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Evaluation Conference -- Cost Accounting Standards; Evaluation Conference -- Transcript of proceedings, January 12-13, 1977

Cost Accounting Standards Board

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Cost Accounting Standards Board

**Evaluation
Conference**

**Transcript Of
Proceedings**

October 12 – 13, 1977

COST ACCOUNTING STANDARDS BOARD

**SHERATON HOTEL
810 Sunrise Valley Drive
Conference Room A
Reston, Virginia**

October 12-13, 1977

**ELMER B. STAATS,
Chairman**

HERMAN W. BEVIS, Board Member

ROBERT K. MAUTZ, Board Member

FRED P. WACKER, Board Member

JOHN M. WALKER, Board Member

ROBERT KELLER, Deputy Comptroller General

BERTOLD BODENHEIMER, Acting Executive Secretary

J. JETT McCORMICK, Acting General Counsel

TABLE OF CONTENTS

| | |
|---|-------|
| Opening Remarks: Elmer B. Staats, Chairman Cost Accounting Standards Board | 1-3 |
| Statement of Donald Wait | 1-15 |
| Statement of Mortimer Dittenhofer | 1-22 |
| Statement of Robert W. Williamson | 1-36 |
| Statement of Gordon M. Johns | 1-52 |
| Statement of Ronald L. Leach | 1-65 |
| Statement of Franklin R. Johnson | 1-79 |
| Statement of Dr. Howard Wright | 1-93 |
| Statement of Ray Kleinberg | 1-118 |
| Statement of Philip J. Blattau | 1-139 |
| Statement of Gary Hill | 1-154 |
| Open Discussion | 1-167 |
| Statement of Philip J. Blattau | 2-4 |
| Statement of Lester Fettig | 2-36 |
| Statement of Howard Teeter | 2-42 |
| Statement of David J. Mahrer | 2-62 |
| Statement of Paul Anderson | 2-73 |

P R O C E E D I N G S

(9:00 a.m.)

CHAIRMAN STAATS: I believe our microphones are working here now so we can get under way.

I want to welcome all of you here to this conference where we hope to learn from you how we can make the Cost Accounting Standards Board operation more effective.

I would like to introduce those of us here at the table: Down at my end -- at the left -- is Board member John Walker, Senior Vice-President and Treasurer of Texas Instruments. Fred Wacker -- next to him -- is Assistant Secretary of Defense, a member of the Board.

Bob Mautz, who is a partner in Ernst and Ernst, a member of the Board. Herman Bevis, Senior Citizen --

(laughter.)

CHAIRMAN STAATS: Also a member of the Board and, on my right, Bert Bodenheimer, who is acting for Art Schoenhaut. Art, as you may have heard, has had an operation and is in the hospital.

And, Jett McCormick is here -- counsel for the Board and Bob Keller, at the end, is the Deputy Comptroller General and serves as Vice Chairman of this Board.

I would like to say that the purpose of this conference is to emphasize what we have already communicated --

to obtain suggestions to improve the effectiveness of the Standards.

As we stated in the announcement of the conference, we are particularly hopeful of obtaining advice and suggestions relative to the measurement of cost and benefits in order to assist the Board in its evaluation of future Standards.

The Board regards this meeting with you as being important in its continuing efforts to improve the effectiveness of its efforts to fulfill the responsibilities assigned to it by the Congress.

Many of you were present at the Board's first Evaluation Conference held in Chicago in June 1975. At that time we obtained a good many suggestions concerning the Board's operations.

After reviewing the record of that Conference, the Board established three projects which it believed would be responsive to many of the comments made by persons who appeared at the Evaluation Conference, or persons who submitted papers for the Board's consideration.

The projects which we established were directed toward the following three areas:

One: Establishing more definitive materiality criteria.

Two: Defining the meaning of cost accounting

practices as used in the Board's regulations, and

Three: investigating means by which the CASB could more expeditiously and directly participate in the resolution or the avoidance of implementation and contract administration problems.

I would like to give you a brief summary of our efforts relative to these projects before going on to the agenda for this second Evaluation Conference.

I would like to discuss first our activity relative to the resolution of implementation and contract administration problems.

Members of the CASB staff contacted 23 different companies -- including 10 who were participants in the first Evaluation Conference -- to obtain a better understanding of the nature and scope of the problems being experienced by contractors.

The issues which appeared to give the most trouble fell into three areas:

One: Contract administration;

Two: Operation of standards;

Three: Cost accounting practices.

A great many of the problems in the contract administration area appeared to be unique to specific situations arising between a contractor and its cognizant government

representatives.

The Board feels that while some effort may be devoted to assisting in resolution of these individual problems, they are not of such a general nature as to warrant additional or amended CASB regulations.

Further, these problems are essentially matters over which the procurement agencies have cognizance and are in a position to resolve.

The Staff's findings were turned over to the Department of Defense CAS Working Group. I think that substantial progress has been made in this area due to the efforts of the CAS Working Group which has prepared a series of guideline papers to provide answers to questions which have arisen in contract administration.

We have furnished comments on the various guideline papers and we are confident the Working Group's efforts will assist both government representatives and contractors in either avoiding contract administration problems or resolving them expeditiously.

Further, we are maintaining a close relationship with the Army Logistics Management Center and other training organizations which offer instructions in CASB matters.

While we had contemplated that we would be more directly involved in training, the Office of Federal Procurement Policy has assumed responsibility for overall procurement

training of Government personnel and it will cover CAS matters in this training. We have offered to provide such assistance as we can in this educational process.

I would like to say as an aside here that we have met yesterday with Mr. Fetting. It was our first meeting with him. We believe he can be helpful to our Board in two other ways: One, as Chairman of the Inter-Agency Committee of the Executive Branch, he can assist a great deal in inter-agency problems.

Secondly, -- pursuant to his policy -- we are generally hopeful of avoiding duplicate or different regulations applying to different agencies.

Being of the Executive Branch, he is in a unique position to assist in the prevention of this sort of thing from happening.

He will be joining us a little later on in our discussions and will have an opportunity to make a few comments.

In the area of operation of standards, the Board -- after detailed consideration of various problems raised by contractors -- concluded that the CASB's role would of necessity be advisory to the procurement agencies unless the circumstances were such that a change to a Standard, rule or regulation or an interpretation of a Standard was required.

The Board has in the past amended its contract

clause and other regulations as well as issuing interpretations to CAS 401 and 402.

We are ready at anytime to consider amendments or interpretations to the Standards, rules and regulations if wide spread problems arise.

Each of the problems disclosed by our review again appeared unique to a given contractor, and our role seems best suited to assisting informally in helping the parties resolve the specific problem.

Now, the third group of problems in implementation seemed to correspond to the project which we established to define "cost accounting practice" and "change in cost accounting practice."

In mid-1976, a staff draft containing definitions of the two terms and dealing with materiality criteria was distributed to a large number of interested parties and, in February of this year, proposed definitions and criteria were published in the Federal Register.

We received numerous comments on our proposals from contractors, trade associations, Governmental agencies and accounting associations.

The Board considered the matter at several of its meetings and at its September 1977 meeting voted to promulgate amendments to its regulations concerning criteria on materiality.

This amendment to the Board's regulations appeared in the Federal Register of October 5, 1977. At its meeting yesterday the Board gave further consideration to the question of cost accounting practices and changes in practices as well as the effect of changes.

As a result, it is republishing this material -- together with proposed changes in the contract clause. In general, the proposed change in the clause adds a provision that when the contracting officer considers that a proposed accounting change is desirable and not detrimental to the interests of the Government, there can be an equitable adjustment in affected contracts.

Absent agreement, the change may be made, but at no increased cost to the Government. The provisions concerning equitable adjustment for new Standards and the results of non-compliance have not been changed. Your comments, of course, on these changes are invited.

I don't want to leave the impression that the Board is devoting all of its attention to questions about existing Standards and regulations.

The Board has active projects on a number of potential additional Standards.

As many of you know, most recently the staff has been devoting considerable attention to subjects dealing with

overhead costs.

Potential Standards in this area include distinguishing between direct and indirect costs; accounting for indirect costs; allocation of manufacturing, engineering and service overhead costs; accounting for the costs of service centers; and allocation of material related overhead costs.

In addition, the Board has recently published for comment in the Federal Register a proposed Standard on Accounting for Insurance Costs.

Other subjects on our work plan include: Joint product costing; accounting for contract terminations and excess capacity; indirect costs of colleges and universities; contract changes; cost of money as an element of operating capital; and independent research and development costs.

I would now like to go on with the agenda for this conference:

As our notice of the Conference stated, this meeting is being undertaken to receive suggestions and recommendations to improve the effectiveness of CAS rules and regulations, and to enhance their utility in contract negotiation, administration and audit.

It is hoped that each suggestion or recommendation will, to the extent possible, be substantiated by examples

and data arrived at from experience.

However, we welcome any constructive criticism and suggestions which you feel will assist the Board in its efforts.

At the time of the first Conference only Standards 401 through 406 had been in effect for more than a year, and our evaluation was primarily on those Standards.

Since then, nine additional standards have been issued as well as interpretations of Standards 401 and 402, so that the subjects which can be covered are approximately twice the number that was available at the prior Conference.

However, since Standards 413 and 415 have been promulgated for only a limited period of time, we did not include these in the subject matter on which we elected to have comments.

But, if you have recommendations to make on these two standards, obviously, your comments will be considered by the Board.

One of the major areas which is always discussed in connection with the Board's operations is that of comparing costs and benefits.

The statute under which the Board operates requires that the Board take into account "the probable cost of implementation, including inflationary effects -- if any --

compared to the probable benefits, including advantages and improvement in pricing, administration and settlement of contracts."

The Board, in its recently published Restatement of objectives, Policies and Concepts, included a section on its views of costs and benefits.

It states what is considered to be cost and what is considered to be benefits.

Since the Board's first promulgation in 1972, some commentators have expressed the view that the Board should be more precise in its comparisons of costs and benefits, apparently feeling that these two elements should be quantified in some manner.

The Board normally requests that persons reviewing a proposed Standard tell the Board how much it would cost to implement it.

The responses have been that either there will be no particular cost, or if costs are anticipated to be incurred in implementation, only general estimates are given.

Even if the respondents were to make more precise estimates, we would have only the statements of those who do respond, leaving the Board without data from other affected sources.

However, as we stated in our announcement, we are

interested in receiving comments on the Board's position as contained in its Restatement of Objectives, Policies and Concepts, and we are interested in suggestions as to ways in which costs and benefits may be quantified.

We are here to receive your constructive criticism. We welcome general comments but what we need are specific suggestions as to how we can make prior and future Standards better and more workable.

We are going to have oral statements from five accounting associations, one from a public accounting firm and from four contractors and four industry associations, in that order, over the next two days.

In addition, we have received written statements from interested parties who will not be making oral presentations. All of the printed statements and/or presentations will be published as part of the record of this Conference.

You will be able to purchase a copy of the complete record if you so desire.

