION

A. Structure and Function of the Current CAS Board

As presently configured, the CAS Board is an "independent board" within the OFPP which is part of OMB under the Executive Office of the President. It consists of five members, all of whom are required to have experience in Government contract cost accounting: the OFPP Administrator, the Board's Chairperson, who is appointed by the President, with the advice and consent of the Senate; one member appointed by the Secretary of Defense; an officer or employee of the General Services Administration appointed by the GSA Administrator; and a "representative of industry" and one "who shall be particularly knowledgeable about cost accounting problems and systems," both of whom are appointed by the OFPP Administrator.¹ The Board members (with the exception of the OFPP Administrator) serve staggered four-year

¹ 41 U.S.C. § 422(a)(1).

terms and can be reappointed indefinitely.² They serve part-time, as each holds another full-time position in the Government, private sector or academia.

The Board has the "exclusive authority to make, promulgate, amend, and rescind cost accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States."³ New standards and modification or rescission of existing standards, or any interpretations thereof, must be approved by a majority of the Board, with each Board member receiving one vote.⁴ Prior to promulgating any accounting standards or interpretations thereof, the Board is required to solicit the views of the Comptroller General and professional accounting organizations, contractors, and other interested parties on the probable costs of implementation compared to the probable benefits; the advantages, disadvantages, and improvements anticipated in the pricing and administration of, and settlement of disputes concerning, contracts.⁵ Although the Board's rulemaking activities are specifically exempted from the rulemaking and judicial review requirements of the Administrative Procedure Act,⁶ it is required to publish advance notices of proposed rulemaking and proposed rules in the Federal Register, with a 60-day public comment period for each of these rulemaking phases.⁷ Rules, regulations, cost accounting standards, and modifications thereof have the full force and effect of law, and become effective within 120 days after publication in the Federal Register in final form, unless the Board determines a longer period is necessary.⁸

The Board is also required to promulgate rules and regulations to administer its cost accounting standards.⁹ These administrative rules and regulations now appear in Parts 30 and 52 of the Federal Acquisition Regulation ("FAR") and must, at a minimum, require contractors and subcontractors as a condition of contracting with the United States to:

(A) 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

² See 41 U.S.C. § 422(a)(2).

³ 41 U.S.C. § 422(f).

⁴ 41 U.S.C. § 422(f)(3).

⁵ 41 U.S.C. § 422(g)(1)(A).

⁶ 41 U.S.C. § 422 (g)(3).

⁷ 41 U.S.C. § 422(g)(1)(C)-(D). During the 60-day ANPRM comment period, the Board must also consult with the Comptroller General and consider any recommendation the Comptroller General may make. 41 U.S.C. § 422(g)(1)(D).

⁸ 41 U.S.C. § 422(g)(2).

⁹ 41 U.S.C. § 422(h)(1).

(B) agree to a contract price adjustment, with interest, for any increased costs paid to such contractor or subcontractor by the United States by reason of a change in the contractor's or subcontractor's cost accounting practices or by reason of a failure by the contractor or subcontractor to comply with applicable cost accounting standards.¹⁰

Certain responsibilities are specifically reserved to the Board's Chair, the OFPP Administrator. In addition to appointing the two private sector members, the Administrator, after consultation with the Board, may appoint an executive secretary and two additional staff members and may, at his or her discretion, hire temporary staff to support the Board.¹¹ The Administrator, again after considering input from the other Board members, also has the power to prescribe rules and procedures governing actions of the Board. Such rules and procedures must provide, at a minimum, that any cost accounting standard promulgated, amended, or rescinded (and interpretations thereof) be adopted by majority vote of the Board members.¹²

B. Constitutional Considerations

1. Appointments Clause

Article II, § 2, clause 2 of the Constitution (the "Appointments Clause") provides:

[The President] shall nominate, and by and with the Advice and Consent of the Senate, shall appoint Ambassadors, other public Ministers and Consuls, Judges of the Supreme Court, and all other Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law: but the Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments.

"Officers" under the Appointments Clause are of two types: "principal officers" and "inferior officers." "Principal Officers" are selected by the President with the advice and consent of the Senate and include "Ambassadors, other public Ministers and Consuls, Judges of the

¹⁰ *Id.* FAR Part 30 contains only the rules relating to the administration of CAS, which are administered by the procuring activity. The CAS and other rules and regulations of the CAS Board now appear in Chapter 99 of Title 48 of the Code of Federal Regulations. Although Chapter 99 is considered part of the "FAR System," it is under the exclusive regulatory control of the CAS Board. 57 Fed. Reg. 39586 (Aug. 31, 1992).

¹¹ 41 U.S.C. § 422(c)-(d).

¹² 41 U.S.C. § 422(f)(3).

Supreme Court, and all other Officers of the United States.”¹³ “Inferior officers” are appointed by the President, the Judiciary, or the Heads of Departments.¹⁴ The line between “inferior” and “principal” officers is one that is far from clear, and the Framers of the Constitution provided little guidance on where it should be drawn.¹⁵

In the Supreme Court’s most recent decision addressing the distinction between the two groups, *Edmond v. United States*, “inferior officers” are defined as those officers whose work is directed and supervised at some level by others who were appointed by presidential nomination with the advice and consent of the Senate.¹⁶ In that case, judges of the Coast Guard Court of Criminal Appeals were held to be “inferior officers” by reason of the supervision over their work exercised by the General Counsel of the Department of Transportation in his capacity as Judge Advocate General of the Court of Appeals for the Armed Forces. Although the Court relied on a single factor, it acknowledged the importance of the factors upon which it relied in *Morrison v. Olson*,¹⁷ where the issue was whether an independent counsel who had been appointed by a Special Division of the U.S. Court of Appeals for the District of Columbia was a “principal” or “inferior” officer. The Court examined four factors in making its determination: (1) the scope of the officer’s duties; (2) the scope of the officer’s authority; (3) the length of the officer’s tenure; and (4) whether the officer is subject to removal by a higher Executive Branch official.¹⁸ Because the independent counsel was subject to removal by a higher officer (the Attorney

¹³ *Buckley v. Valeo*, 424 U. S. 1, 132 (1976). See also *Morrison v. Olson*, 487 U.S. 654, 670-71 (1988) (citing *Buckley*).

¹⁴ There is some question as to the scope of the term “Heads of Departments” for purposes of the Appointments Clause. It is clear the term “Department” refers to “a part or division of the executive government, as the Department of State, or of the Treasury, expressly created and giv[en] . . . the name of a department by Congress” and does not embrace “inferior commissioners and bureau officers.” *United States v. Germaine*, 99 U.S. 508, 511-12 (1879). In *Freytag v. Commissioner*, 501 U.S. 868 (1991), citing *Germaine*, the Court concluded the Tax Court was not a “Department” under the Appointments Clause and specifically rejected the Commissioner’s position that “every part of the Executive Branch is a department, the head of which is eligible to receive the appointment power” because in its view, such a holding would be contrary to the “Framers’ conclusion that widely distributed appointment power subverts democratic government.” *Id.* at 885. The Court also specifically stated, however, that its conclusion did not address “any question involving an appointment of an inferior officer by the head of one of the principal agencies, such as the Federal Trade Commission, the Securities and Exchange Commission, and the Federal Reserve Bank of St. Louis.” *Id.* at 887 n.4.

¹⁵ *Morrison*, 487 U.S. at 671 (citing 2 J. Story, *Commentaries on the Constitution* § 1536, pp. 397-98 (3d ed. 1858)) (“In the practical course of the government there does not seem to have been any exact line drawn, who are and who are not to be deemed inferior officers, in the sense of the constitution, whose appointment does not necessarily require the concurrence of the senate.”).

¹⁶ 520 U. S. 651, 663 (1997).

¹⁷ 487 U.S. 654 (1988).

¹⁸ See *id.* at 671-72.

General), performed only limited duties, had narrow jurisdiction and limited tenure, the court found that she was an "inferior officer."¹⁹

In *Buckley v. Valeo*,²⁰ the Supreme Court held that "administrative functions" of an executive agency which "represent the performance of a significant governmental duty exercised pursuant to a public law" may only be exercised by persons who are "Officers of the United States" as that term is used in the Appointments Clause.²¹ Such "administrative functions" include "rulemaking" and "determinations of eligibility for funds."²²

In analyzing the impact of the Appointments Clause on the CAS Board, it is clear that the Board engages in "administrative functions" which "represent the performance of a significant governmental duty exercised pursuant to a public law." The CAS Board promulgates rules which must be followed by contractors and subcontractors as a condition of contracting with the federal government, and which provide for a contract price adjustment for any resulting increased costs resulting from their violation. Accordingly, for the Board's cost accounting standards to have the force and effect of law, as required by its authorizing statute, its pronouncements may require approval by a "principal officer" of the United States.²³

The CAS Board is described in its implementing statute as an "independent Board within the Office of Federal Procurement Policy." The term "independent," however, may refer to the fact that the Board is a distinct organizational unit within OFPP, or that it is "independent" from the procuring agencies, not that it is "independent" from OFPP. The statute places the Board "within" OFPP and its two private sector members serve solely at the discretion of the OFPP

¹⁹ *Id.* at 666. Justice Souter, in his concurring opinion in *Edmond*, opined that "[t]he mere existence of a 'superior' officer is not dispositive," and that the four factors in *Morrison* must be analyzed in every case. *Id.* at 668. In *Varnadore v. Secretary of Labor*, 141 F.3d 625 (6th Cir. 1998), the issue was the status of an Administrative Review Board ("ARB") composed of three members, appointed by the Secretary of Labor for two year terms, which was responsible for "issuing final agency decisions on questions of law and fact arising in review or on appeal" in certain "wage and hour" cases. The Sixth Circuit concluded that the members of the ARB were, "at most" the type of "inferior" officers that the Appointments Clause allows the heads of departments, such as the Secretary of Labor, to appoint. *Id.* at 631.

