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STATEMENT OF THE
HONORABLE ELMER B. STAATS, CHAIRMAN
COST ACCOUNTING STANDARDS BOARD
BEFORE THE
PRODUCTION AND STABILIZATION SUBCOMMITTEE
OF THE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE
ON
COST ACCOUNTING STANDARD NO. 409

APRIL 14, 1975

Mr. Chairman and Members of the Subcommittee:

I welcome this opportunity to discuss Cost Accounting Standard Number 409, Depreciation of Tangible Capital Assets. There has been considerable misunderstanding among some defense contractors and defense industry associations as to what the Standard provides. This hearing should help both in clarifying the reasons for promulgation of the Standard and also in explaining its provisions.

The Cost Accounting Standards Board believes that the Standard is a keystone to the development of Cost Accounting Standards for defense contracts. The Board believes that it establishes fair and equitable requirements for measuring and allocating depreciation costs under negotiated defense contracts and subcontracts, and that it promotes a greater degree of uniformity and consistency in the pricing of those contracts.

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I have prepared a brief statement about the background of the Board about the nine Cost Accounting Standards which the Board has promulgated and about the Board's Disclosure regulations. The statement also includes other background information which may be of interest to the Subcommittee. Rather than read that background material, I would appreciate your including it as part of the record of this hearing as an attachment to this Statement.

I want to discuss the background of the Standard and the provisions of it which I understand are objectionable to some defense contractors.

The Board instructed its staff almost four years ago to begin the work which has led to Standard No. 409. The subject of depreciation is not a new one. It was identified as a major problem area in the General Accounting Office's Feasibility Study conducted in 1968 and 1969--the work which preceded Congressional creation in 1970 of the Cost Accounting Standards Board. Beginning in May 1971, our staff conducted rigorous research of published material, including Government procurement regulations dealing with depreciation and the changes made in them from time to time. We considered the research data made available to us by the American Institute of Certified Public Accountants and the Management Accounting Practices Committee of the National Association of Accountants. We consulted with the Treasury Department and the Internal Revenue Service.

We also have had the benefit of a great deal of research work performed by the Board relating specifically to depreciation in connection with negotiated defense contracts. We made analyses of the several hundred Disclosure Statements of contractor accounting practices which are on file with the Board. An issues paper dealing with capitalization and depreciation was distributed on December 23, 1971 to 50 individuals and organizations who expressed an interest in the Board's work. A questionnaire derived in part from the responses to the issues paper was distributed to about 100 interested parties in April 1972. Staff Members made numerous plant visitations and held discussions with company officials at contractor locations during the more than three years spent in developing the Standard on depreciation. We benefited from a detailed Staff study of depreciation costs of 107 contractor profit centers.

In addition the Board invited representatives of the Department of Defense, the Aerospace Industries Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, and the Machinery and Allied Products Institute to meet with us for a discussion of the issues involved. Board staff also arranged for informal meetings with representatives of professional accounting and industry organizations. We rely heavily on these organizations to provide us with an understanding of the view of those who will be affected by any Standard, if promulgated.

Based on this general background research and on our understanding of the issues involved, a preliminary Staff proposal was mailed in March 1973, to 270 contractors and others to provide them an opportunity

to comment and advise the Board. We received over 100 letters of comment on that Staff proposal. At subsequent meetings, the Board had numerous discussions about issues highlighted and alternative approaches to those issues.

On June 11, 1974, a Board exposure draft was published in the Federal Register, soliciting comments from all interested parties. It was also mailed directly to the approximately 1,000 persons then on the Board's mailing list of individuals and organizations who have expressed an interest in the Board's work. We received more than 100 letters commenting on that proposal. After careful Board consideration of those comments, the proposed Standard was revised and published again in the Federal Register of October 3, 1974. This second publication of a proposal was unprecedented for the Board; it was also sent to the entire Board mailing list. We received 80 letters in response to this second exposure draft.

On December 20, 1974, at the request of industry spokesmen, the Board scheduled a special meeting. This meeting was attended by many industry representatives who provided a further exchange of views which assisted the Board as it began its final deliberations on the proposed Standard. The Board by a four to one vote decided at its January meeting this year to promulgate the Standard.