I might say here that we are making advance notice to people who plan to make presentations, that we hope that some of the people who were scheduled for tomorrow, will be able to make them sometime this afternoon.

In other words, we want to be optimistic about our schedule and we would like, if at all possible, to finish up

by noon tomorrow.

We are interested in hearing what we can get from you in obviously a very limited amount of time for all of us.

We will hear first this morning from the National Association of Accountants, Mr. Donald Wait.

STATEMENT OF DONALD J. WAIT

NATIONAL ASSOCIATION OF ACCOUNTANTS

MR. WAIT: My name is Donald Wait and I am Consultant-Product Cost accounting on the Corporate Finance Staff of the General Electric Company.

However, I am here representing the National Association of Accountants, in response to your specific invitation to our President.

More specifically, I am appearing as a member of the Management Accounting Practices Committee of NAA.

We appreciate the opportunity to summarize the viewpoints regarding the Standards and Regulations of the Cost Accounting Standards Board as expressed in our written communication to the Board.

Among its functions, the Management Accounting Practices Committee regularly submits comments to the Cost Accounting Standards Board, or to Staff members, on proposed Standards.

We have had a close, and to us very satisfactory, working relationship with the Staff in this respect and look forward to continuing it.

As you know, NAA is an association of individual accountants primarily devoted to educational services to its members.

It does not, in any way, represent the companies,

public accounting firms or schools where its members are employed.

Consequently, our Committee has very limited knowledge as to experience under the Standards and Regulations promulgated to date.

In view of this, we have no comments to make on the application of the individual Standards listed in the Federal Register notice.

Our committee, in fact, has no substantial disagreement with the overall effectiveness of the Standards and Regulations issued to date even though we have not always been in full agreement with the final Standards.

In our written statement, we did point out, however, three areas which have been of primary concern to the Committee over the past several years in reviewing the proposed Standards.

First, a tendency to mandate specific practices rather than defining a framework within which practices might be developed.

Although we see the need for this in some instances, we urge the Board and the Staff to mandate specific practices only where necessary not as an expedient to the extra effort that may be involved in defining a true standard.

Although I do not propose to reopen discussion of specific Standards, CAS 403 might be cited as one unnecessary

example of this tendency.

Second, an impression that provisions in some Standards are aimed at forbidding specific abuses. It seems to our Committee members that most such abuses must be limited to one or a few contractors.

Wherever possible, we believe the Government should be correcting these specific situations rather than issuing generally applicable restrictive and detailed Standards.

Since this is primarily an impression resulting from informal conversations, it seems best not to attempt to cite examples.

Third, a tendency towards ever greater refinement of indirect costs. Although some refinement of past allocation practices is probably correct conceptually and desirable, more is not necessarily better.

Excessive fragmentation of indirect costs means unproductive additional expense by contractor organizations. Moreover, it can lead to allocations that are mechanically correct but represent spurious accuracy.

CAS 403 may also be cited as indicative of this tendency but what concerns us most is the possible total effect of all existing and proposed Standards.

The Board has also invited comments on its Restatement of Objectives, Policies and Concepts and, specifically, on the provision relating to comparing costs and

benefits.

Our Committee believes the published statement is generally adequate while recognizing that various sections are subject to differing interpretation or to application in ways we might not consider appropriate.

We know of no uniform method of comparing costs and benefits. In fact, we believe that this subject must be addressed:

One: In the context of each specific proposed Standard, and;

Two: Through the exercise of judgment rather than through detailed and burdensome comparisons.

However, we do believe the Board should be mindful of the cumulative cost of fragmentation of indirect cost imposed by a number of standards not simply judge each one separately.

In addition, we would like to emphasize that all cost benefit comparisons properly include the delineation of alternatives which may produce most of the benefit at significantly less cost and thus have a better cost benefit ratio than an initial proposal -- even though the initial proposal might in itself be satisfactory.

Finally, we wish to commend the Board for expanding its exemption levels as published in the Federal Register on September 12th.

We are particularly sensitive to the burden of conforming to Standards by NAA members in small companies which do not have the staff, funds or time to do so and we find the exemption of all small business concerns very appropriate.

The lost benefit from this exemption, if any, will certainly be nominal. Moreover, we believe that those Standards which are conceptually sound will eventually become common practice on a voluntary basis throughout industry.

It is the overall opinion of the Management Accounting Practices Committee that the Cost Accounting Standards Board and its Staff are doing a conscientious job in this difficult area where there is room for much difference of unbiased opinion, and where conflicting interests often exist.

We repeat our appreciation of the opportunity to comment and hope that our comments will be viewed as constructive.

If you have any questions concerning our written statement or my comments today, I shall be pleased to try to answer them.

Thank you.

See Appendix I for entire statement.

CHAIRMAN STAATS: Thank you very much for your statement.

I do have one question: Your reference to use of alternatives -- did you have in mind here that when we go for first publication we might outline alternative approaches or thinking, rather than in a given Standard as finally promulgated, that industry would be allowed to select alternative practices?

MR. WAIT: The former. I am saying that in making cost benefits comparisons, one really needs to look at well, can you get 90 percent of this benefit -- something that means a lot less burden.

CHAIRMAN STAATS: I would like to say for your benefit, as well as the rest of us here, that we have to draw this distinction between cost and benefits on given Standards and the cumulative effect of all Standards, and I doubt if we could have written the exemption Standard much earlier than we did.

It was partly out of recognition of the cumulative effect on small business -- that we decided to go ahead. I think your point is very well taken. The Board is very mindful that as time goes along we are going to have to give more attention to the second aspect -- the cumulative aspect.

MR. WAIT: I am very glad to hear that.

MR. BEVIS: I don't think I have any questions. No.

CHAIRMAN STAATS: I might say for the benefit of the rest of the group that NAA has been very helpful to this Board from its very inception.

I recall a statement of 10 principles which were developed by the NAA at the outset. I think you will find some of those principles still in existence in our written material.

So, thank you very much.

Now we are going to hear from the Association of Government Accountants. I believe we have Mr. Dittenhofer, the Executive Vice President.

You may proceed.

STATEMENT OF MORTIMER DITTENHOFER
ASSOCIATION OF GOVERNMENT ACCOUNTANTS

MR. DITTENHOFER: Thank you.

CHAIRMAN STAATS: If you can keep your statement fairly brief, it will give us a chance to ask questions.

MR. DITTENHOFER: My name is Mortimer Dittenhofer and I am the Executive Vice President of the Association of Government Accountants.

I am here today to discuss the results of our survey of the membership of the Association of Government Accountants concerning these cost accounting Standards.

The Association of Government Accountants is a professional association of approximately 10,000 government members in 75 chapters throughout the world, primarily in the United States.

With me today are Harold Stugart, Chairman of the Financial Management Standards Board of the Association, and also Chairman of the Ad Hoc Task Force that carried out this survey; John Crehan, former Chairman of the Financial Management Standards Board, under whose direction this survey was initiated; and Ronald J. Points, the Executive Secretary of the Financial Management Standards Board.

Our survey was conducted through the use of a questionnaire mailed to a sample of the AGA members and covered 13 Standards.

We mailed questionnaires to 2750 members. We received completed questionnaires from 1626 members. The survey was intended to ascertain the views of AGA membership in two areas.

The first: The actual and also appropriate extent of involvement by AGA and its membership in the development of cost accounting standards, and second; their perception on standards issued thus far.

My statement is going to concentrate on the latter aspect because I am sure that is the prime interest of the Board.

Before doing that, however, I would like to make two other points:

First: Our responses indicated that the membership of the Association are concerned about the way in which the cost accounting Standards are developed and do consider them to be of considerable importance to themselves as government members.

Second: Fifty-three percent of the respondents said that they needed additional information, education or training concerning the Standards.

Now, although the Board has offered training on the Standards in the past, you may wish to consider some new action to meet these educational needs.

During the design of this survey, we gave particular

attention to ensuring the validity of the responses relating to the impact of Standards on the contracting process.

Because these AGA members are relatively familiar with the standards, we encouraged the answering of questions relating to effects only by those AGA members relatively familiar with the Standards.

In addition, we selected a disproportionately large sample from that portion of the Association membership list that was deemed most likely to be familiar with the Standards than we selected for the membership as a whole.

We asked the members to characterize their present level of familiarity with the 13 cost accounting Standards promulgated at the time of our survey.

As expected, there was quite a range in the respondents familiar with the Standards. Seventeen percent had not been previously aware of their issuance -- quite surprising.

(Laughter.)

I don't know whether that speaks well or poorly of the government people.

Thirty-eight percent were aware of their issuance, but had little or no knowledge of their content.

Twenty-eight percent had a general awareness of their content, but little knowledge of the content of specific Standards.

Six percent had detailed knowledge of from one to five of the Standards.

Five percent had detailed knowledge of from six to ten and, finally, six percent felt that they had detailed knowledge from 11 to 13 Standards.

The members also were asked to indicate the extent fo which their day-to-day work activities involve the Standards and the answer to this question was consistent with the extent of detailed familiarity that I have just mentioned.

Of the 1626 members participating in our survey, 279 -- or approximately 17 percent -- felt that they were sufficiently familiar with the Standards to have informed opinions as to their effect.

Now, 56 percent of this group were employed by either DOD, NASA or ERDA. The AGA members were asked to assess the extent to which the Standards had met the legislative objective of achieving uniformity and consistency in cost accounting principals under the federal contracts. Of the 225 members that felt that they had sufficient knowledge to respond to the question, 75 percent indicated that the standards have caused contractors' practices to become either slightly or significantly more uniform.

Twenty-three percent believed that the Standards have little, if any, effect on uniformity.

Only two percent said that the Standards have

caused practices to become less uniform.

As to consistency, 78 percent indicated the Standards have caused practices to become more consistent. Twenty percent felt they have little or no effect on consistency. Two percent indicated that they have caused practices to be less consistent. Thirty-five percent expressed the opinion that Standards had been significantly effective in this regard.

Our members were asked to use conditions that existed under ASPR and Federal Procurement Regulations as a point of reference for their opinions on impact of Standards in three other areas.

They were first asked to indicate whether the Standards imposed a smaller or larger or about equal paperwork burden on government personnel.

Fifty-one percent of the 232 members who responded to this question indicated that the Standards imposed a significantly larger paperwork burden, while 28 percent felt that they imposed a slightly larger paperwork burden.

Fourteen percent indicated that they imposed about an equal paperwork burden and seven percent felt that they imposed a slightly or significantly smaller paperwork burden.

The members were next asked to compare paperwork burdens imposed on contractor personnel by the Standards to those imposed on them under ASPR and FPR.

Fifty-five percent indicated that the standards imposed a significantly large paperwork burden while 28 percent felt that the paperwork burden was slightly larger.

Eleven percent indicated that the paperwork burden for the standards was about equal to that imposed by ASPR and FPR and six percent felt that the standards impose a smaller paperwork burden.