Other examples of persons found to be "inferior officers" include a district court clerk, *Ex parte Hennen*, 13 Pet. 225, 258 (1839); an election supervisor, *Ex parte Siebold*, 100 U.S. 371, 397-98, (1880); a vice-consul charged temporarily with the duties of the consul, *United States v. Eaton*, 169 U.S. 331, 343 (1898); and a "United States commissioner" in district court proceedings. *Go-Bart Importing Co. v. United States*, 282 U.S. 344, 352-54 (1931).

²⁰ 424 U.S. 1 (1976).

²¹ *Id.* at 140-41.

²² *Id.* at 140.

²³ See 41 U.S.C. § 422(h)(1).

Administrator. OFPP, in turn, is "established in" OMB,²⁴ which itself is "in" the Executive Office of the President.²⁵

The OFPP Administrator is appointed by the President, with the advice and consent of the Senate, an indicator of "principal officer" status. However, in order for the OFPP Administrator to deny the promulgation of, or rescind, any Government wide-regulation or final rule relating to procurement, the OFPP Administrator must obtain the *concurrence* of the OMB Director.²⁶ This fact, combined with the statutory framework of OFPP discussed above, indicates the OFPP Administrator is subordinate to the Director of OMB who is appointed by the President, with the advice and consent of the Senate, and who administers OMB "under the direction of the President."²⁷

Because the OFPP Administrator is directed and supervised by the Director of OMB, the OFPP Administrator may be considered an "inferior officer," despite being appointed by the President and confirmed by the Senate. With regard to the other four CAS Board members, one appointing official, the Secretary of Defense, is clearly a Department head, as is possibly the GSA Administrator. Thus the two members appointed by those officers are probably, at best, "inferior officers." The OFPP Administrator, who appoints the two private sector members, is not the "Head of a Department." Thus, the two private sector members would likely be deemed "employees."²⁸

Assuming the CAS Board is headed by an "inferior officer," the OFPP Administrator, with the remaining members as either "inferior officers" or "employees," the Board's standards, rules and regulations may not have the force and effect of law because there is no "principal officer" on the Board to approve them. Even if all of its members were appointed by the President, with the advice and consent of the Senate, as is currently the case only for the OFPP Administrator, it is conceivable that none of the Board members would qualify as "a principal officer" if the Chair of the Board were subservient to the head of the agency, as the OFPP Administrator currently is to the OMB Director.

One means of overcoming this potential impediment to the CAS Board's rulemaking authority would be to establish the Board as an independent agency comprised only of members who are appointed by the President with the advice and consent of the Senate. This

²⁴ See 41 U.S.C. § 404(a).

²⁵ 31 U.S.C. § 501.

²⁶ 41 U.S.C. § 405(f).

²⁷ 31 U.S.C. § 502(a).

²⁸ Although not contemplated by the statute, it might be possible to satisfy the constitutional appointment requirement for "inferior officers" by having the Director of OMB, an individual who might be considered a Department head, approve the appointment of the two private sector members.

configuration increases the likelihood that the Board's actions would have the force and effect of law, while at the same time balancing power among the Board members, because each Board member would clearly be a "principal officer" within the meaning of the Appointments Clause. Therefore, the Board would have unequivocal constitutional authority to promulgate standards that are binding upon all executive agencies. In addition, as "principal officers," the Board members would each be vested with the same authority. Each member would have one vote, and any Board decision would require approval of a majority of the members.

The Federal Energy Regulatory Commission ("FERC" or "Commission") is an example of this configuration. Although the FERC is "within" the Department of Energy, similar to the location of the CAS Board within OFPP, FERC is an "independent regulatory commission." FERC members are not subject to direction in the performance of their functions by any other members or by officers of the Department of Energy. Actions of the Commission are determined by a majority vote of the members present and each member, including the Chairman, has one vote.

One significant difference between FERC and the CAS Board is the amount of time members devote to the performance of their duties. FERC members cannot engage in any other business, vocation or employment while serving on the Commission. CAS Board members, conversely, serve in a part-time capacity. The Supreme Court addressed the required frequency with which Officers of the United States perform their tasks in *United States v. Germaine*.²⁹ In that case, a surgeon appointed by the United States Commissioner of Pensions alleged that he was not an "officer" and could not be prosecuted under a criminal statute that applied to "officers of the United States." The Court determined that the Commissioner of Pensions was not a department head. Because the defendant was not appointed in the manner prescribed by the Appointments Clause, he was not an "officer of the United States" and not covered by the statute.³⁰ The court noted that even if the defendant had been appointed by a department head, he would not have been an officer because his employment was not "continuing and permanent."³¹ The surgeon would only be requested to conduct examinations in special cases and may have made "50 examinations . . . in a year, or none."³² The "occasional and intermittent" nature of the surgeon's work would preclude his being an officer of the United States.³³

While the members of the CAS Board serve part-time, there is much greater continuity in their work than in the work of the defendant in *Germaine*. The execution of the Board's tasks requires the continuous attention of its members, and the Board has regular meetings. The nature of its work is comparable to the work of the Federal Retirement Thrift Investment Board which is

29 99 U.S. 508 (1879).

30 *Id.* at 512.

31 *Id.*

32 *Id.*

33 *Id.*

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an independent agency within the Executive Branch that was established to administer the Thrift Savings Plan. The Thrift Investment Board has five members who are appointed by the President and confirmed by the Senate, and all but one serve part-time. While the work of the Thrift Investment Board does not require the full-time attention of its members, they communicate frequently and meet quarterly. The existence of an independent board composed of principal officers with part-time status lends support to the conclusion that if the CAS Board were established as an independent agency, the part-time status of its members would not likely be an impediment to their having "principal officer" status.

To maximize the protection against a successful constitutional challenge to the Board's standards and rules, in the event the Board retains its current composition, the OFPP Administrator would have to be free of the OMB Director's control. The statutory provision that requires the OFPP Administrator to obtain the OMB Director's concurrence with certain decisions would have to be amended to state expressly that the provision is inapplicable to promulgations of the CAS Board. It should be clear that neither the OMB Director nor any other individual can direct the Administrator in the performance of his or her duties as chair of the CAS Board. Under a scheme where the OFPP Administrator would be the only "principal officer" on the Board, however, the Administrator may have to adopt Board pronouncements in order for them to pass Constitutional muster. The Administrator would not have merely one of five votes but would instead have exclusive control of CAS Board decisions. The other Board members would be advisors to the OFPP Chair with no decision-making power. Attempts to limit the Administrator's power by requiring him or her to adopt those standards upon which a majority of the Board members agree and not to take action without a majority vote may be deemed an unconstitutional restraint of the Administrator's authority. The Chair's power would likely be greater than the authorizing statute contemplates.

If the Board retains its current composition and the Chair is subordinate to the OMB director (or any other executive officer in the event the Board were moved outside of OMB to another executive agency), the language in the Board's underlying statute should be modified in order to avoid a possible violation of the Appointments Clause, in the event it is determined that there are no "principal officers" on the Board. The statute should specifically provide that the Board's standards and interpretations, after being adopted by a majority of the Board, must then be approved by the head of the agency; or the language indicating the Board's standards "have the full force and effect of law" must be replaced with language indicating the Board's actions are only recommendations which executive agencies are free to accept or reject at their discretion. The Section views this as a highly undesirable alternative, for if the Board were divested of its rulemaking authority, the goal of uniformity and consistency in the cost accounting standards would be threatened.

