

Adequacy of Contractors' Cost Records

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GAO's study of the feasibility of establishing and applying cost accounting standards in the negotiation and administration of defense contracts, as required by Public Law 90-370, was described in the GAO Review, Spring 1970. In connection with this study, 15 GAO regional offices made a special inquiry into the nature and extent of cost accounting systems and related records maintained by selected contractors.

A provision of the Armed Services Procurement Act, as revised in 1956, (10 U.S.C. 2313(h)), sets forth that:

• • • each contract negotiated under this chapter shall provide that the Comptroller General and his representatives are entitled, until the expiration of three years after final payment, to examine any books, documents, papers, or records of the contractor, or any of his subcontractors, that directly pertain to, and involve transactions relating to, the contract or subcontract.

The approach taken in making this review was to gather information on the characteristics of cost records maintained by defense contractors and evaluate their usefulness for specific purposes. The cost accounting records of 45 contractors were examined. The selection included large, medium, and

small contractors engaged in both Government and commercial work on a wide variety of products. Of these contractors, 18 had total annual sales of more than \$50 million; 14 had annual sales ranging between \$15 million and \$50 million; and 13 had annual sales of less than \$15 million.

Efforts were directed toward ascertaining whether contractor cost accounting records and the records used to support price proposals for negotiated contracts were generally adequate; in particular, the purpose of the study was to find out:

—Whether the accounting system provided sufficient data to determine the cost of performing given contracts.

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—Whether the accounting records permitted pricing evaluation reviews.

—Whether they were useful for other evaluation reviews such as those for terminations, delay claims, or change-order pricing.

A byproduct of this inquiry was the information it provided on the extent of similarity and/or uniformity of cost records presently prepared by defense contractors. This information should be useful to the Cost Accounting Standards Board.

Results of Survey

The survey showed that supporting documentation was maintained by all contractors for basic accounting transactions. Material costs, both direct and indirect, and regardless of the type of accounting system, were supported by records such as purchase orders, invoices, receiving reports, vouchers, and paid checks. Similarly, labor costs, both direct and indirect, were supported by some form of labor timecard or job ticket and other payroll and payment records. To this extent the survey showed a general uniformity in types of cost records in use by contractors.

The area in which contractors' cost records were found to differ was in the summary records prepared from the above source documents. Reports for management summarized material, labor, and overhead costs in many forms. For example, labor costs were summarized by contract, work package, labor classification, or whatever other form was required by management or the customer.

As shown below, several types of cost systems were found among the 45 contractors:

<i>Type of cost system</i>	<i>Number of contractors</i>
Job order	35
Process	2
Product	3
Departmental	1
Job order/process	1
Job order/product	1
None	2
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	45
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There was little relationship between the type of cost accounting system and the type of summary or report-type records available.

During the survey emphasis was directed to the following:

- Adequacy of contractor cost accounting records for the calculation of cost of performance.
- Identification of costs by contract, line item, and change order.
- Inclusion in contractor records of the information required for pricing reviews.
- Comparability of proposal costs with incurred costs.

Each of these points is commented upon below.

Calculation of Cost of Performance

From the results of our inquiries, we classified the adequacy of contractor cost accounting records for the calculation of cost performance. (See the table on the following page.)

Noteworthy is the fact that the contractors whose records were inadequate were in the lower sales volume groups and that more than half in the third group were inadequate.

Annual sales volume	Number of contractors	Records considered	
		Adequate	Inadequate
Over \$50 million.....	18	18
\$15 to \$50 million.....	14	11	3 or 21%
Under \$15 million.....	13	6	7 or 54%
Total.....	45	35	10

The 10 contractors whose records were inadequate employed a variety of cost accounting systems and practices, but there was little correlation of the type of system with the type of product or the volume of Government sales.

Of the 10 inadequate accounting systems, two did provide for the recording of costs by contractor or job order, but neither of the two contractors effectively administered its system. For those contractors who employed other than a job order system, our conclusions that sufficient data were not available were based on overall aspects of the systems or practices. For example, one contractor's costs were recorded by department; as a result, costs applicable to Government work were not identifiable to specific contracts or products. Two small contractors who had no cost systems maintained only records required for basic financial requirements and operating statements.

Overall, the survey results suggest that the nonavailability of sufficient summary data to provide cost of performance by contract may be limited to relatively small companies having a low volume or percentage of Government sales. However, the aggregate of their prime and subcontract sales to the Government is likely to be quite substantial even though the relatively small size of

the individual contracts may generally exempt their records from any critical scrutiny to determine the bases for pricing.

The larger defense contractors segregate costs in such a manner that summary data related to overall costs of performance are readily available. They maintain not only source documents but also summaries that identify, in one format or another, costs associated with total contractual effort. However, in only a relatively few cases are contract costs segregated as between basic contract costs and separately negotiated modifications to the contract. These contractors, who receive a large percentage of the defense procurement dollars, already have, in effect, standards of their own for summarizing costs.

The reason or reasons for this difference in recordkeeping between large and small contractors were not developed in depth during this survey. In the case of the smaller contractor, however, it appears that management is more closely associated with production and other aspects of operations; thus there is less need for records to provide a cost control or a reporting system. Conversely, the larger contractor whose management is possibly three or four echelons removed from operations finds

that a comprehensive reporting system is essential for the assembly of data for informed decisions.

A contractor whose involvement is substantial in either Government or commercial work, or both, develops and records significant cost accounting data because they are needed for effective operations. With respect to inadequate records, the most critically affected group of Government contractors may be expected to be those who have outgrown the personalized control possible in the small enterprise but have not yet adopted the sophisticated reporting practices that are indispensable when responsibility must be delegated. The adverse effect on the contractor will, to some extent, almost always be passed on to the Government.