The third comparison -- the members were asked to comment on -- concerned the quality of the guidance provided by the cost accounting Standards for the administration of contracts compared to that provided by ASPR and FPR.

Twenty-five percent indicated that the standards provide significantly better guidance while 31 percent said that they provide slightly better guidance.

Twenty-nine percent felt that the standards provide guidance of about equal quality and 15 percent believed that the guidance provided by the standards was worse than that of ASPR and FPR.

Our members were also asked to respond to specific questions on each of the Standards issued to date. Initially, we asked members to comment on clarity with which each Standard had been written.

Generally the standards were rated as being pretty clearly written, with two standards -- 406 and 401 -- receiving the highest marks in this regard.

406 was described as clear by 84 percent of those making such an assessment, while 80 percent considered Standard 401 to be clearly written.

At the other end of the clarity scale was Standard 412 on composition and measurement of pension costs, with 24 percent characterizing it as unclear.

With the exception of Standard 411 entitled "Accounting for Acquisition Costs of Material," it was interesting to note that the most recently issued Standard among the 13 being assessed received fewer high clarity assessments than did the earlier Standards.

Now, details on each of those Standards is in our attachment to the paper.

Next, the members were asked whether each of the 13 standards has, in their opinions, increased, decreased or had little or no effect on the control of costs during contractor performance -- the visibility of cost or pricing data and the frequency of disagreement between the government and its contractors concerning cost accounting questions.

For these three aspects there is a significant number -- 43 to 80 percent -- of the members offering an opinion who saw little effect -- either good or bad -- of the individual Standards.

However, in this case, the first two standards promulgated by the Board were generally assessed as having

a more positive impact than others.

Attachment No. 2 to my statement presents a complete tabulation of responses to these questions.

The next area in which we sought an evaluation of each standard was that of the contracting process. We asked the AGA members to assess the contribution of each standard to four aspects of the contracting process: Negotiation, administration, audit and settlement.

Once again, 401 and 402 received a high proportion of positive responses. Close to 50 percent of those providing an assessment thought that these two standards had made contract audit easier, while about 40 percent, 37 percent and 34 percent felt the same way regarding contract negotiations, contract settlement and contract administration respectively.

At the opposite end of the scale, Standards 410 and 412 were cited the most frequently as having made a negative contribution to the contracting process.

Attachments 3 and 4 to my statement contain the complete results to the series of questions on the contracting process.

At the time of our survey, the cost accounting Standards Board has nine additional areas under consideration for possible future issuances of Standards.

The AGA members in our survey who indicated that they were familiar with the existing Standards were asked to

comment on the need for a Standard in each of the nine areas under consideration.

The areas in which a high percentage of the respondents expressed a great need for a standard are:

Independent research and development and bid and proposal costs -- 57 percent of the respondents; accounting for cost of service centers -- 44 percent; and indirect costs of colleges and universities -- 43 percent.

We have attachments supporting this also.

In summary, what emerges from these survey results is an assessment of the standards that is favorable from the standpoint of two legislative objectives as well as from that of guidance and contract administration.

The only real negative aspect is perceived in increased paperwork burden associated with the Standards. Whether the increased paperwork burden imposed by the cost accounting Standards -- if in fact it exists -- is sufficient to outweigh the benefits resulting from the development and implementation of the Standards is a question that a survey of this type will not answer.

The Board, of course, may wish to look further into this question. In our opinion, if the Standards have succeeded in achieving greater consistency and a clearer set of rules to be followed, they will have made a significant contribution toward enabling the government to deal with its contractors

on a more fair and equitable basis than was the case prior to the establishment of the Board.

As I said previously, we have not yet completed our analysis. However, we intend to do so and report the results to the Board and our membership.

This concludes my statement. I and my associates would be pleased to try to answer any questions you may have.

See Appendix I for entire statement.

CHAIRMAN STAATS: Your membership is not limited to the government?

MR. DITTENHOFER: No, sir.

We have --

CHAIRMAN STAATS: You have no way of breaking out these responses in terms of people who work in government or outside of government?

MR. DITTENHOFER: Yes. I think that information is available.

CHAIRMAN STAATS: I think we are interested in that and I am also interested if you could break out of the respondents how many were contracting officers or auditors.

MR. DITTENHOFER: Yes, I think that is available to us.

CHAIRMAN STAATS: That would be very, very good.

MR. DITTENHOFER: We have that information.

CHAIRMAN STAATS: Questions?

MR. MAUTZ: I guess my overall conclusion is we should have quit when we were ahead. We should have stopped at 402.

(laughter.)

MR. MAUTZ: But on the two questions you asked about improvements in uniformity and improvements in consistency, is there anything in the questionnaire that would give us some constructive suggestions from those who felt we had not made

significant improvements in consistency and uniformity -- as to how to go about that?

MR. DITTENHOFER: I believe we have comments in this area.

We can provide that specific information from the comments that the questionnaire respondents produced.

MR. MAUTZ: We look forward to that.

MR. WACKER: Just a general question. 275 is a fairly small data base for a survey. I wonder if you could comment generally as to how the base was chose, the distribution of the 275 in terms of your various chapters?

MR. DITTENHOFER: We used a segmented type of sampling. We divided the group into the areas that we thought would have the most impact or most familiarity with the Standards:

DOD, NASA, ERDA people.

MR. WACKER: Fell short a little there.

MR. DITTENHOFER: Yes. We had -- we specifically picked out a group within that group to be sure we had a good representation from people that would have familiarity with it.

Then we used a sampling technique in the remaining part of our membership.

MR. WACKER: Thank you.

MR. BEVIS: You talk about an opinion that emerged from your sample of paperwork burden, which is the subject of

much discussion these days, that the government is causing industry.

Will you get any clue or will we get any clue from the comments or anything else that you are going to submit to us as to the approximate cause of this paperwork?

MR. STUGART: Only if the respondents answered in a narrative context.

We have an open-ended question at the end of the questionnaire where we let them unload on us and they may have answered that.

MR. BEVIS: Because obviously, in order to conform to accounting standards and regulations you have got to have paperwork of some kind. You always do to a certain extent.

So one question will be whether accounting records have to be more elaborate or not and what causes the elaboration.

I think it would be helpful to us if we had some elaboration of why we are causing more paperwork because I am somewhat allergic to causing more paperwork and I am sure our Chairman is because he was involved in that work for the government.

MR. DITTENHOFER: Well, we will certainly provide any information we can from the questionnaires.

CHAIRMAN STAATS: I think we would like to invite comment from others appearing here on this paperwork side of it.

That seems to be what is coming through. I have

recently been serving as a member of the Federal Paperwork Commission, which has been working for three years, and we have just finished a paperwork report.

Thank you very much -- unless there are other questions here. We appreciate your coming and are very much interested in your survey.

STATEMENT OF ROBERT W. WILLIAMSON

UNIVERSITY OF NOTRE DAME

CHAIRMAN STAATS: Will you identify yourself?

MR. WILLIAMSON: I am Robert Williamson, Chairman of the Department of Accounting at the University of Notre Dame and also currently the Chairman of the Committee on Cost Accounting Standards of the American Accounting Association or AAA.

Although I am here as a representative of AAA, we have learned from long and sometimes bitter experience that no one person or committee can speak for a grumpy group of college professors --

(Laughter.)

CHAIRMAN STAATS: You are looking at a former president right now.

MR. WILLIAMSON: So, officially I do speak only as an individual member.

I would like to concentrate my remarks on two basic issues concerning cost accounting standards: First, the concept of a governmental board promulgating such standards and, second, the general procedures adopted by the Board.

I will leave to others -- those who are in a much better position to do so -- the comments concerning the effectiveness and costs of current standards.

As we all know, there is currently considerable

discussion and controversy -- both within and outside the accounting profession -- concerning accounting standards.

Much of this discussion is centered on financial accounting standards, but the arguments seem to apply to cost accounting standards as well.

A major consideration is the propriety and efficacy of a government body setting accounting standards.

Although others may and in fact do disagree, I see the creation and continued existence of the Cost Accounting Standards Board as a logical step in a historical chain of events.

Treasury Decision 5000, issued in 1940 by the Commissioner of Internal Revenue, the so-called "Green Book" issued in 1942, and Section XV of the Armed Services Procurement Regulations were all predecessor attempts at solving a thorny issue of equity between contractors and taxpayers.

The GAO report of January 1970 found Section XV of the ASPR to be limited in effectiveness because it made frequent references to Generally Accepted Accounting Principles and/or the Internal Revenue Service regulations -- neither of which was intended to serve contract costing purposes.

Thus a conflict between governmental and contractor goals was probably inevitable.

Given this conflict, to whom or what authority

could the contracting parties turn? Certainly not to any extant body of accounting theory.

Paton and Littleton, as early as 1940, stated that "cost allocations at best are loaded with assumptions and in many cases highly arbitrary methods of apportionment are employed in practice."

The AICPA national defense committee, in 1958, did ask the Institute's executive committee to establish a new body to recommend cost accounting standards, but as far as I know, nothing ever came of that recommendation.

The American Accounting Association in its "Tentative Statement of Cost Concepts Underlying Reports for Management Purposes," issued in 1956, made the now famous and somewhat trite statement that the "Cost of anything will depend upon the purpose for determining costs."

The statement observed that --

(Laughter.)

MR. WILLIAMSON: -- "There seems to be a belief in some quarters that there is or should be some scientifically correct way of dividing indirect costs," but concluded that "This belief is incorrect."

Regarding cost-type contracts, the statement proclaimed, "Cost is that which the parties define it to be." From this perspective, I consider Cost Accounting Standards, as promulgated by the Board, to be the end result of public

negotiation between the government and contractors as a group.

The subject of this negotiation, of course, is the definition of cost which will be used by both parties.

In my opinion, this process is infinitely better than the previous semi-secret and ad hoc procedures.

On a broader scale, I look upon the Cost Accounting Standards Board as an experiment in accounting theory.

Professor Joel Demski, writing in *The Accounting Review*, has shown that no set of standards exists which will, when applied to accounting alternatives, always rank these alternatives in relation to consistent individual preferences and beliefs.

He concluded that:

"We know that standards do not always work. When, then, do they work? Under what types of conditions will various types of standards work; when they fail, how badly do they fail?"

"We know that ... cost-allocation guides cannot be relied upon to provide the desired result in every situation. This does not, however, necessarily imply that they never provide the desired result."

"Hence, a major question in accounting theory must be conditions under which standards do work."

The purpose of the cost figures is fairly well defined, the parties are known and identifiable, and the results observable. The question remains as to what factor

or combination of factors allows standards to work.

My conclusion is that the Board should continue to place increasing emphasis on the development of cost-benefit comparisons.

This is comparable to the FASB asking for research on the economic impact of its standards. The greatest need in the area of Cost Accounting Standards, of course, is to develop significant measures of the benefits.

A common definition and visibility of costs should lead to meaningful comparisons of cost among both contractors and contracts, to the reduction of controversies, to simplified negotiation, administration, audit and settlement procedures -- and to greater equity.