2. Separation of Powers: CAS Board Under Comptroller General

One proposed scenario for the restructuring of the CAS Board is to move the Board from OFPP and place it under the authority of the Comptroller General. This arrangement is potentially violative of the principle of separation of powers between the Legislative and

Executive branches of the Government. The Framers of the Constitution divided the delegated powers into three defined categories - Legislative, Executive, and Judicial - to encourage each branch to confine itself to its assigned responsibility.³⁴ The principal function of this separation of powers is to protect individual liberty by providing a "safeguard against the encroachment or aggrandizement of one branch at the expense of the other."³⁵ However, the Framers understood that a "hermetic sealing off of the three branches of Government from one another would preclude the establishment of a Nation capable of governing itself effectively"³⁶ Consequently, "while the Constitution diffuses power the better to secure liberty, it also contemplates that practice will integrate the dispersed powers into a workable government."³⁷

A violation of the separation of powers doctrine occurs, *inter alia*, when one branch attempts to expand its purview beyond the Constitutional limits, even if such expansion is condoned by another branch.³⁸ The seminal case on this issue is *INS v. Chadha*.³⁹ In *Chadha*, Chadha's deportation was suspended by the Attorney General, pursuant to Immigration and Nationality Act section 244(c)(2). The House of Representatives then vetoed the Attorney General's suspension order, as permitted under the Act, resulting in Chadha's deportation. Chadha filed a petition for review of the deportation order with the United States Court of Appeals for the Ninth Circuit, which held that the House was without constitutional authority to order Chadha's deportation and that section 244(c)(2) violated the constitutional doctrine of separation of powers. The Government appealed to the Supreme Court. In finding that Congress had violated the separation of powers in reserving to itself the right to overturn the Attorney

34 *INS v. Chadha*, 462 U.S. 919 (1983).

35 *Buckley*, 424 U.S. at 122.

36 *Id.* at 120-21.

37 *Youngstown Sheet & Tube Co. v. Sawyer*, 343 U.S. 579, 635 (1952) (Jackson, J., concurring).

38 *Bowsher v. Synar*, 478 U.S. 714 (1986). The Supreme Court first directly addressed this issue in *Myers v. United States*, 272 U.S. 52 (1925). *Myers* revolved around a statute which limited the President's ability to remove certain postmasters by providing they could be removed only "by and with the advice and consent of the Senate." In the ensuing suit resulting from the President's removal of one such Postmaster without Senate approval, the Court declared the statute unconstitutional on the ground that for Congress to "draw to itself, or to either branch of it, the power to remove or the right to participate in the exercise of that power . . . would be . . . to infringe the constitutional principle of the separation of governmental powers." *Id.* at 161.

The issue next came before the Court in *Humphrey's Executor v. United States*, 295 U.S. 602 (1935), where a Federal Trade Commissioner who had been removed by the President sought backpay. The relevant statute permitted removal "by the President," but only "for inefficiency, neglect of duty, or malfeasance in office," none of which was present. Here the Court upheld the statute, holding that "illimitable power of removal is not possessed by the President [with respect to Federal Trade Commissioners]." *Id.* at 628-29. The Court distinguished *Myers*, reaffirming its holding that congressional participation in the removal of executive officers is unconstitutional.

39 462 U.S. 919 (1983).

General's decision regarding deportation, the Supreme court stated that Congress can implement policy determinations only by the bicameral passage of legislation followed by presentment to the President and that Congress must abide by a delegation of authority to the Executive Branch until that delegation is legislatively altered or revoked.⁴⁰

In a subsequent decision involving the Comptroller General, *Bowsher v. Synar*,⁴¹ the issue before the Supreme Court was the Emergency Deficit Control Act of 1985 (more popularly known as the "Gramm-Rudmann-Hollings Act"), which established a maximum deficit amount for federal spending for each of the fiscal years 1986 through 1991. If in any fiscal year the budget deficit exceeded the prescribed maximum by more than a specified sum, the Act required basically across-the-board cuts in federal spending to reach the targeted deficit level. The Directors of OMB and the Congressional Budget Office were required to submit their deficit estimates and program-by-program budget reduction calculations to the Comptroller General who, after reviewing the Directors' joint report, then reports his conclusions to the President. The President then had to issue an order mandating the spending reductions specified by the Comptroller General that became effective unless, within a specified time, Congress legislated adequate reductions to bring the deficit under the statutory budget ceiling.⁴²

A complaint seeking a declaratory judgment that the Act was unconstitutional was filed immediately after the Act was signed into law. The District Court concluded the Act did not pass constitutional muster because the powers conferred upon the Comptroller General as part of the automatic deficit reduction process were executive powers, which could not constitutionally be exercised by an officer removable by Congress.⁴³ On appeal, the Supreme Court found the Comptroller General's role to be that of "interpreting a law enacted by Congress to implement a legislative mandate," the very essence of "execution" of the law.⁴⁴ The Comptroller General was required to exercise judgment concerning facts that affected the application of the Act and to interpret the provisions of the Act to determine precisely what budgetary calculations were required.⁴⁵ The executive nature of the Comptroller General's functions under the Act was also demonstrated by the grant of authority to determine the budget cuts to be made.⁴⁶

Having determined the Comptroller General's activities constituted executive functions, the Court then turned to the legislative branch's involvement in those functions. The Court began by noting that "the Constitution does not contemplate an active role for Congress in the

40 *Id.* at 954-55.

41 478 U.S. 714 (1986).

42 *Id.* at 717-18.

43 *Id.* at 720.

44 *Id.* at 733.

45 *Id.*

46 *Id.*

supervision of officers charged with the execution of the laws it enacts.”⁴⁷ The President appoints “Officers of the United States” with the advice and consent of the Senate and once the appointment has been made and confirmed, the Constitution explicitly provides for removal of Officers of the United States by Congress only upon impeachment by the House of Representatives and conviction by the Senate. An impeachment by the House and trial by the Senate can rest only on “Treason, Bribery or other high Crimes and Misdemeanors.”⁴⁸ In the Court’s view, any additional direct congressional role in the removal of officers charged with the execution of the laws, beyond impeachment, was inconsistent with separation of powers.⁴⁹

Although nominated by the President and confirmed by the Senate, the Comptroller General was subject to removal not only by impeachment, as were other “principal officers,” but was also capable of being removed by joint resolution of Congress at any time for: “(1) permanent disability; (2) inefficiency; (3) neglect of duty; (4) malfeasance; or (5) a felony or conduct involving moral turpitude.”⁵⁰ The Court recognized the President could veto such a joint resolution but concluded the Comptroller General “could be removed in the face of Presidential opposition” because the veto could be overridden by a two-thirds vote of both Houses of Congress.⁵¹ This ability to remove the Comptroller General on its own volition was critical factor, in the Court’s view, evidencing Congress’s control over the Comptroller General.⁵² This was distinctly different, according to the Court, from the typical statutes establishing independent agencies which provide for removal only by the President for a specified cause or else did not specify a removal procedure at all.⁵³ In the Court’s opinion:

To permit an officer controlled by Congress to execute the laws would be, in essence, to permit a congressional veto. Congress could simply remove, or threaten to remove, an officer for executing the laws in any fashion found to be unsatisfactory to Congress. This kind of congressional control over the execution of the laws, *Chadha* makes clear, is constitutionally impermissible.⁵⁴

In analyzing the constitutional implications of reassigning the CAS Board under the Comptroller General, it is clear that the Board’s functions are executive in nature. Its authorizing statute’s grant of the “exclusive authority to make, promulgate, amend, and rescind cost

⁴⁷ *Id.* at 722.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ 31 U. S. C. §703(e)(1)(B).

⁵¹ 478 U. S. 714, 727 n.7 (1986).

⁵² *Id.* at 727.

⁵³ *Id.* at 724 n.4.

⁵⁴ *Id.* at 726-27.

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accounting standards and interpretations thereof designed to achieve uniformity and consistency in the cost accounting standards governing measurement, assignment, and allocation of costs to contracts with the United States" impacts a substantial number of Executive Branch contracts and contractors and is "the very essence of execution of the law" required by *Bowsher*. Because the statute permitting Congress to remove the Comptroller General from office remains unchanged from the time of *Bowsher*, the requisite legislative involvement in the activities of the Comptroller General would also be present.⁵⁵

If the Comptroller General were simply substituted for the OFPP Administrator, with the remainder of the statutory scheme remaining the same, the arrangement would run afoul of the separation of powers doctrine. Because all of the members of the Board except for the Comptroller General would be, at most, inferior officers, the Board would be forced to rely on the Comptroller General's "principal officer" status to make its standards mandatory. Thus, a legislative branch official rather than an executive branch official would be exercising sole rulemaking authority.

If, however, all members of the CAS Board possessed principal officer status, i.e., were appointed by the President with the advice and consent of the Senate, and the Board were truly independent in the sense that its actions would not be subject to the approval of any department head or other officer of the United States, the Board could be attached to GAO for administrative support purposes without causing separation of powers problems. While there is a possibility that the participation of the Comptroller General on the Board could raise constitutional questions in those instances in which the Comptroller General was the "swing vote," the principal officer status of the other members of the Board would give it a good chance of withstanding constitutional scrutiny.

CONCLUSION

The current configuration of the CAS Board may be violative of the Appointments Clause because the Board is empowered with rulemaking authority and if its members are all "inferior officers" of the United States or employees, the constitutionality of its exercise of that power is open to question. To make the Board's pronouncements less vulnerable to challenge, it should be restructured so that its decisions are clearly independent and not subject to the approval of any other executive officer. The Board may be established as an independent agency composed of members appointed by the President and confirmed by the Senate. Because each member would be a "principal officer," this configuration would ensure the Board's ability to make binding rules and the balance of power among the Board members. If the Board retains its current composition, in order for the Board Chair to have clear principal officer status, the Chair should be freed of the OMB Director's control. The statutory provision that requires the OFPP Administrator to obtain the OMB Director's concurrence with certain decisions would have to be

⁵⁵ A bill (H.R. 4296) that would have made the Comptroller General and the Deputy Comptroller General congressional appointees instead of presidential appointees died with the conclusion of the 105th Congress. Fed. Cont. Rept. Oct. 26, 1998 at 407.