Although summary data related to cost of performance of the smaller contractors may not be available or readily assembled, and the volume of transactions involved might seem to limit the significance of this problem area, the facts, if available, might well show that this is not the case. Reviews made by the GAO Philadelphia Regional Office have disclosed indications of significant overpricing which were not reported because of the inadequacy of documentation available to GAO from existing accounting records. On the other hand, we have seen instances where failure to summarize cost data in the normal course of operations has caused contractors to be unaware of or to overlook costs that would be acceptable in price negotiations.

With respect to contractor records providing cost of performance, we made determinations as to adequacy on the basis of contractor definitions and

procedures. However, from the survey it appears that the problem is not only whether records are available by which a contractor's interpretation of cost of performance can be evaluated, but also whether the various treatments employed by contractors yield uniform and meaningful cost determinations.

Identification of Costs by Contract, Line Item, and Change Order

We found that contractors whose accounting records permit a calculation of cost of performance generally provide for identification of cost by contract. The survey, however, indicated instances where adequate determinations of cost of performance could be made even though costs were not recorded by contract. Typical of such a situation is one in which a contractor with a process or product line cost system has records that require only the establishment of individual contract production cutoff points to identify the shop costs related to a contract. Applicable general and administrative and other costs could then be allocated.

Both large and small contractors tended to minimize the need for cost reporting systems refined to the point of associating incurred costs to line items or change orders. Although the reasons for minimizing such refinements in their costs systems were not developed as a part of this survey, we believe they represent the difference between satisfying the recognized needs of company management and the Government in the identification of costs.

The identification of cost by line item or change order is, nevertheless, necessary in certain instances. For example,

contractors' claims against the Government occur with some frequency and a reasonably precise identification of cost is necessary if an equitable settlement is to be achieved. In addition, congressional inquiries regarding contract overruns may request an identification of cost not only by contract but also by items procured under the contract. Also, the segregation of cost by line item and/or change order generally provides a better basis for identifying procurement and/or production weaknesses. All in all, it would seem that such a desirable refinement of costs has depended primarily on a company's view as to whether the value to management exceeded the added cost.

The Defense Contract Audit Agency and contracting officers are continually required to make pricing decisions that rest on the reasonableness and validity of contract costs. In addition the Armed Services Board of Contract Appeals, the GAO, and the Federal courts are from time to time involved in efforts which require determination of the reasonableness or equitability of contract costs. The fact that such reviews may be necessary makes difficult any persuasive argument for denying the need for records to be kept in such a manner as to permit identification, when necessary, of cost by significant line item and/or change order, especially for the larger procurements.

Information Required for Pricing Reviews

Reviews of pricing proposals could not be effectively performed at the plants of several relatively small contractors. Comparisons of proposal costs with costs of performance for these

contractors could not be made because data related to cost of performance were not recorded by contract, line item, or change order to permit comparison with pricing proposals. As indicated previously, individual instances of such a condition may not be significant in respect to possible adverse contract pricing. However, the author believes that in the aggregate a significant number of Government procurements and contracting entities are seldom subjected to the restraints provided by independent reviews of pricing and pricing practices.

For the larger contractors, historical cost data were considered generally adequate for pricing reviews. It was noted that contractor records generally were retained for a sufficient period to satisfy any postaward audit requirements.

Comparison of Proposed and Incurred Costs

Not all desirable comparisons of proposed and incurred costs could be made readily for 20 of the 45 contractors surveyed. For some of these contractors, summaries of cost of performance were not available; for others, certain comparisons could not be made for reasons such as the commingling of basic contract costs and change order costs. The deficiencies here concerned the smaller contractors and contracts. We feel that a close line of reference should exist between the classifications of proposed costs and actual costs.

The inability to make a reasonable comparison appears to be the result of a lack of similarity between estimating and accounting systems. Although such comparisons may not provide a total measure of a contractor's efficiency,

reliability, or overall technical capability, they do provide a common basis for evaluating the performance of a contract, procurement decisions, and/or the effectiveness of operations by contractor officials as well as by those Government representatives with related responsibilities.

The degree to which contract costs should be segregated depends upon the specific circumstances involved. A clear relationship between line item costs on a proposal and the costs subsequently recorded for the contract should be evident. Where this relationship is not evident, the identification of costs by contract and cost element should be the minimum requirement for cost presentation. With respect to the recording of such data, regulations or standards could provide for specific contractual agreement on the identification of costs by change order whenever practicable and necessary. In many instances, the segregation of change order costs may be neither feasible nor economical. In such instances, contractors might be required to satisfy Government procurement officials, generally in advance of performance, as to why costs of change orders cannot or should not be identified.

Improvement in the auditability of proposals and performance data for any desired review, including those for postaward audit or contract pricing purposes, depends largely on improvement in estimating and cost accounting systems and a corresponding improvement in the relationship between these systems.

Concluding Comments

As mentioned previously, the direction taken in this inquiry was to gather information on the kinds of records kept by defense contractors and the adequacy of the records for examinations made by the Comptroller General. All of the 45 contractors surveyed maintained basic transaction records. From that point their accounting summations ranged from simple operating statements prepared on an enterprise basis to highly sophisticated statements prepared in great detail on a division, plant, contract, task, product, process, or other basis.

The existence of a wide variety of systemized cost controls certainly is no surprise to the accountant with broad commercial or Government experience. Correspondingly, it should be no great surprise to find inconsistencies among contractors as to what should be the nature of any selected cost accounting principles to be applied in the identification, classification, and control of costs. Cost control systems, whatever their form, can be guided by broadly defined cost accounting standards, when established, generally without radically changing present systems or attempting to introduce uniform systems. Existing cost controls provide a valuable fund of information on procedures and systems which could serve as a framework for the development and application of sound cost accounting standards that will gain general acceptance.