The Board believes these benefits can be measured, although with some difficulty. I for one would like to see the Board sponsor definitive studies to address this issue.

Although I do believe that the CASB represents a logical and beneficial step, I also do have some misgivings. My understanding is that the GSA, NASA, AEC, and certain state governments have adopted the Board's promulgated standards.

This too is logical enough, but I begin to be worried about the pervasiveness of Cost Accounting Standards. To what other areas will they be soon applied?

CAS 414, dealing with the cost of money, is increasingly quoted in the literature as a guide or norm for

managerial and external financial reporting.

We now run the danger, it seems to me, of going full circle. The CASB is necessary to define costs for contracting parties, and it came into being -- in part at least -- because Congress recognized that GAAP and IRS regulations cannot provide those definitions.

It is equally important to recognize, however, that the "different costs for different purposes" dictum works both ways.

Costs defined for contract purposes have no necessary relevance for any other purposes -- especially including reporting to third parties.

It seems likely that, as the Board continues, it will become increasingly involved with matters which have received or will receive the attention of the APB or FASB.

I believe that the Board has so far made more than reasonable efforts to avoid direct conflict, but I also believe it may find it increasingly difficult to be so cooperative, given its Congressional mandate.

I have no doubts as to who would prevail in such a future conflict, but I do have grave doubts as to the ultimate results of such confrontation.

Another misgiving I have concerns the very nature of the Cost Accounting Standards as promulgated. The GAO report of 1970, previously referred to, helped persuade Congress to

establish the Board.

That report found Section XV of the ASPR lacking because it did not contain specific criteria for the use of alternative accounting principles and indirect cost allocation methods.

We may now legitimately ask if Cost Accounting Standards provide these specific criteria or do they simply proscribe and prescribe various alternatives.

Since we are dealing with definitions, I have no problem with either course, but I do believe the Board should make a determination as to which to follow and then consistently apply that decision.

Now, let me turn my attention briefly to some procedural matters. In my opinion, the basic procedures laid down by Congress and the Board are quite satisfactory.

The series of issue papers, draft standards, proposed standards and Congressional review serve to provide both parties, including the public with an extraordinary opportunity to be heard.

Without question, from my experience, the staff is extremely competent, dedicated and responsive. I have only two recommendations to make dealing with procedural matters.

First, I would like to see more advance warning on the topics under consideration. It is true, of course, that the Board's annual Progress Report to the Congress includes a

listing of studies currently underway, but it is not always easy to discern from this report what is going to happen next. I am sure the staff would like to know too.

A more formalized agenda released to the public would be of much assistance.

Second, I would suggest that the Board release, in addition to each Standard, a summary of the reasoning process which led to the adoption of that Standard.

It would be helpful to know if the Board chose a particular alternative because of theoretical niceties, because of the requirements of consistency, or because of a presumed cost-benefit relationship.

Without knowing the basis for a decision, it is extremely difficult to argue for or against that decision, and much time is spent -- and lost -- in finding a common ground for discussions.

In summary, I find the establishment of the CASB is a desirable and logical step in governmental contract negotiations. Its procedures are basically sound and consistent with the discernable purpose of a public definition of cost terms in a free and open society.

I caution the profession to give no further meaning to the Board's activities, and I implore the Board to be cognizant of the growing impact of its promulgations.

Finally, and probably most importantly, I called

upon the Board to commission basic studies into the measurement problems related to cost-benefit analysis of Cost Accounting Standards.

Thank you.

See Appendix I for entire statement.

CHAIRMAN STAATS: Thank you very much.

On your first suggestion as to greater visibility for future work plans, I think your suggestion is very well taken.

We have discussed this and your comment helps to focus the discussion we have had.

With respect to the second point on the reasoning and rationale for our Standards, we discussed this at our Board meeting only yesterday, as to whether or not our prefatory comments could be made a fuller statement than in the past.

We have a trade-off here of getting something that could be extremely long and I might say a reargumentation of issues that have been resolved, but it is possible we could do more in the future than we have on this point.

I would like to ask my colleagues if they would like to ask any questions.

MR. BEVIS: Cost-benefits: That is a matter of great concern to us, also a very puzzling challenge as to how you get cost-benefits.

We get some data, estimates of what your cost or potential cost of a standard will be. Any quantification of benefits to compare with cost seems to be far more difficult.

In the first place, we have very few constituents who will estimate any benefits to start out with; but the

benefits very probably are going to be more intangible than measurable.

You suggest a study on this and I think one of the other papers is going to also suggest that. Have you got any preliminary thoughts about how we might go about a more formal analysis of cost-benefit problems?

MR. WILLIAMSON: Well, my feeling is that there needs to be -- in the area of measuring benefits -- there needs to be some very basic research and thinking done as to just what our definitions are -- how are we going to go about translating those definitions in an empirical measurement term, and actually do the study -- the empirical work.

It seems to me in this area it really should be approached in a two stage process. One, a kind of theoretical, basic approach -- what do we mean by benefits and what is a way to do it.

And, second, actually do it, because I think we are so far behind in the measuring benefits area compared with measuring cost areas, that to go out and do a study to measure benefits would probably be doomed to failure.

MR. BEVIS: I probably should let my fellow professor ask questions on this. He is much more expert in how you accumulate information.

MR. MAUTZ: Bob, I would have asked the same questions Herman did.

As a one time researcher, I am always eager about research as a solution to all problems. I have great reservations about this. I must confess that I don't know how to begin.

Your thought -- maybe to work first with the definitions and see where they lead us -- could be helpful. I would like to ask another kind of question, however.

I am very interested in the point you make on page 2 of your statement, when you describe the process of promulgating Standards as a public negotiation between the government and the contractors as a group, and you conclude that we go through a kind of a negotiation process.

I would like to address a question to an entirely different aspect of this because it comes up in some other presentations we have received and will have today, and that is within what branch of the government should that kind of negotiation take place?

One of the proposals made is that it ought to be in the Executive Branch rather than in the Legislative Branch.

Now, in my own thinking, I think of promulgation of any kind of accounting standards as a sort of legislative function, and the Cost Accounting Standards Board operates within the Legislative Branch of Government. Have you thought about this, any thoughts as to whether it ought to be one place or another?

MR. WILLIAMSON: Yes, I have thought about that and in connection with the comments I made especially in my summary, where I talked about a free and open society.

It seems to me that this makes much more sense to have it in the Congress side because it seems to me that Congressmen are much more responsive than any administrative agency could be to the public and to whatever kinds of pressure or lobbying or just plain giving them plenty of facts could do.

And, I think to make the end result much more responsive, it makes much more sense, in my opinion, to have it on the Congressional side.

MR. MAUTZ: Thank you.

MR. WALKER: Following Elmer's questions with respect to the prefatories and your suggestion about more of the reasoning process, could you elaborate on that a little bit?

Could you be more specific in regard to what some of the prefatories lacked in this area?

MR. WILLIAMSON: Well, my basic feeling is that whenever the Board chooses a particular alternative -- Okay -- or says they are going to choose a particular alternative, those of us who want to respond are placed at a disadvantage because we don't know how you choose that.

Just to take the cost of capital standard, you say,--

look at the Treasury Decision for example: Presumably, that is not a very controversial sort of thing and you could probably justify that on a very practical sort of a basis -- it's as good as any other.

On the other hand, there are some cases where decisions have been made because the Board thought this, from a cost-benefit standpoint, is better than a different alternative.

Okay. If that was the case, I would like to know about it because I may have a completely different conception of what cost and benefits are and then, I would respond on those rather than going off on some theoretical conclusion which you have already considered and eliminated and perhaps concluded already that yes, theoretically, although A was best and I am arguing for A -- that it is best -- but you already agreed with that and so I am spinning my wheels, rehashing something that you already agreed with.

Whereas, if I knew you had agreed with me, I would have directed my attention towards that decision rather than thinking about the theoretical aspects.

MR. WALKER: On the cost-benefit side, have you thought more about the measurements of the costs?

The question of full cost versus incremental -- versus a ranking of choices?

MR. WILLIAMSON: I guess I thought about it, but

frankly, have not come to any conclusion on that.

CHAIRMAN STAATS: I am sure we are going to be hearing a great deal more about the cost-benefit point the rest of today and tomorrow.

Both Bob and I are on the FASB Advisory Council and at the last meeting we devoted -- I think probably two-thirds of the discussion -- to the economic impact of the statement.

They are having the same kinds of problems that we are facing in this Board.

The other point I would like to make is that at the time a specific standard is promulgated, it is much more difficult to assess the cost and benefits than it is later on.

In other words, it is much more difficult to do it prospectively than retrospectively. So, I think all this does is emphasize the point made earlier that perhaps cumulatively you can do better than by making this kind of a judgment, standard-by-standard, prospectively.

MR. WILLIAMSON: Yes.

CHAIRMAN STAATS: With respect to the point in relation to FASB, we are very mindful of the fact that in some cases we are going to be dealing with the same subject matter.

That is a case in point -- we have a very fine relationship with the Board and so far, we have avoided any kinds of conflict.

I hope that that will continue under Don Kirk's chairmanship. I know it will be.

He has been the liaison between that Board and our Board and GAO as well, but I say that to assure you and all the others that we have a cooperative relationship and so far no problem.

I do not foresee any difficulty arising. Thank you very much.

MR. WILLIAMSON: Thank you.

CHAIRMAN STAATS: We appreciate your statement.

Now, the AICPA, I believe, is with us this morning, and I don't have your names. You can supply that for us.

STATEMENT OF GORDON M. JOHNS

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

MR. JOHNS: My name is Gordon Johns and I am the new Chairman of the Committee for Liaison with the CASB.

At our meeting in New York last month, it was the consensus of our committee that we should not comment as to specific problems of implementation of cost accounting standards or as to any analysis of cost and benefits arising from Cost Accounting Standards, because we believe that these issues which are your focus of this year's conference can best be addressed by contractors and government agencies directly.

As a matter of general committee policy, we do not want to join the comment on feelings that we have on a second-hand informational basis.

We did consider the Board statement of objectives, policies and concepts and concluded that there was a need for resource material to be used in assisting contractors and government agencies in applying cost accounting standards.

We suggest that the Board consider publication of what we call Staff Cost Accounting Bulletins. One of our committee members immediately said, "Well, the acronym of that is SCAB," and I hope that doesn't prejudice those --

(Laughter.)

MR. JOHNS: -- listening to our suggestion.

These bulletins would provide examples and

illustrations relating to implementation and judgment problems associated with particular cost accounting standards, indicating the conclusions reached under the circumstances set forth.

The objective of the Staff Cost Accounting Bulletins would be to develop a body of sound precedents for contractors and government agencies to be used in particular situations.

This precedent -- since it would not be authoritative -- would not be binding on the parties. The general format of cost accounting standards has a section entitled illustrations, as you are all aware.