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amended to state expressly that the provision is inapplicable to promulgations of the CAS Board. If the Board retains its current configuration, with certain of the Chair's decisions subject to the control of the OMB Director, it should be recognized that the Board may lack the power to make binding rules.

If the CAS Board were established as an independent entity with each member appointed by the President and confirmed by the Senate, the Board could be located within any executive agency. As an independent Board comprised only of "principal officers," the CAS Board could be transferred from OFPP to GAO and chaired by the Comptroller General with a good chance of passing constitutional muster.

METHODOLOGY USED TO IDENTIFY CAS-COVERED CONTRACTS

The federal government does not maintain a database of contracts subject to the CAS; therefore, the universe of the CAS-covered contracts is not readily available. The federal government-wide data base for contract actions, FPDS, was used to determine the amount of cost-based actions; however, it has two major limitations for the purpose of using it to identify CAS-covered actions. First, the FPDS does not identify contract actions that are CAS-covered and secondly, it does not collect contract actions by CAS-covered contractor segments. These limitations prohibited the use of the FPDS data to determine alternative threshold or trigger analysis. Therefore, to analyze the impact of alternative CAS applicability thresholds for individual contracts and for full and modified coverage, the Panel used a surrogate CAS universe developed by DCAA and DCMC. DCAA obtained data on the CAS-covered contracts from its defective-pricing database. That database includes contract awards subject to TINA that are also generally subject to the CAS. The data was obtained for a single annual period—April 1997 to March 1998. The defective-pricing universe is created and maintained by each DCAA Field Audit Office¹¹³ and includes negotiated prime contracts, subcontracts, and modifications where the government required cost or pricing data. The data source includes the contract and modification numbers, pricing action amount, and the award or definitization data. Since the CAS are also applicable to contracts when TINA does not apply, DCAA requested that field offices report competitively awarded CAS-covered contracts they were aware of and not included in the defective-pricing universe. Using these two sources of data, DCAA and DCMC estimated that the CAS universe includes 588 business segments, totaling approximately \$72 billion.

DCAA does not audit each contract action and focuses instead on those contracts where the financial risk to the government is highest. Thus, the DCAA CAS universe has limitations because the defective pricing-universe may be incomplete for low dollar cost-type contracts due to the low risk of defective pricing. This limitation may cause underreporting of contractors with cost-type contract awards of less than \$100 million and, in turn, affect the analysis concerning contractors with modified CAS coverage. DCAA's CAS universe may also under-report the CAS-covered contracts where certified cost and pricing data was not obtained and thus may not include CAS-covered firm-fixed-price contracts when cost data (but not certified cost and pricing data) was obtained.

¹¹³DCAA's field audit offices consist of 18 resident offices and 64 branch offices and are responsible for oversight involving approximately 9,000 active contractors.

CAS Coverage Analysis Using Alternative Trigger Concept and Full Coverage Thresholds¹¹⁴ Applicability threshold remains at \$500,000 (Dollars in millions)

Full coverage threshold	Trigger = \$500 thousands				Trigger = \$2 million				Trigger = \$5 million			
	Number of contractors	Percent of total contractors	Dollars	Percent of contract dollars	Number of contractors	Percent of total contractors	Dollars	Percent of contract dollars	Number of contractors	Percent of total contractors	Dollars	Percent of contract dollars
\$25 Million												
Reductions:												
Modified to none	0	0%	\$0	0%	120	20%	\$261	0%	219	37%	\$916	1%
Full to none	0	0%	\$0	0%	1	0%	\$29	0%	7	1%	\$227	0%
Full to modified	0	0%	\$0	0%	0	0%	\$0	0%	0	0%	\$0	0%
Remaining:												
Total Modified	308	52%	\$2,226	3%	188	32%	\$1,965	3%	89	15%	\$1,310	2%
Total Full	280	48%	\$69,811	97%	279	47%	\$69,782	97%	273	47%	\$69,584	96%
Total Coverage	588	100%	\$72,037	100%	467	79%	\$71,747	100%	362	62%	\$70,894	98%
\$50 Million												
Reductions:												
Modified to none	0	0%	\$0	0%	120	20%	\$261	0%	219	37%	\$916	1%
Full to none	0	0%	\$0	0%	1	0%	\$29	0%	7	1%	\$227	0%
Full to modified	91	15%	\$3,315	5%	90	15%	\$3,286	5%	84	14%	\$3,088	4%
Remaining:												
Total Modified	399	68%	\$5,541	8%	278	47%	\$5,251	7%	173	29%	\$4,398	6%
Total Full	189	32%	\$66,496	92%	189	32%	\$66,496	92%	189	32%	\$66,496	92%
Total Coverage	588	100%	\$72,037	100%	467	79%	\$71,747	99%	362	61%	\$70,894	98%
\$75 million												
Reductions:												
Modified to none	0	0%	\$0	0%	120	20%	\$261	0%	219	37%	\$916	1%
Full to none	0	0%	\$0	0%	1	0%	\$29	0%	7	1%	\$227	0%
Full to modified	127	22%	\$5,472	8%	126	21%	\$5,443	8%	120	20%	\$5,245	7%
Remaining:												
Total Modified	435	74%	\$7,698	11%	314	53%	\$7,408	10%	209	36%	\$6,555	9%
Total Full	153	26%	\$64,339	89%	153	26%	\$64,339	89%	153	26%	\$64,339	89%
Total Coverage	588	100%	\$72,037	100%	467	79%	\$71,747	99%	362	62%	\$70,894	98%

Source: Table based on data provided by DCAA and DCMC

¹¹⁴Data for under \$25 million is probably understated due to use of DCAA Defective Pricing database which may not collect all low dollar cost-type contract actions and associated dollars.

Full coverage threshold	Trigger = \$10 million				Trigger = \$25 million			
	Number of contractors	Percent of total contractors	Dollars	Percent of contract dollars	Number of contractors	Percent of total contractors	Dollars	Percent of contract dollars
\$25 Million								
Reductions:								
Modified to none	279	47%	\$1,700	2%	308	52%	\$2,226	3%
Full to none	30	5%	\$1,137	2%	88	15%	\$4,212	6%
Full to modified	0	0%	\$0	0%	0	0%	\$0	0%
Remaining:								
Total Modified	29	5%	\$526	1%	0	0	0	0
Total Full	250	42%	\$68,674	95%	192	33%	\$65,599	91%
Total Coverage	279	47%	\$69,200	96%	192	33%	\$65,599	91%
\$50 Million								
Reductions:								
Modified to none	279	47%	\$1,700	2%	308	52%	\$2,226	3%
Full to none	30	5%	\$1,137	2%	88	15%	\$4,212	6%
Full to modified	65	11%	\$2,429	3%	29	5%	\$1,137	2%
Remaining:								
Total Modified	94	16%	\$2,955	4%	29	5%	\$1,137	2%
Total Full	185	31%	\$66,245	92%	163	28%	\$64,462	89%
Total Coverage	279	47%	\$69,200	96%	192	33%	\$65,599	91%
\$75 million								
Reductions:								
Modified to none	279	47%	\$1,700	2%	308	52%	\$2,226	3%
Full to none	30	5%	\$1,137	2%	88	15%	\$4,212	6%
Full to modified	97	17%	\$4,334	6%	51	9%	\$2,408	3%
Remaining:								
Total Modified	126	21%	\$4,860	7%	51	9%	\$2,408	3%
Total Full	153	26%	\$64,340	89%	141	24%	\$63,191	88%
Total Coverage	279	47%	\$69,200	96%	192	33%	\$65,599	91%

Source: Table based on data provided by DCAA and DCMC.

Trigger Contract Analysis - Modified Coverage¹¹⁵

CAS Awards 1 April 1997 - 31 March 1998

	Applicability = \$500,000			Applicability=\$500,000, Trigger=\$1 million			Applicability=\$500,000, Trigger=\$2 million		
	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
Modified	308	981	2,225,923	260	913	2,175,216	188	712	1,964,875
Change to no CAS coverage				48	68	50,707	120	269	261,048
Percent changed to no coverage				16%	7%	2%	39%	27%	12%

	Applicability=\$500,000, Trigger=\$5 million			Applicability=\$500,000, Trigger=\$10 million			Applicability=\$500,000, Trigger=\$25 million		
	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
Modified	89	324	1,309,560	29	84	526,089	0	0	0
Change to no CAS coverage	219	657	916,363	279	897	1,699,834	308	981	2,225,923
Percent changed to no coverage	71%	67%	41%	91%	91%	76%	100%	100%	100%

(Source: DCAA and DCMC.)

¹¹⁵Data for modified coverage is probably understated due to use of defective pricing database which may not collect all low dollar cost-type contract actions and associated dollar values.