The Standard was submitted to the Congress on January 24, 1975, in accordance with Section 719(h)(3) of the Defense Production Act, which requires that sixty days of continuous legislative session elapse before the Standard goes into effect. In the absence of a concurrent resolution

stating in substance that the Congress disapproved of the promulgated Standard, it became final on March 25, 1975. It will be incorporated in appropriate negotiated defense contracts made on and after July 1, 1975.

Even after that date, however, the requirements of the Standard are phased so that those contractors for whom accounting changes will be required will not experience the full impact of the Standard for many years. This long-delayed impact of this Standard on the negotiation of defense contracts will not even begin for most defense contractors until some time in 1978.

I would like to turn now to a discussion of the provisions of the Standard itself. The first point I would make--and it is a matter of very considerable significance--is that the Standard has not been challenged or questioned with respect to its accounting concepts or techniques. The purpose which the Congress prescribed for any Cost Accounting Standard is that it provide for fair and equitable means whereby costs under negotiated Government contracts may be measured and allocated to the Government business of the contractor, in such a way as to provide increased uniformity and consistency in cost accounting practices used in Government contracts. The Board has heard little criticism that Standard No. 409 fails to satisfy this primary, statutory requirement of all Cost Accounting Standards.

As I mentioned earlier, accounting for depreciation costs was clearly identified as a significant problem area, even before the Cost Accounting Standards Board was created. The Government's procurement regulations such as the Armed Services Procurement Regulation were relying

largely on financial accounting practices and Federal income tax regulations for the determination of depreciation costs. The Board's research showed that defense contractors often used minimum lives permitted for tax purposes for financial accounting rather than lives based on actual experience. During its research, the Board was also urged to rely on tax accounting for the determination of service lives. The Board recognized that contract costing often deals with the same expenditures and the same problems of allocation to time periods that are of interest in income tax accounting. The Board recognized however that tax regulations are intended to achieve a variety of social and economic goals quite foreign to the purposes of contract costing.

I should emphasize at this point that Cost Accounting Standards do not modify tax laws or accounting practices used for reporting Federal income taxes. Compliance with Standard No. 409 for contract cost accounting purposes will in no way affect the accounting practices a firm uses for making its tax returns, and accounting practices suitable for tax accounting will continue for that purpose.

Standard No. 409, which permits the determination of the proper measurement and allocation of depreciation costs under negotiated defense contracts should be of value to both the Government and the contractor. If a contractor performs nothing but defense work, it is important that his different defense contracts bear the correct costs of depreciation of the assets used in performance of those contracts. The costs of all procurements are distorted if some procurements bear disproportionately heavy depreciation costs while others bear disproportionately light depreciation costs. For the same reason, a contractor whose business is mixed between

defense and commercial business must be able to allocate the correct costs of depreciation to the defense portion of his business. Finally, it is in the public interest that the Government not be forced to continue to make premature borrowings or an unduly early use of its revenues to reimburse contractors for depreciation costs which under sound cost accounting principles would not be subject to reimbursement as early as they now are.

What then are the economic arguments being presented against Standard No. 409? Let me say briefly that the principal objections from those opposing the Standard have been that it will, several years from now, require them to base depreciation costs under negotiated defense contracts on estimates of the actual expected lives of the assets being depreciated, rather than on the shorter periods of time which they have up to now been entitled to use for tax purposes. The result of this future requirement will in most cases stretch out the period of time under which the costs of those assets will be reimbursed, from an artificially short period to a more realistic and longer period based on the experience of each company.

This in turn leads to what the opponents of the Standard see as a deprivation of cash-flow advantages which many defense contractors have enjoyed for many years. They believe that the effect of the Standard may inhibit investment in plant and equipment, that it may "strangle" capital formation and regeneration, and that it may adversely affect earnings.

The Board was of course well aware of the potential impact on many contractors' cash-flow of Standard 409, and it heard the arguments of the economic consequences of this impact from industry spokesmen. The Board sought to answer these arguments in its prefatory comments issued at the time the Board promulgated the Standard. For contractors who have been using realistic service lives, the Standard is likely to have little effect. For contractors who have not been using realistic service lives, what we indicated in the prefatory comments and would repeat today is that the Board understands that the stretching out of lives will deprive them of the cash-flow advantages which they have been realizing in the performance of those contracts.