One might ask then: What is different about our suggestion from the concept of presently providing illustrations within the Cost Accounting Standards as promulgated?

Well, as set forth by the Board, illustrations are an integral part of each cost accounting standards, and as such, these illustrations have the same authority when considered within the context of the Standard as a whole -- as any other section of the Standard -- such as the fundamental requirement section and the techniques for application.

Given this authority, these illustrations need to be clear-cut as to compliance or non-compliance with a particular standard.

The illustrations were not clear-cut. The Board could be open to criticism that its Standards, as basically set forth in fundamental requirement and techniques for

application were modified and implicit in the set of subrules involved with the particular illustrations chosen.

In our view, illustrations which are an integral part of the Standards cannot be used to obtain guidance in gray areas one will necessarily run into.

A cost accounting standard cannot envision all circumstances related to a particular cost accounting practice when written.

This is in spite of extensive research, analysis, exposure drafts and other processes followed by the CASB in promulgating Standards.

We believe, furthermore, the Standards should not be written in an attempt to envision all circumstances because the increased complexity of rules resulting therefrom would detract from the objectives the CASB has adopted.

Our suggestion for Staff Cost Accounting Bulletins is to make available knowledge gained in implementing Cost Accounting Standards.

For example, business conditions and methods of operations may change over time, but perhaps not to the degree that a cost accounting standard has to be formally interpreted or completely revised. Examples of applying existing standards to new business conditions could be useful. As another illustration of potential usefulness of Staff Cost Accounting Bulletins, some contractors may find it difficult to apply

new Standards due to the nature of their industry or their circumstances.

A sharing of the knowledge as to how such cost accounting standards were adopted in other somewhat similar circumstances may help to share the burden of making the change.

Sources of such examples and illustrations would be obtained from matters referred to the CASB staff by contractors and government agencies as well as by the Government's CAS working group.

Appropriately, Cost Accounting Standards refer in many instances to materiality and significance. We recognize the conceptual problems inherent in trying to define materiality and significance -- whether this be in government contracting or in financial statement presentation.

But, even assuming that the cost Accounting Standards Board would be able to develop a standard for materiality consistent with its objectives, policies and concepts, there would still be the problem of application in particular instances.

For example, there are gray area judgments where men of good intent can arrive at differing conclusions. By being non-authoritative and non-binding on the parties, Staff Cost Accounting Bulletins could be useful in developing guidelines for the determination of materiality or immateriality.

The suggestion I have made here on behalf of the

Committee has resulted from the Committee's belief that contractors, particularly those that are not primarily in the government contracting business, do have difficulty in understanding and applying cost accounting standards and that the solution to these difficulties is not necessarily more standards.

Our suggestion for developing a body of resource material which we have referred to as Staff Cost Accounting Bulletins results from our experiences as CPAs in referring to precedents when trying to make a judgment on a financial accounting issue.

Thus, our suggestion is submitted in a constructive vein, with no foreknowledge as to its feasibility. We also recognize that there is the need to consider the legal ramifications involved in issuing Staff Cost Accounting Bulletins -- that by being non-authoritative, would be outside the scope of the CAS law.

But, we hope that these would not be insurmountable. In conclusion, on behalf of AICPA, I would like to say that we appreciated the accessibility of the Board and of the Staff in Cost Accounting Standards promulgated and the consideration that has been given to our letters of comment over the years.

See Appendix I for entire statement.

CHAIRMAN STAATS: We appreciate your statement and look forward to working with you in your role as Chairman of the Liaison Committee with the Institute.

We had a great deal of help from the Institute and we feel particularly pleased that the Institute has set up this committee to work with our Board.

Herman, do you have any questions?

MR. BEVIS: Defining materiality -- you and I know from our experience that when you look out at that whole big varied universe, if you write a given specific test, you immediately run afoul in a particular situation of just being wrong.

And, I know that the profession and many others have tried to come up with some general standard of materiality which is specific enough to give the answer in every case.

We have done our best to get the considerations down in a statement of what should be considered -- sort of in a hierarchy of what should be considered in determining a particular case -- whether something is or is not material.

We are continually urged to be more explicit. At the same time, we are continually urged not to get so explicit as to write a rigid rule and put people in a strait-jacket.

How are we going to resolve this dilemma?

MR. JOHNS: Well, as you know, we wrestled with this for many, many years, and I saw an earlier draft of what was

in the Register, of considerations and basically agreed with the considerations expressed therein, with respect to how one would judge it.

As we all know, materiality -- when talking about it, it is a continuing thing. There is that which everyone would consider to be insignificant to that where everyone said, "Yes, this is significant."

This is where we felt that to write a rigid rule within the law that you really cannot provide the guidance, one could provide it if one had a whole series of cases and precedents wherein this situation was considered to be a significant fact -- you should account for it on the segmented basis, for example -- a series of segments and, "Here is a case rather similar."

Maybe say that those things are almost comparable in concept, but this is a grey area you are dealing with and one can take one's own set of facts and consider the examples available to it and, on the basis of that, decide whether in this particular instance, it is material or it isn't.

Obviously, from time-to-time, people are wrong and financial statements have been found, for example, in public financial statements to be deficient -- when the Judge said this fact was material and should have been disclosed but we felt otherwise. This is why we are making the suggestion that you can't do it properly within the concept of the law or have

this strait-jacket.

But, unlike financial statements, there needs to be more information in the cost accounting standards area of particular instances so that one can take one's own circumstances and compare one's own situation with decisions previously made on a non-binding basis.

This would, in effect, advise a contractor when considering it if he considered something to be immaterial and wanted to ignore it -- he was wrong -- comparing that with something that had a lot of similarity to him and would provide the same kinds of guidance to an auditor looking at something and saying this is immaterial and two examples of very similar circumstances of materiality.

But, I don't think all these particular instances should be directly put into the law, where you have got the problems of trying to have to resolve simple conflicts.

MR. BEVIS: So, you in effect think a series of cases or case studies or case histories --

MR. JOHNS: Situations.

MR. BEVIS: -- codified -- could help in clarification?

MR. JOHNS: Right.

MR. BEVIS: Thank you.

MR. WACKER: I have one question as the newest member of the Board. I can assure you that I am spending a lot

of time trying to get caught up myself on various policies, proposed publications and the like, and it is no small task, but I didn't really digest where the Staff Cost Accounting Bulletins -- so-called SCABs -- fit in the process here as I view the publications issued by the Board and the DOD's cost accounting standards working group publications which are issued in collaboration with the Board's staff.

I am concerned about a proliferation of guidance and counseling and wonder if you can just amplify that a little bit.

MR. JOHNS: Well, from the standpoint of the standards at the time the standard is written, of course, you have illustrations which have been obtained as a result of the staff's research and consideration of probable implementation problems, probable judgment problems in applying the standard.

The feeling of our Committee was that the Staff Cost Accounting Bulletins would really result from the Cost Accounting Standards Staff's involvement on a subsequent or an ongoing basis at a level below the level where you felt you needed to formally interpret an existing standard.

We are not in any way suggesting that your procedures for formal interpretation should be in any way changed or abandoned.

But, below a level of interpretation as people develop practices, run into situations and concepts that these

be in effect the sound precedents that the Cost Accounting Standards Board Staff found, be published for general use as opposed to coming only from one contractor hearing another contractor doing something, or from an exchange of information between one government agency and another.

MR. WALKER: Do you see the DODCAS working group guidelines?

MR. JOHNS: I personally have -- some of us have.

MR. WALKER: I wonder how far they go to meeting the needs you are talking about.

MR. MAUTZ: It is a very appealing idea, but it scares me a little bit -- this idea of Staff Accounting Bulletins. You make the statement that the precedents set by these, since they are not authoritative, are not binding on the parties. I think that is a little optimistic.

All you have to do is get it in writing. It is not the same as casting it in concrete, but once it is there, you have to live with it.

Recently I was quoted in SEC's release on something I wrote back in 1961. That's a long time ago and conditions are changed but I am kind of stuck with it. I have to explain my way out or stand by it.

I have a feeling that our staff, once on record, would have difficulty backing off. Let me go on from there to add another point, really the one that disturbs me most.

I guess I have been assailed time and time again since the Board was formed with this question of whether the Board is equal to handling the staff -- to put it in the bluntest possible terms.

(Laughter - applause.)

MR. MAUTZ: You see what I mean?

(Laughter.)

MR. MAUTZ: We have a very strong, competent staff. It is a fulltime staff and we are a part time Board.

Time after time, you know, as I have made talks on this subject or been in meetings, people raised that question. There is a general feeling, I think, that sooner or later the staff -- the bureaucracy of every regulatory commission or board -- would kind of take over.

It almost seems to me that your recommendation is kind of that notion. Really, it is the staff we are concerned with living with. This is what scares me.

Do you have any comments on that general subject?

MR. JOHNS: Well, we are trying to suggest that precedents be available without it being law.

Now, that is how we came to the concept of staff. It doesn't necessarily have to be -- the focus wasn't intended to be on staff, as it was the focus being more on this concept that yes, there is a written precedent and we did recognize that whatever you do, by putting something in writing and

making it available, it does tend to become authoritative.

At the same time, if there is sufficient volume of such examples, the concept would be that one would tend to have more information with which to deal with a particular circumstance than one would, just taking the standard itself and trying to apply that standard.

In other words, as I see it, up to now, unlike say a pronouncement of the American Institute Committee on Real Estate Accounting, one is at one's peril in cross-cutting cost accounting standards. It is a direct part of law.

When you go to deal with how do you illustrate what is material, you have to get down into an illustration where everyone would agree that it is or isn't material.

Yet, to take the financial statement analogy, when you have a series of reports coming out, you have considerable volume of judgments made that you can look at -- some of which would merit stronger consideration than others.

In other words, it would be hoped that you could publish those situations wherein it is not a clear-cut agency case. Because that doesn't fully provide guidance for one's making decisions, and that is why we wanted it something weaker than authority.

I recognize it is a difficult concept to work with. We felt it was something worth considering and, obviously, would have to take further thought on some parts.

CHAIRMAN STAATS: I guess the only additional point or question I would raise would be whether or not this would be better in the form of cases actually decided, to give them visibility, rather than having it come as something emerging from the Board and staff.

I also wondered, could something like this be useful if it were done by the academic community as a research effort -- to take actual cases?

MR. JOHNS: I guess the question we have on contract administration would be whether or not that would hit all of the issues that were faced by people in implementing the individual cost accounting standards.

Issues just too difficult to deal with, that don't generally end up in contract disputes.

CHAIRMAN STAATS: It is an interesting idea. I am certainly sure we will be objective.

If there are no more questions, thank you very much.

It is 10:30 (a.m.) and we are going to take a ten minute break and come back here and hear from the FEI.

(Ten minute recess.)

CHAIRMAN STAATS: We are pleased to have the Financial Executives Institute representative here to make their presentation this morning.

Again, we have had very good relations with FEI and we are delighted to have you here.