Trigger Contract Analysis - Full Coverage CAS Awards 1 April 1997 - 31 March 1998

Threshold (dollars in millions)	CAS covered	Applicability = \$500,000			Applicability = \$500,000, Trigger = \$1 million			Applicability=\$500,000, Trigger=\$2 million		
		Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
\$25	No	0	0	0	0	0	0	1	29	28,918
	Modified	0	0	0	0	0	0	0	0	0
	Full	280	5,915	69,810,682	280	5,915	69,810,682	279	5,886	69,781,764
\$30	No	0	0	0	0	0	0	1	29	28,918
	Modified	24	216	660,991	24	216	660,991	23	187	632,073
	Full	256	5,699	69,149,691	256	5,699	69,149,691	256	5,699	69,149,691
\$35	No	0	0	0	0	0	0	1	29	28,918
	Modified	43	395	1,283,690	43	395	1,283,690	42	366	1,254,772
	Full	237	5,520	68,526,992	237	5,520	68,526,992	237	5,520	68,526,992
\$40	No	0	0	0	0	0	0	1	29	28,918
	Modified	61	565	1,959,856	61	565	1,959,856	60	536	1,930,938
	Full	219	5,350	67,850,826	219	5,350	67,850,826	219	5,350	67,850,826
\$45	No	0	0	0	0	0	0	1	29	28,918
	Modified	74	776	2,510,741	74	776	2,510,741	73	747	2,481,823
	Full	206	5,139	67,299,941	206	5,139	67,299,941	206	5,139	67,299,941
\$50	No	0	0	0	0	0	0	1	29	28,918
	Modified	91	921	3,314,746	91	921	3,314,746	90	892	3,285,828
	Full	189	4,994	66,495,936	189	4,994	66,495,936	189	4,994	66,495,936
\$55	No	0	0	0	0	0	0	1	29	28,918
	Modified	104	1,014	3,992,253	104	1,014	3,992,253	103	985	3,963,335
	Full	176	4,901	65,818,429	176	4,901	65,818,429	176	4,901	65,818,429
\$60	No	0	0	0	0	0	0	1	29	28,918
	Modified	113	1,091	4,508,720	113	1,091	4,508,720	112	1,062	4,479,802
	Full	167	4,824	65,301,962	167	4,824	65,301,962	167	4,824	65,301,962
\$65	No	0	0	0	0	0	0	1	29	28,918
	Modified	115	1,118	4,631,807	115	1,118	4,631,807	114	1,089	4,602,889
	Full	165	4,797	65,178,875	165	4,797	65,178,875	165	4,797	65,178,875
\$70	No	0	0	0	0	0	0	1	29	28,918
	Modified	121	1,197	5,038,549	121	1,197	5,038,549	120	1,168	5,009,631
	Full	159	4,718	64,772,133	159	4,718	64,772,133	159	4,718	64,772,133
\$75	No	0	0	0	0	0	0	1	29	28,918
	Modified	127	1,317	5,471,776	127	1,317	5,471,776	126	1,288	5,442,858
	Full	153	4,598	64,338,906	153	4,598	64,338,906	153	4,598	64,338,906
\$80	No	0	0	0	0	0	0	1	29	28,918
	Modified	131	1,357	5,780,170	131	1,357	5,780,170	130	1,328	5,751,252
	Full	149	4,558	64,030,512	149	4,558	64,030,512	149	4,558	64,030,512
\$85	No	0	0	0	0	0	0	1	29	28,918
	Modified	137	1,419	6,276,986	137	1,419	6,276,986	136	1,390	6,248,068
	Full	143	4,496	63,533,696	143	4,496	63,533,696	143	4,496	63,533,696
\$90	No	0	0	0	0	0	0	1	29	28,918
	Modified	143	1,502	6,803,240	143	1,502	6,803,240	142	1,473	6,774,322
	Full	137	4,413	63,007,442	137	4,413	63,007,442	137	4,413	63,007,442
\$95	No	0	0	0	0	0	0	1	29	28,918
	Modified	151	1,629	7,546,013	151	1,629	7,546,013	150	1,600	7,517,095
	Full	129	4,286	62,264,669	129	4,286	62,264,669	129	4,286	62,264,669
\$100	No	0	0	0	0	0	0	1	29	28,918
	Modified	159	1,808	8,329,850	159	1,808	8,329,850	158	1,779	8,300,932
	Full	121	4,107	61,480,832	121	4,107	61,480,832	121	4,107	61,480,832

(Source: DCAA and DCMC.)

Trigger Contract Analysis - Full Coverage (continues)

Threshold (dollars in millions)	CAS covered	Applicability = \$500,000 Trigger = \$5 million			Applicability = \$500,000, Trigger=\$10 million			Applicability=\$500,000, Trigger=\$25 million		
		Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
\$25	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	0	0	0	0	0	0	0	0	0
	Full	273	5,745	69,583,969	250	5,304	68,673,248	192	4,458	65,598,261
\$30	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	21	161	576,763	14	70	390,851	4	13	110,439
	Full	252	5,584	69,007,206	236	5,234	68,282,397	188	4,445	65,487,822
\$35	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	38	291	1,137,922	29	168	885,673	11	27	341,581
	Full	235	5,454	68,446,047	221	5,136	67,787,575	181	4,431	65,256,680
\$40	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	55	436	1,777,172	42	244	1,381,540	15	39	491,336
	Full	218	5,309	67,806,797	208	5,060	67,291,708	177	4,419	65,106,925
\$45	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	67	606	2,284,028	50	305	1,718,525	19	59	662,274
	Full	206	5,139	67,299,941	200	4,999	66,954,723	173	4,399	64,935,987
\$50	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	84	751	3,088,033	65	410	2,429,171	29	111	1,136,602
	Full	189	4,994	66,495,936\	185	4,894	66,244,077	163	4,347	64,461,659
\$55	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	97	844	3,765,540	77	488	3,056,364	39	147	1,659,402
	Full	176	4,901	65,818,429	173	4,816	65,616,884	153	4,311	63,938,859
\$60	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	106	921	4,282,007	85	549	3,514,811	45	176	2,000,696
	Full	167	4,824	65,301,962	165	4,755	65,158,437	147	4,282	63,597,565
\$65	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	108	948	4,405,094	87	576	3,637,898	46	188	2,063,483
	Full	165	4,797	65,178,875	163	4,728	65,035,350	146	4,270	63,534,778
\$70	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	114	1,027	4,811,836	93	655	4,044,640	49	199	2,264,357
	Full	159	4,718	64,772,133	157	4,649	64,628,608	143	4,259	63,333,904
\$75	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	120	1,147	5,245,063	97	706	4,334,342	51	211	2,408,361
	Full	153	4,598	64,338,906	153	4,598	64,338,906	141	4,247	63,189,900
\$80	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	124	1,187	5,553,457	101	746	4,642,736	54	224	2,639,349
	Full	149	4,558	64,030,512	149	4,558	64,030,512	138	4,234	62,958,912
\$85	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	130	1,249	6,050,273	107	808	5,139,552	60	286	3,136,165
	Full	143	4,496	63,533,696	143	4,496	63,533,696	132	4,172	62,462,096
\$90	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	136	1,332	6,576,527	113	891	5,665,806	64	324	3,490,676
	Full	137	4,413	63,007,442	137	4,413	63,007,442	128	4,134	62,107,585
\$95	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	144	1,459	7,319,300	121	1,018	6,408,579	70	370	4,046,990
	Full	129	4,286	62,264,669	129	4,286	62,264,669	122	4,088	61,551,271
\$100	No	7	170	226,713	30	611	1,137,434	88	1,457	4,212,421
	Modified	152	1,638	8,103,137	129	1,197	7,192,416	74	428	4,436,639
	Full	121	4,107	61,480,832	121	4,107	61,480,832	118	4,030	61,161,622

(Source: DCAA and DCMC.)