The Board believes that if the profits made in the performance of defense contracts are inadequate to provide an incentive for the necessary investment in new plant and equipment or inadequate to provide sufficient incentive to American industry to undertake defense contracting, then this problem should be addressed directly by the procuring agencies in the application of, or in a reformulation of, their profit policies. The Board believes that profits should not be realized on the basis of inappropriate accounting practices. Profit objectives should be set openly and realistically as a matter of public policy. The Government obviously wants to retain its present supplier base and expand that base if possible. Profits should be sufficient and sufficiently visible to accomplish those objectives.

Contrariwise, we do not believe that Cost Accounting Standards should overlook real costs involved in fulfilling a negotiated contract. For example, the Cost Accounting Standards Board has under consideration the question of whether the cost of capital should be recognized as a cost in fulfillment of these contracts. Interest, as you know, is now disallowed. The Board does not have authority to direct that this policy be changed. However, we do have authority to require that these costs be identified and properly allocated as a cost in fulfilling negotiated contracts, and our staff is currently working on such a standard with this as our objective.

The Board deliberately delayed the impact of Standard No. 409 so that any necessary readjustments of Government profit policy could be made deliberately. Thus Standard No. 409 will have no impact at all on most Government contractors until some time in 1978, almost 3 years after its promulgation. Furthermore, even if the Standard begins at that time to affect the reimbursement of depreciation costs of some contractors, it will be three or four more years before that impact can possibly be substantial. The Board is fully confident that the Government and its suppliers, both current and potential, given several years within which to address themselves to the proper profit levels and the need for new plant and equipment for the performance of Government contracts, will resolve these matters equitably. These solutions can be arrived at in an atmosphere in which both parties can address themselves specifically to the profit and capital requirements of

Government suppliers, without the distortion which has persisted throughout prior years of consideration of these specific issues because of the availability to some of accounting practices which may produce unacknowledged profits during the performance of Government contracts.

One final argument has been made against the Standard which I have not specifically dealt with. That is that the Standard will require the establishment and maintenance of records bearing on the life of capital assets beyond anything presently established and maintained by defense contractors, and that this record-keeping requirement will be so burdensome and expensive that its costs themselves will outweigh any advantage to be derived from use of the Standard.

The Board gave careful consideration to these arguments prior to its promulgation of Standard No. 409. The Board responded to these concerns by providing that contractors might employ statistical sampling from existing records or judgmental samples with analyses to support a large portion of the dollar amounts involved. In this way, reasonable estimates may be developed through the use of relatively small samples. Furthermore, the Board urged procurement agencies to provide early written guidance to their field personnel on ways in which contractor estimates of the expected lives of assets will be evaluated by Government auditors and contracting officers. The Board also volunteered its own assistance, if requested, in the development of this guidance. Our assistance has indeed been requested, and our Staff is now working with Government agencies on this matter.

We have in this connection learned that the Department of Defense has surveyed 92 defense contractors, including large, medium and small firms, to determine the quality of their records of their fixed assets. Of that number, all 92 have records showing the acquisition dates of their assets, 91 have records showing the acquisition costs of those assets, and 82 have records showing the disposition date of those assets. The survey concluded that all of the 92 contractors have records which are either adequate to determine the service lives of assets or which are available for that purpose but required analysis to determine such lives. All of the 92 companies surveyed were found to have records adequate to be used as a base line for estimating the service lives of future acquisitions.

All of these companies and other defense contractors will have until some time in 1978 in which to develop the necessary estimates. The Board's belief that the record-keeping requirements of the Standard are not unusual and do not in fact require the huge majority of defense contractors to establish and maintain records which they do not already maintain appears to have been wholly justified.

I have taken some time to explain the way in which the Board researched the entire subject of depreciation before promulgating Standard No. 409. My purpose was to provide to you an understanding of the way in which the Board seeks to carry out its statutory responsibilities of promulgating this and all other Cost Accounting

Standards to achieve greater uniformity and consistency in the cost accounting practices used by defense contractors and subcontractors.

The Board's research, development, testing, consideration, and reconsideration of proposals have been exhaustive, have been conducted objectively by skilled professional staff, and have resulted in Cost Accounting Standards which we believe are most likely to satisfy the requirements which the Congress through Public Law 91-379 has placed upon the Board.

Having entered a strong defense of the Board's action, let me hasten to add that we will proceed with an open mind and, should experience indicate the desirability of a modification of the Standard, you can be assured that we will make the appropriate changes. This principle applies to all of the Standards issued by the Board, and for this reason we have agreed that we need to systematically assess from time to time how these Standards are working out. We do this on a continuing basis. In addition, we have scheduled in early June a 2-day conference in Chicago specifically for this purpose at which we will hear the views of all interested parties with respect to the Standards which have been in effect for a reasonable period of time.