STATEMENT OF RONALD L. LEACH
FINANCIAL EXECUTIVES INSTITUTE

Thank you.

Mr. Chairman and members of the Board, my name is Ronald L. Leach, Controller of Eaton Corporation. I am appearing today on behalf of the Financial Executives Institute's Committee on Government Business.

I have two members of that committee with me to assist in answering any of your questions that you may have: Al Johns is on my right and Bob Harbrecht is on my left.

As you know, FEI is a professional organization of senior accounting and financial managers with over 9,000 members, affiliated with approximately 5,000 companies, representing virtually all segments of the economy.

FEI promotes continuous improvement in all forms of financial reporting, while taking a leading role in developing better reporting of financial information.

Accordingly, FEI interacts through its various committees, Congressional Agencies of the Federal Government and private standard setting bodies such as the FASB.

In this regard, the Committee on Government Business has worked with the Cost Accounting Standards Board and its staff since its inception.

We believe we contributed greatly in developing of those standards promulgated to date and we intend to continue

that relationship in the future.

Obviously, we are not always in agreement and that is one of the reasons why we are here today. We believe this is an excellent forum for direct and objective exchange of viewpoints on your work.

We would like to express our appreciation for the time given to us by your staff in the past and to express our concerns.

You already received our written statement, sent to you by Chuck Hornbostel, President of FEI. In that letter we discussed CAS coverage, definitions and changes in cost accounting practice, allowability of costs, the full costing theory and CAS Board meetings.

I would like to summarize these points here. The first point covers exemptions and CAS coverage. In 1975 the Board established contract value required for initial CAS coverage of \$500,000.

We supported this concept as we did the 1977 February proposal to exempt all contracts of \$500,00 or less. Both of these threshold levels were set as a result of studies and were considered by the Board to be appropriate and consistent with the purposes sought to be achieved by Public Law 91-397.

In September 1977, two reasons were given by the Board in support of its failure to adopt the earlier proposal

to exempt all contracts of \$500,00 or less.

These are -- and I quote -- "Some commentators contend that once a contractor has to establish practices in compliance with standards, there is no additional burden involved in applying these practices to its small contracts," and, "In any case, it is unlikely that application of these practices could result in burdens that would be equal to those that would result from applying one set of cost accounting practices to large contracts and another set to small contracts."

We believe these reasons have very limited application, as most contractors will be involved with accounting for both CAS-covered and non-CAS-covered contracts, regardless of the threshold level required for contract coverage.

The distribution of business between the two will determine feasibility of applying CAS to non-CAS business.

FEI suggests that all contracts of \$500,000 or less be exempt from CAS coverage and that in recognition of inflationary trends, this threshold be periodically increased by an indexing technique.

We do not believe Congress intended that increased administrative cost should be borne either by the Government or industry by requiring compliance with standards and regulations when a contract or subcontract is awarded under

competitive conditions in which price is not directly related to cost data.

FEI recommends that the Board exempt from CAS coverage all contracts except those for which the price was established by use of cost data as provided for in the Truth in Negotiations Act.

As the disclosure statement requirement now reads, a company can incur a filing requirement by virtue of accepting CAS-covered contracts aggregating \$10 million taken at several business units for unrelated products.

As the value of CAS-covered awards at the business unit is the basis for determining CAS coverage, FEI believes it should also be the basis for the disclosure statement threshold, with filings being required only for those business units whose CAS-covered awards exceed the \$10 million threshold.

We believe that Congress intended that Cost Accounting Standards and Regulations should not apply to either a commercial oriented company or a segment of a company whose CAS-type business is not a material part of that enterprise's effort.

Our recommendations are made with the intent of eliminating what, in our opinion, is overregulation, while maintaining CAS coverage in those areas where such coverage can be justified.

Our second point, concerning Cost Accounting Practice and Cost Accounting change -- this is a complex problem and we created a special Ad Hoc committee to deal with it.

Our letter to you dated April 5, 1977, expressed our comments in addition to that which was included in our letter for this conference.

Suffice it to say that we believe the CAS rules in this area are unfair, in that changes -- even though they may be proposed by the government -- cannot permit any increase in the cost paid by the government.

Without going into more details of the problem, we recommend that the definitions dealing with cost accounting practice and changes to accounting practices be amended to incorporate concepts that:

One: Recognize that circumstances determine whether or not an accounting change is voluntary or mandatory;

Two: Waive the equitable adjustment requirement when there will be a long-term benefit to the government;

Three: Define the method of computing increased costs so that the government does not recover costs for which payment has not been made.

Our third point concerns allowability and allocability. The Board has taken the position that they have no authority about allowability and can only deal with

allocations.

We believe the Board and the procuring agencies should make a better attempt to coordinate those areas which are involved in this problem.

CAS 414, dealing with the cost of money, is an illustration of what we mean.

DOD and some other agencies have implemented policies consistent with the intent of this standard while other agencies are disallowing this cost.

Other examples were included in our paper. We recommend the Board initiate action to:

One: Coordinate through OFPP the allowability of all costs which are mandated as allocable by CAS:

Two: Assure that there is compatibility of allocation base and the allowability of expense in the cost pool to be allocated;

Three: Vigorously pursue the establishment of an interagency agreement providing for the consistent treatment of CAS issues on a government-wide basis.

Point four, on the Board's concept of full costing -- we will not repeat our comments here except to suggest that the Board's position be reconsidered.

Point five, concerning Board meetings as to open versus closed meetings -- there are times when Board meetings should be closed, such as when they are dealing with internal

matters or discussion of specific agencies or contractors.

However, we believe that open meetings where standards and regulations are discussed would lead to improved understanding among all parties concerned.

In lieu of open meetings, public hearings which permit discussion with the Board could be a useful alternative.

Our final comment concerns the cost versus benefit of standards. The Board stated it is vitally interested in data or methods of measuring the impact on the cost-benefit of implementing standards and/or regulations.

This has been an intangible thing in the past and we have not been able to come up with any concrete recommendations on the subject.

We do, however, strongly recommend that the Board appoint a seven person discussion group to evaluate the feasibility and potential of a study to develop acceptable cost-benefit criteria. This group should have equal representation from government and industry.

Assuming the discussion group is successful, they would develop a charter and appoint a task force responsible for conducting such a study. Our Committee stands ready and willing to assist you in any manner of implementation of this recommendation.

To summarize, we feel the points covered in our evaluation paper represent real problems which the Board

should address.

The joint industry/government group which was our last point could provide some real input into the dilemma of dealing with cost versus benefit of the Board's promulgations.

We want to restate our willingness to work with such a group. We hope our comments have been helpful and we would like to assure you of our continued interest and input through the Committee on Government Business.

If any of us can assist you in answering questions now or at a later date, we would be most pleased to do so.

See Appendix I for entire statement.

CHAIRMAN STAATS: Thank you very much.

Three points. On the question of allowability versus allocability, the Board does not deal with allowability.

There are some who are somewhat critical of Standard 414 because they felt that it was tantamount to taking a position on allowability, but that one, I suppose, is the closets standard we have come to in that regard.

The question of allowability, however, is a matter that I think deserves attention. Perhaps through the OFPP would be an appropriate channel.

I liked the specificity of your statement. I did have one question with respect to the point that I don't know that you emphasized much in your oral statement, and that has to do with a short form type of disclosure statement.

I wonder if you all could give us an example -- not necessarily right now -- an illustration of what might be considered to be a short form.

MR. LEACH: Yes, we could work on that and present something to you.

CHAIRMAN STAATS: I don't believe I have any other questions.

Herman; Bob?

MR. MAUTZ: I have a question, if I may.

Ron, in your discussion of full costing, I need a little help. In one of the paragraphs you say G&A expenses

allocated only to those final cost objectives which are directly responsible for contractor income.

By that, do you mean income in a revenue sense or a net income sense?

I think I know, but I would like to be sure.

MR. LEADH: I would think the revenue sense is the way.

MR. MAUTZ: And the purpose in doing that is to avoid the necessity for deferring any.

Now, on almost any basis of, you know, theoretical objectivity, some part of G&A should have some future benefits -- this gets back to the point made earlier by the American Accounting Association representative -- this would be one where if we were to agree with your position, we would be doing it on some practical basis rather than some theoretical basis?

MR. LEACH: Yes.

MR. MAUTZ: That is the sort of thing I would like to have you point out. Just one other thing on the full costing idea:

You suggested that we look it over thoroughly again. Down there, in the government, are some people who feel that full costing is not a good basis for government contracting; that contractors already have their plans set up and like to price on a marginal costing basis.

I assume that is not what you are asking for?

(Laughter.)

MR. LEACH: No.

MR. WALKER: On the cost benefit question, you suggest a group.

Could you talk a little about some of the thing you people have kicked around on this question as to approaches that might be taken?

I gather qualitative things would apply as a large rule.

MR. LEACH: We kicked around trying to respond to what was in the Federal Register because we knew you wanted comments on that and had great difficulty in trying to come up with how to tackle the problem -- as you have, as well -- and we didn't get down into any great detail as to where to go from here, except we thought it would be beneficial if both parties got together and tried to discuss at great length the problems and maybe at that point, wouldn't have to go any further or comment any further.

That's why we decided on a seven person committee to start out with -- to see what kinds of problems there were and if you could agree on something there to develop a more comprehensive task force of representatives from associations, industry groups and government as well.

We didn't get into any more specifics than that.

MR. WALKER: Okay.

On another matter, the publication had to do with change back in February when the Federal Register described some changes resulting from law, regulations and so on, as being introduced by the contractor, but then letting the chips fall as they may, as opposed to any sort of adjustment.

Do you have any comment on the use of equitable adjustment versus just letting the chips fall where they may on a change?

MR. LEACH: I don't think I -- Al or Bob?

MR. JOHNS: I am not real clear what you mean by: "Chips fall as they may."

MR. WALKER: A change compelled by law or regulation would not be a change which therefore means they just introduce it, period, and the costs would fall where they would fall, with no further action.

I wondered if you had any comments on that as opposed to specific action which is equitable adjustment calling for impact statements and the like.

MR. JOHNS: I am still not clear.

Where we are required to change our pension contributions upwards and downwards refers to contract cost and certainly, we would want equitable adjustment on something like that.

Now, as I understand it from this promulgation in February, we only have a negative adjustment. We would like

to have the off-sets.

MR. WALKER: Okay.

CHAIRMAN STAATS: We would hope that you could pay particular attention -- I'm sure you will -- to the changes we agreed upon yesterday, for publication on the change in accounting practices.

The language we have adopted doesn't quite fit precisely the language suggested in your statement, but I hope it will be in substance a way of achieving what you want to achieve.

MR. LEACH: I realize from your statement this morning that you had taken action in this area.

MR. BEVIS: Change in accounting practices -- let's assume a change which your company wants to make, which you think will be an improvement for some reason or another, and your contracting officer agrees with that.

How would you like to see that situation handled insofar as the effect on contract costs, contract prices and so forth?