Trigger Contract Analysis - Full Coverage (continues)

Threshold (dollars in millions)	CAS covered	Applicability = \$500,000			Applicability = \$500,000, Trigger = \$1 million			Applicability=\$500,000, Trigger=\$2 million		
		Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
\$25	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Full	100%	99%	100%	100%	99%	100%	100%	99%	100%
\$30	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	9%	4%	1%	9%	4%	1%	8%	3%	1%
	Full	91%	96%	99%	91%	96%	99%	91%	96%	99%
\$35	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	15%	7%	2%	15%	7%	2%	15%	6%	2%
	Full	85%	93%	8%	85%	93%	98%	85%	93%	98%
\$40	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	22%	9%	3%	22%	9%	3%	21%	9%	3%
	Full	78%	90%	97%	78%	90%	97%	78%	90%	97%
\$45	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	26%	13%	4%	26%	13%	4%	26%	13%	4%
	Full	74%	86%	96%	74%	86%	96%	74%	86%	96%
\$50	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	33%	15%	5%	33%	15%	5%	32%	15%	5%
	Full	68%	84%	95%	68%	84%	95%	68%	84%	95%
\$55	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	37%	17%	6%	37%	17%	6%	37%	17%	6%
	Full	63%	82%	94%	63%	82%	94%	63%	82%	94%
\$60	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	40%	18%	6%	40%	18%	6%	40%	18%	6%
	Full	60%	81%	93%	60%	81%	93%	60%	81%	93%
\$65	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	41%	19%	7%	41%	19%	7%	41%	18%	7%
	Full	59%	81%	93%	59%	81%	93%	59%	81%	93%
\$70	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	43%	20%	7%	43%	20%	7%	43%	20%	7%
	Full	57%	79%	93%	57%	79%	93%	57%	79%	93%
\$75	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	45%	22%	8%	45%	22%	8%	45%	22%	8%
	Full	55%	77%	92%	55%	77%	92%	55%	77%	92%
\$80	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	47%	23%	8%	47%	23%	8%	46%	22%	8%
	Full	53%	77%	92%	53%	77%	92%	53%	77%	92%
\$85	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	49%	24%	9%	49%	24%	9%	49%	23%	9%
	Full	51%	76%	91%	51%	76%	91%	51%	76%	91%
\$90	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	51%	25%	10%	51%	25%	10%	51%	25%	10%
	Full	49%	74%	90%	49%	74%	90%	49%	74%	90%
\$95	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	54%	27%	11%	54%	27%	11%	54%	27%	11%
	Full	46%	72%	89%	46%	72%	89%	46%	72%	89%
\$100	No	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Modified	57%	30%	12%	57%	30%	12%	56%	30%	12%
	Full	43%	69%	88%	43%	69%	88%	43%	69%	88%

(Source: DCAA and DCMC.)

Trigger Contract Analysis - Full Coverage (continues)

Threshold (dollars in millions)	CAS covered	Applicability = \$500,000 Trigger = \$5 million			Applicability = \$500,000, Trigger=\$10 million			Applicability=\$500,000, Trigger=\$25 million		
		Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)	Number of contractors	Pricing actions	Total CAS awards (\$000)
\$25	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	0%	0%	0%	0%	0%	0%	0%	0%	0%
	Full	98%	97%	100%	89%	89%	98%	69%	75%	94%
\$30	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	8%	3%	1%	5%	1%	1%	1%	0%	0%
	Full	90%	94%	99%	84%	88%	98%	67%	75%	94%
\$35	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	14%	5%	2%	10%	3%	1%	4%	0%	0%
	Full	84%	92%	98%	79%	86%	97%	65%	74%	93%
\$40	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	20%	7%	3%	15%	4%	2%	5%	1%	1%
	Full	78%	89%	97%	74%	85%	96%	63%	74%	93%
\$45	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	24%	10%	3%	18%	5%	2%	7%	1%	1%
	Full	74%	86%	96%	71%	84%	96%	62%	74%	93%
\$50	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	30%	13%	4%	23%	7%	3%	10%	2%	2%
	Full	68%	84%	95%	66%	82%	95%	58%	73%	92%
\$55	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	35%	14%	5%	28%	8%	4%	14%	2%	2%
	Full	63%	82%	94%	62%	81%	94%	55%	72%	92%
\$60	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	38%	15%	6%	30%	9%	5%	16%	3%	3%
	Full	60%	81%	93%	59%	80%	93%	53%	72%	91%
\$65	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	39%	16%	6%	31%	10%	5%	16%	3%	3%
	Full	59%	81%	93%	58%	79%	93%	52%	72%	91%
\$70	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	41%	17%	7%	33%	11%	6%	18%	3%	3%
	Full	57%	79%	93%	56%	78%	93%	51%	72%	91%
\$75	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	43%	19%	8%	35%	12%	6%	18%	4%	3%
	Full	55%	77%	92%	55%	77%	92%	50%	71%	90%
\$80	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	44%	20%	8%	36%	13%	7%	19%	4%	4%
	Full	53%	77%	92%	53%	77%	92%	49%	71%	90%
\$85	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	46%	21%	9%	38%	14%	7%	21%	5%	4%
	Full	51%	76%	91%	51%	76%	91%	47%	70%	89%
\$90	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	49%	22%	9%	40%	15%	8%	23%	5%	5%
	Full	49%	74%	90%	49%	74%	90%	46%	70%	89%
\$95	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	51%	25%	10%	43%	17%	9%	25%	6%	6%
	Full	46%	72%	89%	46%	72%	89%	44%	69%	88%
\$100	No	3%	3%	0%	11%	10%	2%	31%	24%	6%
	Modified	54%	28%	12%	46%	20%	10%	26%	7%	6%
	Full	43%	69%	88%	43%	69%	88%	42%	68%	88%

(Source: DCAA and DCMC.)

FULL VERSUS MODIFIED COVERAGE RISKS

Full CAS coverage requires compliance with all 19 standards, while modified CAS coverage requires compliance with only four. Thus, there are 15 standards that apply to full but not to modified coverage. As a result, there is an inherent risk associated with contractors that move from full to modified coverage.

For contracts that are not covered by FAR Part 31 (e.g., fixed-price contracts), the risk to the government would be its loss of the right to a contract price adjustment due to contractor's failure to comply with the requirements contained in these 15 standards. To the extent that FAR Part 31 incorporates the CAS, cost-reimbursement contracts continue to be subject to the referenced standards.

The 15 standards that apply to full but not to modified coverage concern a myriad of subjects, including cost allocation, capitalization and depreciation, standard costs, materials, pensions, cost of money, deferred compensation, insurance, and B&P, and IR&D. FAR Part 31 incorporates by reference 5 of these 15 standards (including standards concerning deferred compensation, pensions, and cost of money) and duplicates another 4 (including standards concerning consistency in allocating costs incurred for the same purpose, unallowable costs, self-insurance, and IR&D costs and B&P costs excluding allocation provisions). Thus, for contracts covered by FAR Part 31, the risk is mitigated to the extent that these CAS provisions are incorporated into the FAR. However, additional risk would exist for the other 6 standards, and for the parts of the 4 standards that are not duplicated in the FAR.

The CAS include 4 standards that address in detail cost allocation requirements (CAS 403, 410, 418, and 420). Conversely, FAR Part 31 does not include the detailed cost allocation requirements contained in these 4 standards. Instead, the FAR contains a broad based cost allocation rule that has not markedly changed since 1959. For these 4 standards, the risk to the government may be higher to the extent that broader based allocation requirements could allow an increase in inequitable cost allocations to government contracts.

The CAS also include 2 standards that address accounting for tangible capital assets (CAS 404 and CAS 409). These standards include detailed requirements regarding when to capitalize an asset, how long its useful life will be, and what method of depreciation will be used. While FAR Part 31 also addresses the accounting for tangible capital assets, it provides general criteria. Under FAR Part 31, depreciation costs are generally deemed to be reasonable if they are the same as those used in non-government segments, are the same as those included in the contractor's records and financial statements, and are the same as those used for tax purposes. Thus, the FAR permits more flexibility in asset cost assignment between accounting periods. The risk related to this particular standard exists to the extent contractors may move costs between accounting

periods and use this movement as a means of redistributing costs between contracts (due to variations in government cost-type contract participation between accounting periods).

CAS 407 contains detailed requirements for use of standard costs, while FAR Part 31 provides general criteria. CAS 407 requires that (1) the standard costs be entered into the books of account, (2) the standard costs and related variances be appropriately accounted for at the level of the production unit, (3) the practices regarding the use of standard costs be stated in writing and consistently followed, and (4) standard cost variances be allocated to contracts at least annually and on the same basis as the standard costs. FAR 31.201-1 has a broader based requirement that requires that standard costs be properly adjusted for applicable variances. The increased risk related to this standard exists to the extent contractors may use the broader FAR criteria to reallocate costs between cost-type government contracts and all other contracts. Such cost reallocation could result from allocating variances less frequently than annually or from not allocating variances on the same basis as the standard costs are allocated. In addition, without the written practices required by the standard, it would be more difficult for the government to cite a contractor for noncompliance with disclosed practices.

While CAS 411 and FAR Part 31 both contain accounting requirements for material costs, the CAS 411 requirements are significantly more detailed. CAS 411 (1) requires consistent contractor policies for accumulating and allocating material costs, (2) permits direct allocation of material cost to cost objectives if the cost objective was specifically identified at the time of purchase or production of the units, (3) states that indirect material not consumed by the end of the period cannot be charged in that period but instead must be established as an asset, and (4) provides five acceptable inventory costing methods (FIFO, moving average, weighted average, standard cost, and LIFO). FAR 31.205-26 requires that materials purchased solely for and identifiable to a contract be charged directly to that contract and that the inventory method used be a generally recognized method that is consistently applied and has equitable results. The increased risk related to this standard exists to the extent contractors may use the broader FAR criteria to reallocate costs between cost-type government contracts and all other contracts. This could result from using an inventory method that is not recognized by the CAS or by charging indirect material that is not consumed by the end of the period to a contract or contracts. In addition, without the written practices required by the standard, it would be more difficult for the government to cite a contractor for noncompliance with disclosed practices.