I am prepared to respond to your questions at this point.

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ATTACHMENT A

Summary of
Cost Accounting Standards Board Achievements
and Activities, 1970-1974

The Cost Accounting Standards Board was established as an agent of the Congress and independent of the executive departments by enactment of Public Law 91-379 on August 15, 1970.

In January 1971, following appropriations for the work of the Board, I appointed the four persons who first served with me on the Board. These were Mr. Herman W. Bevis, who was Senior Partner of Price Waterhouse & Co., Certified Public Accountants; Mr. Robert K. Mautz, who is currently a Partner in the firm of Ernst & Ernst, Certified Public Accountants; Mr. Charles A. Dana, who is Director of Government Accounting Controls of Raytheon Company; and the Honorable Robert C. Moot who was Assistant Secretary (Comptroller) of the Department of Defense. The terms of those four Board Members expired early in 1975, and I reappointed Mr. Bevis and Mr. Mautz to second terms. The Honorable Terence E. McClary, now the Assistant Secretary of Defense (Comptroller) was appointed to succeed Mr. Moot; and Mr. John M. Walker, Vice President and Controller of Texas Instruments, Incorporated, was appointed to succeed Mr. Dana.

Early in 1971, the Board selected Mr. Arthur Schoenhaut as its Executive Secretary, and a small full-time staff--now numbering 24 professional persons--was soon formed.

The Board generally holds monthly meetings lasting from one to three days. The Board operates on the basis of staff papers, and each Board Member is personally briefed by the staff in advance of each Board meeting on the items included in the meeting agenda. Board Members are in frequent communication with the staff on materials being developed by the staff. Thus, the Board Members are deeply involved in all aspects of research and development of Standards and regulations.

The Board has promulgated nine Cost Accounting Standards and implementing regulations; seven of them are now required to be included in negotiated defense contracts and subcontracts covered by Public Law 91-379. Standards Nos. 408 and 409 will be included in such contracts made on and after July 1, 1975.

The nine Cost Accounting Standards promulgated by the Board to date are:

- No. 401 Consistency in Estimating, Accumulating, and Reporting Costs
- No. 402 Consistency in Allocating Costs Incurred for the Same Purpose

- No. 403 Allocation of Home Office Expenses to Segments
- No. 404 Capitalization of Tangible Assets
- No. 405 Accounting for Unallowable Costs
- No. 406 Cost Accounting Period
- No. 407 Use of Standard Costs for Direct Material and Direct Labor
- No. 408 Accounting for Costs of Compensated Personal Absence
- No. 409 Depreciation of Tangible Capital Assets

The Board has also solicited comments from the general public on a proposal for Standard No. 410, dealing with allocation of business unit general and administrative expenses to cost objectives, and a proposal for Standard No. 411, concerned with accounting for acquisition costs of material. Comments submitted to the Board on these proposals are being analyzed prior to Board consideration of whether to go forward with promulgation of Cost Accounting Standards on the two subjects.

The Board is working on approximately 10 additional subjects, many of which we believe will culminate in Cost Accounting Standards.

The Board has also designed a Disclosure Statement of cost accounting practices which certain contractors must submit to the Government as a condition of contracting. These Disclosure Statements require major defense contractors to describe the principal practices they will follow for applicable

negotiated defense contracts. Initially, each contractor who received negotiated prime defense awards in excess of \$30 million in Fiscal Year 1971 was required to submit a Disclosure Statement. The Board amended that regulation to provide that, beginning April 1, 1974, Disclosure Statements were also required from companies which received in excess of \$10 million of negotiated prime defense contracts of the kind subject to the Board's jurisdiction in either Fiscal Year 1972 or Fiscal Year 1973. The Board has only recently published a proposed amendment to its regulations on the Disclosure Statement which, if adopted, would require firms to file Disclosure Statements on the basis of awards received in subsequent fiscal years.

As of March 31, 1975, the Board had received copies of 1,260 Disclosure Statements from 155 multi-divisional companies required to make disclosure of cost accounting practices to the Government. The Board has established a computerized data bank into which are placed the responses contained in every Disclosure Statement received. We have the capacity now to provide aggregate data with respect to any question or combination of questions covered by the Disclosure Statement. This data bank is of considerable assistance to the Board in its research into possible Standards.