MR. HARBRECHT: Well, if material --

MR. BEVIS: I am assuming materiality.

MR. HARBRECHT: I think there should be equitable adjustment. If there is an agreement between the contractor and the ACO, then it would seem to me that any such change should be subject to equitable adjustment.

MR. BEVIS: Thank you.

CHAIRMAN STAATS: I guess I have no more questions.

We thank you very much.

We will call now for a presentation by Price Waterhouse and Co. Do you wish to proceed?

I appreciate your sending us a statement and you are free to follow it as you like.

STATEMENT OF FRANKLIN R. JOHNSON

PRICE WATERHOUSE & COMPANY

MR. JOHNSON: My name is Franklin Johnson and I am a partner with Price Waterhouse, and designated as Partner-in-Charge of Government Contract Speciality.

I have chosen to direct my comments towards the question of allocation of state income taxes. I believe the subject is particularly important at present because Standard 403 will now become applicable to so many more contractors with the elimination of the \$30 million threshold, and I believe that it is this aspect of Standard 403 which has been causing a great deal of difficulty at present, and will cause even greater difficulty when more contractors become subject to 403.

The wording in Standard 403 as interpreted by the government is leading to an insistence upon allocation techniques which, I believe, ignore the primary key cause of tax income and require allocation based on property, payroll and sales.

I believe, for a number of reasons, that this particular method of allocation is less desirable and would like to cover some of these reasons:

The government's interpretation of this standard results in an allocation of income tax to loss segments which, I believe, is illogical and inequitable.

Equally illogically the government is refusing to accept allocation of any portion of income tax paid to one state by a segment in any other state, even if it can be proven that the amount of income earned outside of a particular state was included when computing the tax due that state.

Among other objections, I believe cost accounting should produce information of value in decision making as to performance of management -- whether a segment should be eliminated.

However, if the government's method is used, a division manager with a small profit before taxes could be judged as producing a loss in a case in which taxes allocated to him, based on property, payroll and sales, exceed his profit before taxes.

I then ask the question: Is such an allocation equitable? Does it in that circumstance that I cited produce information that is useful in decision making? Does it produce the most useful and realistic allocation in terms of causal or beneficial relationship?

The Uniform Division of Income for Tax Purposes Act was passed and adopted by most states to divide up the total corporate-wide income of companies engaged in interstate commerce.

Most states adopted the three factor formula, although the adoption can vary. Some states have not chosen

all the three factors, so it is not as uniform as one might think, but assuming it is uniform, is that how the states have chosen to divide up corporate-wide income.

This approach simplifies the job of the states in administering and insuring compliance with their corporation tax since they don't have to be concerned with separate accounting of income earned by state.

Clearly, it is the corporation-wide income which is being taxed and it is an arbitrary three factor formula which produces a result which serves as a surrogate for the actual amount of income earned in each state.

This approach may meet the state's needs, but why should accountants accept as preferred and indeed mandatory, a surrogate for income earned in a state if the real thing, the actual amount earned is available?

In this particular case in government contracting we know to what extent government business contributed to income and I believe to use a surrogate or substitute for income earned is a less desirable alternative.

The Cost Accounting Standards Board made it clear throughout its literature that cost should be allocated on the basis of causal or beneficial relationship. Most accountants would agree in the cost accounting literature that the preferred criterion is to relate a total cost to its most causal factor, and I believe that income is the most causal

factor.

An increase or a decrease in any part of a corporation's activity in any state will impact the income taxes paid to every state.

Moreover, total state income taxes will increase or decrease in direct proportion to the change in total corporate income.

Furthermore, if there is a loss in any activity, this will reduce the amount of tax paid everywhere and if in total a corporation incurs a loss, no tax except for nominal amounts will be paid.

I think this argument on trying to select the most causal factor is also under-considered in the cost accounting literature which says also that the preferable cost allocation base is one that facilitates a prediction in changes in total cost.

Another means of testing which is the best means of allocating state income taxes would be to gather actual data from a representative group or companies for several years and determine statistically the correlation between state income taxes and property, payroll, sales and income.

Based on my experience, I would expect that state income taxes correlate much more closely with income than with the apportionment factors.

If the Board is not convinced by other arguments, I

urge such an empirical study to establish statistically which allocation base best reflects the causal and beneficial relationship between this cost and the appropriate cost objective.

I call particular attention to the fact the Internal Revenue Service has had to deal with the allocation of state income taxes in connection with apportioning deductions for companies with foreign source income to properly allocate deductions between U.S. source income and foreign source income.

The Financial Accounting Standards Board in the Exposure Draft of their Opinion on Financial Reporting for Segments of a Business Enterprise acknowledged the significant income.

They suggest that taxes should be allocated based on the estimated amount that would have been incurred had each segment filed a separate income tax return.

Even the DCAA in responding to the FASB Discussion Memorandum preceding this exposure draft in answer question 3.2(e) on how income taxes should be allocated stated:

"Income taxes should be allocated to segments on the same basis as the individual segment income contributed to the tax liability."

"Loss segments should be given credit for the amount their loss contributed to reducing the overall tax

liability."

If a company wished to publish financial results of segments down to the net profit level under the provisions of FASB opinion 14, their independent accountant would have to report on this information and be satisfied that all allocations were made in accordance with generally accepted accounting principles.

Assuming that state income taxes are material and one of the segments has a loss, I believe most CPAs would argue for an allocation for state income taxes that either allocated no tax to the loss segment or gave the loss segment credit for the tax benefit of the loss.

Certainly, at least in the circumstances of a loss in one or more segments, the government's method appears to be less desirable.

Allocation of state taxes based on income has certainly become the subject of controversy as witnessed by recent and pending Board of Contract Appeals cases.

Cost Accounting Standard 403 has aggravated the matter in that the Government is interpreting the illustration in the Standard so as to ignore the impact of income or loss upon the tax.

I would like to urge the Cost Accounting Standards Board to reopen this subject and either issue an interpretation of Standard 403, or amend it.

I believe an allocation based on income should be established as the preferred method for the following reasons:

One: Allocation based on property, payroll and sales can lead to inequitable and illogical results by allocating taxes to a loss segment.

Two: Property, payroll and sales serve as a surrogate for income in dividing up a corporation's total income. A surrogate is far less desirable if the real thing, the actual amount of income or loss is available.

Three: An allocation base should be selected based on the most causal factor and it is clear that income is the most causal factor in the incurrence of an income tax.

Four: Other bodies knowledgeable in accounting including the FASB and IRS have selected income as the base for allocating state income tax when they have dealt with this subject.

Accordingly, I would like to urge the Board to reopen this subject and issue an interpretation of Standard 403 to permit allocations based on income; amend Standard 403 or perhaps issue a new standard on the issue of state income tax.

See Appendix I for entire statement.

CHAIRMAN STAATS: What do you do with respect to the state that does not have an income tax? There are still several states that have no income tax.

MR. JOHNSON: I believe the question for a contractor is to allocate a tax expense throughout its organization based on where it is located -- assuming that a contractor is located in a state without a tax.

If that contractor in that state generates income that causes tax to be paid in another state, then I believe it is proper to allocate income tax to the segment that causes taxes to be paid in another state.

I don't have any difficulty with that.

CHAIRMAN STAATS: What about property taxes? Did you give any thought to that? You are particularly strong in your request for assessment on income.

Within a given state you have many different jurisdictions, with different property tax rates -- counties or cities.

Have you given any thought to that; as to how to allocate those?

MR. JOHNSON: I haven't given a lot of attention to property tax.

CHAIRMAN STAATS: The same is true with respect to sales taxes and other taxes?

MR. JOHNSON: I believe, however, that if you pay a

tax to a jurisdiction -- I don't believe you should be constrained to only allocate that tax within the jurisdiction paid.

So, if one paid a sales tax to a given state for an item going to be used in another state, I believe the tax should follow the beneficial and causal relationship and not the jurisdiction to which it is paid.

MR. BEVIS: I think in view of the fact that Frank is a partner of Price Waterhouse -- a firm dear to my heart -- I will forego any questions.

(Laughter.)

MR. BODENHEIMER: You indicated that it is perfectly acceptable in your mind to allocate taxes in one jurisdiction to segments doing business in another jurisdiction.

Now, I am curious how you can reconcile that with at least one theory of allocation of taxes? I am sure that you are not unaware of the fact that some people suggest that the benefit from taxes is to the company, or to the employees of a company, which does business in a given jurisdiction.

How can you say that taxes in one jurisdiction benefit the business in another jurisdiction?

MR. JOHNSON: Mr. Bodenheimer, I believe that the Board and the Staff with respect to the beneficial theory has proposed an allocation based on looking at benefits to the taxpayer for example, based on a head count of employees.

So, you are turning the tables on me on what I thought was a position contrary to that.

However, in terms of selecting an allocation base, I have suggested that a preferable method is one that helps you predict changes in cost and I believe that if you accept as a beneficial argument that it is more difficult to predict changes of cost and relatively easy to predict changes in cost, if you assume the allocation based should be based on source of income.

MR. BODENHEIMER: So you are really suggesting that cause is more important than benefits in allocating state income taxes?

MR. JOHNSON: That is correct.

MR. BODENHEIMER: I would like to pursue something else:

You apparently believe that Standard 403 requires or causes tax allocation on a surrogate of the real thing -- I think that is what I heard you say -- that the base to be used for allocating taxes is a surrogate for the real thing,

MR. JOHNSON: What I said was the states, in adopting uniform division of income, rather than selecting the separate income earned in a state, have developed a formula to develop a substitute for that.

MR. BODENHEIMER: I see -- right -- and you suggest that that is not the proper basis for allocating the tax

because it is a substitute?

MR. JOHNSON: Surrogates are certainly often used for measures of allocations, but if there is a better method than a surrogate, such as the actual item, I think you should not go to the surrogate if you have a much better choice.

MR. BODENHEIMER: Okay, but is it not really the surrogate income -- the income determined by the formula -- rather than the real thing that is the income taxed in the states?

MR. JOHNSON: The state uses this formula and may have often produced results that are entirely different than the actual: And this serves the state's purpose, but I don't think in an accounting sense we should feel constrained to follow the method the state uses, if it indeed taxes income obtained elsewhere.

MR. BODENHEIMER: But the state actually has a formula which tells the company what portion of the corporate income will be taxed in that state.

MR. JOHNSON: If the state tells you you earn income in the state and are going out of business in the state, on an accounting basis, I am saying which is the best number to report.

MR. BODENHEIMER: I guess I still feel the best number to report or the best number to be used for allocation purposes is still the income taxed by the state -- what the

state says is the taxable income.

That is only my personal opinion. Apparently you --

MR. JOHNSON: I respectfully disagree.

(Laughter.)

MR. MAUTZ: I guess I better ask a question.

CHAIRMAN STAATS: I am not sure I understand the concept that you are trying to develop here.

Maybe this can be saved for a different time. I am not at all clear that just because the IRS does it that way, it doesn't necessarily mean it is the proper base for this Board.