ANALYSIS OF THE CAS BOARD WAIVER REQUESTS

Subject of request (requesting agency)	Date of			Days from			Remarks
	Company request (Col A)	Agency request (Col B)	The CAS Board decision (Col C)	Company request to Agency submission (Col A - Col B)	Agency submission to the CAS Board decision (Col B - Col C)	Company request to the CAS Board decision (Col A - Col C)	
Agency Requests							
(1) Waiver for the purchase of classified chips from a company that was reluctant to do business with the government (DOD)	N/A	2/14/91	2/21/91	N/A	8	N/A	The original request was made by the National Security Agency on 2/6/91. DOD needed the chips for Operation Desert Storm.
(2) Waiver for the application of the CAS to health insurance carriers under the Federal Employee Health Benefits Program (OPM)	N/A	9/24/98	10/5/98	N/A	60	N/A	The Omnibus Appropriations Act for 1999 stated that the CAS would not apply to the Federal Employee Health Benefits Program. OPM officials state that this "exemption" is a "waiver" because appropriation law applies for only one year.
(3) Waiver from the period cost assignment provisions of the CAS 412.40(c) (DOD)	N/A	1/10/91 1/10/91	4/8/91 4/10/91	N/A	88	N/A	When the CAS Board was reestablished in 1988, DOD requested the review of five open cases. Also, DOD requested waiver authority for the CAS requirements, when appropriate, on an individual contract basis. The CAS Board focused on issues regarding CAS 412.
(4) Authority for DOD to grant certain CAS waivers for firm-fixed price contracts when cost or pricing information is provided by the prospective contractor (DOD)	N/A	11/14/97	6/15/98	N/A	212	N/A	The acting CAS Board Chairman referred the request to the CAS Board staff on 2/13/98. The waiver was limited to a 2-year period subject to four limitations.
(5) Exemption from the requirements of the CAS for DOD commercial item acquisitions (DOD)	N/A	8/20/92	4/26/93	N/A	246	N/A	<u>Denied</u> . On 12/23/92, DCAA supported a DOD 12/3/92 modified request. A CAS exemption was published on 11/4/93.
Company Requests							
(6) Segment accounting requirements of CAS 413 re: the proposed merger of three defined benefit pension plans (DOD)	8/17/95	8/28/95	9/12/95	12	14	26	The CAS Board conducted a detailed analysis of the waiver request. Based on this analysis, it placed a number of conditions on the approved waiver.

Subject of request (requesting agency)	Date of			Days from			Remarks
	Company request (Col A)	Agency request (Col B)	The CAS Board decision (Col C)	Company request to Agency submission (Col A - Col B)	Agency submission to the CAS Board decision (Col B - Col C)	Company request to the CAS Board decision (Col A - Col C)	
(7) Waiver of segment accounting requirements of CAS 413 for a large defense merger of two companies (DOD)	9/26/96	11/25/96	12/5/96	59	11	70	While the CAS Board approved the waiver request, approval was made contingent on certain conditions pertaining to accounting for period costs and traceability.
(8) Partial waiver request re: a contractor's financial liability if a subcontractor fails to comply with the CAS (NASA)	6/6/98	7/14/98	8/19/98	39	35	74	After a university submitted its letter on 6/6/98, the NASA Resident Office submitted its letter to NASA Headquarters on 6/10/98.
(10) The CAS requirements for all DOD contracts awarded to a contractor for a specific 5-year period of time to acquire needed chemicals (DOD)	2/19/92	3/12/93	6/14/93	24	92	116	<u>Denied</u> . The CAS Board did not believe that the contract required the incorporation of the CAS clause because anticipated purchases did not meet threshold requirements.
(9) The CAS requirements with respect to a proposed subcontract (Department of Energy (DOE))	11/2/92	2/1/93	3/4/93	90	33	123	DOE's Oak Ridge Field Office's letter of 1/14/93 provided a comprehensive explanation justifying the waiver.
(11) The CAS requirements for an urgent subcontract needed by a company to support the Navy's Trident II Missile Program (DOD)	5/17/93	9/17/93	10/8/93	120	22	142	The CAS Board approved the request. However, the Board expressed concerns over competitive sources, basis for contractual refusal, and other issues.
(12) The CAS coverage of three subcontractors supporting Navy's Trident II (DOD)	8/10/90	3/18/91	3/19/91	218	1	219	This request was also based on letters sent 12/21/90 and 1/11/91 from the Navy's Director, Strategic Systems Program. The Navy made its request to DOD on 2/28/91.
(13) The CAS coverage of one contractor supporting the Navy's Trident II (DOD)	1/8/91	9/20/91	10/10/91	253	20	273	After receiving the contractor's letter, the Navy's Director, Strategic Systems Program, sent his request to DOD on 3/8/91.

Subject of request (requesting agency)	Date of			Days from			Remarks
	Company request (Col A)	Agency request (Col B)	The CAS Board decision (Col C)	Company request to Agency submission (Col A - Col B)	Agency submission to the CAS Board decision (Col B - Col C)	Company request to the CAS Board decision (Col A - Col C)	
(14) Partial waiver request re: a contractor's financial liability if a subcontractor fails to comply with the CAS (NASA)	2/18/93	9/21/93	11/26/93	213	65	278	While a university submitted its letter on 2/18/93, the NASA Resident Office did not submit its letter to NASA Headquarters until 9/16/93.

Note: N/A = Not applicable.

COMPARISON OF THE THE CAS AND GAAP

SIMILARITIES BETWEEN THE CAS AND GAAP

The meaning of the term GAAP has varied over time. Originally, GAAP referred to accounting policies and procedures that were widely used in practice. As standards setting bodies and professional organizations increasingly became involved in recording practices and recommending preferred practices, the term came to refer to the pronouncements issued by particular accounting bodies such as the Committee on Accounting Procedure and the Accounting Principles Board (APB), both committees of the American Institute of Certified Public Accountants (AICPA), and more recently the FASB. Today, many different series of authoritative literature exist, some are still in effect but are no longer being issued, like APB Opinions and the AICPA Accounting Research Bulletins (ARB). Others—such as FASB Statements and Interpretations—continue to be issued by accounting organizations.

To better organize and make clear what is meant by GAAP, the accounting community established what is commonly referred to as the GAAP hierarchy. The purpose of the hierarchy is to instruct financial statement preparers, auditors, and users of financial statements concerning the relative priority of the different sources of GAAP used by auditors to judge the fairness of presentation of financial statements. The following displays the four levels of established principles that are supported by authoritative literature as well as additional sources of GAAP.

Hierarchy of GAAP

Level A-

- Financial Accounting Standards (FAS)
- FASB Interpretations
- APB Opinions
- ARB

Level B-

- FASB Technical Bulletins (FTB)
- AICPA Industry Audit and Accounting guides
- AICPA Statements of Position

Level C-

- Consensus Positions of the Emerging Issues Task Force (EITF)
- AICPA Practice Bulletins

Level D-

- AICPA Accounting Interpretations
- FASB Implementation Guides

Other accounting literature

- FASB Concepts Statements
- APB Statements
- AICPA Issue Papers
- International Accounting Standards Committee Statements
- GASB Statements, Interpretations, and Technical Bulletins
- Pronouncements of other professional associations and regulatory bodies
- AICPA Technical Practice Aids
- Accounting textbooks, handbooks, and articles

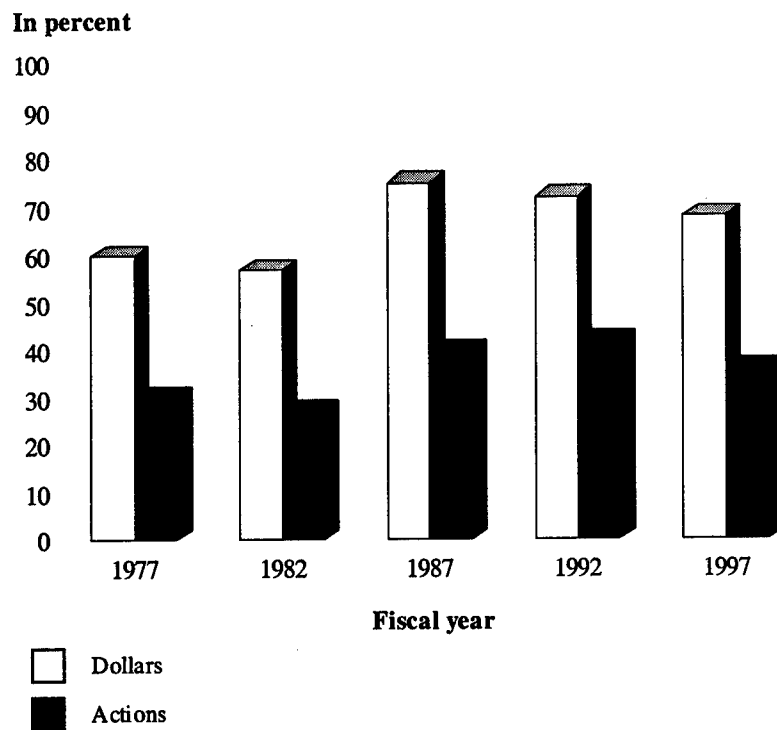
Five of the 19 standards (CAS 401, 407, 408, 411, 417) do not significantly differ from GAAP.