In 1974 the Board promulgated a Disclosure Statement for use by colleges and universities receiving defense contracts and subcontracts. The Statement closely parallels the Disclosure Statement submitted by commercial firms but is designed specifically for use by colleges and universities.

In 1974 the Board completed a study leading to establishment of a contract threshold amount below which the Board's Standards and regulations need not be followed. The Board decided to increase the exemption from the statutory limit of \$100,000 to \$500,000. The increase became effective January 1, 1975. Based on Department of Defense statistics, the Board estimates that about 70 percent of the companies receiving DOD prime contract awards representing only about ten percent of the total dollar value of annual DOD contract awards, will be exempt. Contractors who do not receive a covered contract in excess of \$500,000 can, however, elect to comply with the Board's Standards and regulations.

Recognizing that cooperation by departments and agencies of the Executive Branch would be very important in achieving the full benefit of its regulations and Standards, the Board established an Interagency Advisory Committee in 1972. The Committee is composed of controller and procurement representatives of the Energy Research and Development Administration, the Department of Defense, the General Services Administration,

the National Aeronautics and Space Administration, the Department of Health, Education and Welfare, and the Department of Transportation. The Committee is chaired by a representative of the General Services Administration.

The cooperative spirit of this Committee and of the individual Federal agencies involved has materially assisted in the implementation of promulgated Standards, rules and regulations. For example, the Atomic Energy Commission, the Department of Defense and the National Aeronautics and Space Administration, the original three principal relevant Federal agencies under Public Law 91-379, have issued uniform implementing regulations. The General Services Administration, in its publication of the Federal Procurement Regulations provided that, with certain exceptions, the Board's Standards, rules, and regulations, as a matter of policy, are to be extended to nondefense contracts, thus better assuring consistent application of Board issuances to contractors having both defense and nondefense contracts.

To improve understanding of the Board's fundamental objectives and concepts and thus to provide the basis for a productive dialogue with those concerned with the Board's work, the Board formulated and published in March 1973, a Statement of Operating Policies, Procedures and Objectives. Interested members of the public should, on the basis of this Statement, be better able to focus on the complex and difficult substantive issues which the Board faces in promulgating Cost Accounting Standards.

The task of issuing sound, fair Cost Accounting Standards is exceedingly complex. To assist the Board in achieving its objectives, the Board has actively sought the cooperation of all those who have an interest in its work. The Board has established active, open consultations with representatives of all groups, including Government agencies, professional and industry associations, the academic community, and representatives of individual companies. Participation on both an individual basis and an organizational basis has been excellent. There are now more than 1,500 organizations and individuals to whom Board proposals and promulgations are regularly mailed during the course of the Board's research. These organizations and individuals generally have provided constructive reviews and comments on Board materials.

As an aspect of its conviction of the need for candid and regular communication with industry and Executive Branch agencies and also of its continuing concern for the orderly implementation of its rules, regulations, and Cost Accounting Standards, the Board undertook to sponsor in 1972 and 1973 a series of 1-day briefing sessions held throughout the country for both Government and industry representatives to explain its Standards and regulations. We estimate that approximately 11,000 persons attended those sessions.

Believing that training should be assumed by established training organizations, at least after the Board's early materials had been covered in Board-conducted sessions, the Board in 1974 encouraged

the Civil Service Commission, the Army Logistics Management Center, and the American Institute of Certified Public Accountants to establish and maintain training courses in Cost Accounting Standards matters. The Board worked closely with those organizations in the preparation of their courses and continues to provide assistance with respect to the course material and also to provide occasional speakers at the training sessions.

As a further example of the Board's earnest desire to foster communications between itself and defense industries, the Board has announced that it will hold in June of this year an Evaluation Conference on Promulgated Standards and Regulations. The conference will be held in Chicago, Illinois, in order to facilitate attendance by any interested persons. Anyone wishing to appear before the Board to discuss his company's experience with promulgated Standards and regulations is invited to participate in the conference. The conference will also be open to the general public. There are early indications that industry greatly welcomes this opportunity to meet directly with the Board and that attendance at the conference will be high.

To assure effective coordination of the work of the Board with other agencies and groups concerned with accounting principles, the Board has established and maintains regular exchanges with the Securities and Exchange Commission, the Internal Revenue Service, and the principal standard-setting body in the private sector, the Financial Accounting Standards Board.