The CAS	Related GAAP	Observation
401	FASB Concept Statement 2, APS 4 and APB 20	The CAS address consistency between estimating and accumulating contract costs. GAAP address consistency in reporting financial performance between periods. CAS are concerned with consistency in proposing and recording contract costs, while GAAP are concerned with consistency in reporting financial performance.
407	ARB 43	For financial accounting purposes, GAAP contain a footnote with regard to the use of standard costs. The CAS Board did not believe that this was sufficient for contract costing purposes.
408	FASB 43	FASB 43 and CAS 408 are substantially the same. CAS 408 has not been reviewed to determine if and how FASB 43 could be used to streamline the standard.
411	ARB 43	Both CAS 411 and GAAP provide criteria for acceptable inventory costing methods but the GAAP criteria are general while the CAS list specific costing methods that may be used.
417	FASB 34	GAAP require the capitalization of actual interest costs incurred with the construction of capital assets, while the CAS require the capitalization of an imputed cost of money value.

DIFFERENCES BETWEEN THE CAS AND GAAP

Eight of the 19 standards (CAS 404, 406, 409, 412, 413, 415, 416, and 420) differ from related GAAP requirements as shown below:

The CAS	Related GAAP	Observation
404	FASB Concept Statement 6, APB 16	GAAP permit step-up/step-down of assets while the CAS do not. The CAS Board believed that the government should share in gains or losses subsequent to asset revaluation but developing equitable procedures would be complex and costly. Therefore, the Board concluded that the most acceptable solution would be to retain the original asset acquisition cost as a base for calculating contract costs.
406	APB Statement 4 EITF 94-3 EITF 95-3	The CAS provide specific instances in which a period other than the fiscal year may be used, while GAAP do not provide specific instances in which a period other than one year may or may not be used as an accounting period. For assignment of restructuring costs to accounting periods, the CAS provide flexibility to expense or defer such costs, while GAAP require certain restructuring costs to be expensed in the current period.
409	APB Statement 4 APB 16	GAAP permit step-up/step-down of assets while the CAS do not. The CAS Board believed that the government should share in gains or losses subsequent to asset revaluation but developing equitable procedures would be complex and costly. Therefore, the Board concluded that the most acceptable solution would be to retain the original asset acquisition cost as a base for calculating contract costs.
412	FASB 87	The CAS require funding of the pension liability while GAAP do not. The CAS Board included a funding requirement to allocate pension costs to the current period. The Board determined that it was necessary to link the period assignment of costs to current period funding to ensure the verifiability of the accrued amounts. This was due to the magnitude of the liability and the extended delay between the accrual of the cost and the settlement of the liability.
413	FASB 87 and 88	The CAS address final accounting for segment closings, while GAAP do not. The CAS require that actuarial gains and losses using an immediate-gain actuarial cost method be amortized over 15 years, while GAAP require immediate recognition of certain actuarial gains and losses and different amortization requirements for others.
415	Numerous	A substantial amount of GAAP were formulated after the CAS were issued (e.g., post-retirement benefits); other GAAP were formulated before the CAS promulgation but have changed significantly since the CAS were promulgated (e.g., employee stock ownership plans and stock based compensation).
416	FASB 5 FAS 106	The CAS recognize self-insurance while GAAP do not. The CAS Board staff decided to depart from the GAAP because government procurement regulations in existence at the time the CAS Board was debating this issue already allowed a charge for self-insurance. In addition, the CAS require funding for retiree insurance benefits to measure insurance cost in a particular cost accounting period. This conflicts with GAAP, which do not include a requirement. The original CAS Board believed that if the contractor wished to recognize a cost in the current period when the actual payment would not take place until an indefinite time in the future, such an obligation should be evidenced by funding.
420	FAS 2	GAAP do not permit assignment of IR&D costs to future periods; the CAS permit assignment of IR&D costs to future periods but only if specifically permitted by procurement regulations. The CAS Board stated that FAS 2 was not determinative for contract costing and pricing purposes. The Board stated that it would undertake research on a project to determine the feasibility of a standard for the accounting treatment of deferred development costs. In the interim, the Board wrote the standard so that the procurement agencies could continue to use their existing procurement rules for assigning IR&D costs to accounting periods.

DOD's COST BASED CONTRACTING

Note: Negotiated cost-based awards include cost-type contracts, flexible-price fixed type contracts and firm fixed-type contracts, where certified cost and pricing data was obtained or progress payment were made based on incurred costs. Negotiated cost-based awards do not include non-negotiated awards, firm fixed priced awards where certified cost and pricing data was not obtained, or where progress payments were not made.

SUMMARY INFORMATION ON SELECTED BOARDS

Board/ Commissions	Principal characteristics
FASB	The Board consists of seven members appointed by the Financial Accounting Foundation for 5-year terms, who are eligible for reappointment to one additional 5-year term. Members serve full-time and are required to sever all connections with the firms or institutions they served prior to joining the Board. The Board is assisted by a staff of about 40 professionals from public accounting, industry, academia, and government, plus support personnel. This is not a government agency.
Government Accounting Standards Board	The Board consists of seven members appointed by the Financial Accounting Foundation. The Chairman serves full-time; other members serve on a part-time basis and may be in the employ of other organizations. The Board is assisted by a staff of about 10 professionals from public accounting, academia, and government, plus support personnel. This is not a government agency.
Federal Accounting Standards Advisory Board	Established in 1990 by the Secretary of the Treasury, the Director of OMB, and the Comptroller General (known as the principals), the Board is an advisory committee recommending accounting standards to the principals to promulgate. The Board is comprised of nine part-time members selected from government entities and the private sector. Treasury, OMB, GAO, and CBO select their own members. The principals select the remaining five members. The principals select the Board's Chairperson from among the three non-federal members.
FERC	An independent regulatory commission within DOE, the Commission is composed of five members appointed by the President for a term of 5 years, who can be removed only by the President. All of the members are considered principal officers. Members may not engage in any other business, vocation, or employment while serving on the Commission. In the performance of their functions, the members, employees, or other personnel of the Commission may not be responsible to or subject to the supervision or direction of any officer, employee, or agent of any other part of the Department. In each annual authorization and appropriation request, the Secretary of Energy identifies the portion thereof intended for the support of the Commission and includes a statement by the Commission showing the amount requested by it.
ASBCA	The ASBCA is an independent tribunal to hear and decide contract disputes between government contractors and DOD. The Board consists of attorneys who have been qualified in the manner prescribed by the Contract Disputes Act of 1978. The Under Secretary of Defense (Research and Engineering) and the Assistant Secretaries of the Military Departments responsible for procurement appoint the Chairman and Vice-chairman and other members of the Board. The Department of the Army provides administrative support to the Board. The Departments of the Army, the Navy, the Air Force, and the Office of the Secretary of Defense share the Board's cost on an equal basis and to the extent determined by the Assistant Secretary of Defense (Comptroller).
Railroad Accounting Principles Board (RAPB)	Established in 1980 as part of the legislative branch, Congress charged the Board with developing a set of cost accounting principles for rail carriers subject to the jurisdiction of the Interstate Commerce Commission (ICC). The Board had seven members (five non-government and two government) and was chaired by the Comptroller General. The Board's authorizing legislation called for the Board to cease to exist 3 years after its effective date and for the accounting principles it developed to be adopted by ICC. The principles adopted by the ICC are still binding on all carriers.
Surface Transportation Board (STB)	An independent agency administratively housed within the Department of Transportation, the Board is responsible for the economic regulation of interstate surface transportation to ensure that competitive and efficient transportation services are provided to meet the needs of shippers, receivers, and consumers. Created in 1996 as a successor agency to the ICC, the STB ensures that the cost accounting principles developed by RAPB are followed. The STB is an independent, bipartisan, adjudicatory body. It consists of three members appointed by the President with the advice and consent of the Senate for 5-year terms. The President designates the Board's Chairman from among the members.
Federal Retirement Thrift Investment Board	The Board was established as an independent agency by the Federal Employees' Retirement System Act of 1986, 5 U.S.C. 8472, and is composed of five members. Three are appointed by the President, who designates one of them the Chairman. The other two members are also appointed by the President: one taking into consideration the recommendation made by the majority leader of the Senate, and the other taking into consideration the views of the Speaker of the House. The Board establishes policies for the investment and management of the Thrift Savings Fund. The Board's members are not full-time government employees.

Board/ Commissions	Principal characteristics
Municipal Securities Rulemaking Board	The Board is a self-regulatory organization that is subject to oversight by the Securities and Exchange Commission. It regulates dealers who deal in municipal bonds, municipal notes, and other municipal securities. The Board consists of 15 members—5 of bank dealers, 5 of securities firms, and 5 public members not associated with any bank dealer or securities firm. Board members serve staggered 3-year terms. The Board members elect a chairman and vice-chairman who serve one-year terms. All Board operations are financed by fees and assessments paid by the dealer community. The Board has broad rulemaking authority over municipal securities dealers' activities.