We recognized that from the very beginning, tax policy is one thing and cost allocation is another.

MR. MAUTZ: I need a little help too; Mr. Johnson.

You cited as a clue to whether it is good cost accounting -- whether it permits you to predict cost accounting changes; but the law tells us our assignment is to get uniformity and consistency which is quite different than what you are citing as the clue.

And, secondly, I have a little difficulty -- you refer to income earned by a segment as the proper basis for allocating state income tax. The income is one of the elements in determining what the income earned is for tax purposes and it seems to me that there is some degree of circularity in there that troubles me.

MR. JOHNSON: I don't believe there is circularity if you allocate it based on pretax -- taxable income, for example.

MR. MAUTZ: That takes care of that.

CHAIRMAN STAATS: I guess it would help me if you could give us a couple of examples of actual situations that may have come to your attention.

If you can give us two or three concrete illustrations to show how your concept would differ from 403, I think maybe I can understand it.

MR. JOHNSON: Well, I think 403 does just give an illustration of allocation so that there may be some flexibility in interpretation of 403, but what troubles me most of all is a segment that had a loss, where the overall corporation had large profits and therefore, under the approach the states use, the large tax could be paid to the state in which that segment is located, and that state, under the segment -- under the government's method -- would be asked to absorb maybe a very sizable tax, irrespective of the fact that the loss of that savings actually caused the tax to be less if it hadn't had that loss, and there is an excellent correlation between income -- total corporate-wide income -- and total amount of taxes paid.

There can be no correlation between taxes made in changes in property, payroll and sales, and to select an

allocation method where there is little correlation -- when you have another approach -- seems to me to be far less desirable.

CHAIRMAN STAATS: But you won't take into account property and other taxes at all under your concept?

MR. JOHNSON: I am just devoting my attention to income, Mr. Chairman.

CHAIRMAN STAATS: Well, thank you very much.

The next speaker is from the National Security Industrial Association.

We thank you for coming here. Do you want to introduce your two colleagues?

STATEMENT OF DR. HOWARD WRIGHT

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

DR. WRIGHT: Thank you. I certainly do. The gentleman on my right is William Tolley of the Harris Corporation, who currently is Chairman, of NSIA.

The gentleman on my left is Russell Cooke, Sperry-Rand, the immediate past Chairman of the NSIA Contract Finance Subcommittee.

Unfortunately, because of the acceleration of the schedule, another representative was to be here with us. We hope he will be here in time to come up for the questions, since he can probably answer some of the questions better than we can.

That is Mr. Roger Boyd, Partner and Member of NSIA Legal and Special Task Group -- who is supposed to be here. We called as of 10 o'clock and he is on his way. We hope he will get here and I, for the record, am Howard Wright, Director of Cost Accounting Principles Research Institute.

It is a particular pleasure for NSIA representatives to have this opportunity to appear before you. Normally, when you see us, we are advocating a position concerning a specific proposed standard, an interpretation, or amendment to your regulations.

The broader objectives of an Evaluation Conference provide us with the opportunity to comment on a wider range of

issues.

I will comment on several issues of concern to us. However, the ten minute time limit for oral presentations prevents us from discussing all of the matters we would like to.

Therefore, we have a supplemental written statement which I now submit for the record. We are prepared to discuss any item on our supplemental statement during our discussion period, should you wish to do so. A listing of topics are contained in the written statement.

My testimony will deal with the Board's accounting structure and some perceived errors and inequities therein. My first comment here is that I believe that, as a generality, the Board is to be commended for the conceptual soundness of its structure as expressed in the May 1977 Policy Statement and in the standards themselves. This commendation is the big print.

MR. MAUTZ: What's the "But?"

(Laughter.)

DR. WRIGHT: Now for the little print that takes it away.

(Laughter.)

DR. WRIGHT: My second comment is that you should, in the interest of conceptual accuracy, re-examine your part 400 definition of the direct cost.

This definition limits a direct cost to one which is identified specifically with a particular final cost objective. The limitation of direct costs to final cost objectives only is where the error arises.

A direct cost is one which can be identified specifically with a single cost objective at any level, not only at the level of a final cost objective.

Thus, the cost of administering government contracts if separately identified is a direct cost of government work as a cost objective class of work, while such costs are indirect costs of final cost objectives.

Time doesn't permit me to give any more of the scores of examples that are available. Numerous ASBCA cases have validated my point.

The CAS Board, having authority to issue regulations with the effect of law, has a very special responsibility to guard the accuracy of its definitions. Unlike the APB and FASB, it doesn't have to rely on general acceptance.

Why do I raise this issue? In part because of my academic background. I raise it also because of some of the difficulties you create in your standards.

CAS 403 requires that central payments or accruals that are made by a home office on behalf of its segments shall be directly allocated to segments to the extent that all such payments can be identified specifically with individual segments.

What you really mean is that direct costs of a segment paid by a home office shall be charged to that segment.

But, having adopted a definition which limits direct costs to final cost objectives only, of which a segment is not one, the Board used the terms directly allocated.

You never have defined this term. You are creating problems for ASBCA judges who wonder why the distinction. Witnesses have difficulty coping with an apparent distinction where none truly exists.

Even the CASB staff has some difficulty in understanding what it hears from others because of this definitional problem. So, please take a look at the definition.

A third comment has to do with CAS 414. On March 8, 1977, CODSIA wrote to the Board requesting a change in CAS 414 so as to allocate imputed interest on construction work in process when making the CAS 414 computations.

Our reasons for making that request are included in that letter.

Subsequently, CODSIA received a letter dated April 26, 1977, from the Executive Secretary stating that the Board asked for further staff analysis of the problem.

To date, we have heard nothing more, despite the passage of half a year. We request that the CODSIA letter of March 8, 1977, receive your prompt attention.

My next comment deals with the rigidity of promulgated standards. Unfortunately, all cost accounting systems are based on the assumptions of normality and continuity.

These assumptions, therefore, assume a static state of the environment.

Such an assumption may be valid when one is manufacturing soaps or brooms, but it does not exist in much of the world of defense contracting. Change, not continuity, characterizes that world.

The Board should give more recognition to this fact when writing standards. It should allow the contracting parties some latitude in accomodating to ever-changing circumstances, so long as the fundamental requirements are being adhered to.

The .50 Techniques for Application are becoming more prescriptive, yet there is no CASB statement of which I am aware that states that the Fundamental Requirements shall take precedence over the Techniques for Application where a conflict exists. I commend such a statement for your consideration.

Now, let me be a bit more specific on this point: Our members are now going through the nitty-gritty of coping with CAS 410.

Some are into their second-year-go-around on 410 -- at least for forward pricing purposes. We find that there virtually is no room within the standard to accommodate to

changing circumstances, without triggering the CAS changes clause or receiving a notice of noncompliance.

Some of the aberrations causing problems are transfer pricing inter-divisional work, drop shipments, accommodation purchases, and Government-furnished material.

These circumstances and others require recognition if the beneficial or causal relationship requirement is to be adhered to. Most often a base will have to be adjusted, although sometimes the alteration may be to the pool.

At the risk of stepping outside the ground rules, I suggest that you examine the .50 sections of the forthcoming standards to see how prescriptive the requirements are.

You should know that these are what the auditors apply. The prescriptive requirements of the draft standards on material-related costs and IR&D and B&P costs illustrate my point.

I suggest that you should have more confidence in contracting officers. They know the local situation. Neither you nor the staff can know that situation as well as they.

I notice that particularly the staff seems to believe that they have to help the contracting officers. This is done by writing more prescriptive rules that may be applicable, to a given set of circumstances, but are stultifying when the circumstances change.

I suggest the following: One, a statement that the

.40 section takes precedence over the .50 section; two, the .50 section has some limiting applicability such as "in like circumstances;" and three, criteria for applicability to be included in the .50 section.

Our final comment in this oral presentation deals with an implementation problem that has surfaced for some contractors. The standard involved in CAS 406, Cost Accounting Period.

The problem involves the applicability of CAS 406 to the determination of billing rates to be used in progress payment submissions.

Somewhat more broadly, it is a question as to whether Cost Accounting Standards are applicable to progress payment at all or, to put it another way, are progress payment requests, accounting reports, within the meaning of estimating, accumulating and reporting costs, as those words appear in section G of Public Law 91-379.

The specific problem arising from CAS 406 may be described as follows: A contractor's fiscal year is the calendar year. Heretofore, when submitting progress payment requests, the contractor computed an overhead rate by dividing actual overhead costs recorded to date by actual base costs incurred to the date.

This computation yielded an actual overhead rate incurred to date of submission. This process continued throughout the year, so that by the end of the year the actual rate

computed was the average rate for the year.

After the promulgation of CAS 406 government representatives asserted that the contractor following this practice was not complying with CAS 406 because he was not using a full year's cost in determining the rate. Estimated annual costs, not year to date actuals, had to be used to be in compliance.

The problem arises because social security costs have to be paid in the early portion of the year and not throughout the entire year.

For contractors on a calendar year basis, the use of annual average rates denies a progress payment to finance the entire case outlay for social security disbursements.

A curious result ensues for those contractors whose fiscal year ends June 30. These contractors receive advance financing when average rates are used, since their recovery through progress payments in the first half of their fiscal year exceeds the cash payout.

We suggest that progress payments requests should not be considered accounting reports for the purpose of administering cost accounting standards.

Progress payments are devices to finance a contractor; they are not accounting reports involve in proposals, contract cost incurrence, or contract cost reporting.

While CAS are applicable to cost measurement, they

should not operate to adversely affect the cash flow under progress payments if a cost has been incurred and properly recorded on the contractors books of account and such costs

We suggest further that the Board already has met this issue in another context. In the four Board member response to Mr. McClary's dissent to the promulgation of CAS 410, the following appears:

"The other four Board members believe that the question of progress payment practices referred to by Mr. McClary is outside the scope of the standard. The four Board members fully agree with Mr. McClary that the Department of Defense should correct any existing inequity resulting from the Departments progress payment policies."

Our operational suggestion is that the Board make explicit that which is implicit in the foregoing quotation. Through some device, perhaps in the next revision of the Statement of Accounting Concepts, Policies and Objectives, the Board should distinguish financing a contract from cost accounting for it.

Financing is a matter for the contracting parties.
Cost Accounting is a matter for the Board.

We appreciate very much the opportunity to make this statement. We are now available for any questions you might have.

I am here to answer all the easy ones and my

colleagues will take the hard ones.

See Appendix I for entire statement.

CHAIRMAN STAATS: That has not been my experience.
You are able to take both kinds.

(Laughter.)

CHAIRMAN STAATS: Your last suggestion strikes me as being very good and we do, as you know, revise the statement from time-to-time.

We use this more as a general road map rather than as a blueprint, to help us keep our bearings in terms of general policies.

So, that is a good suggestion.

I don't think I have any particular questions and so I turn my time over to my colleagues here.

MR. BEVIS: On the progress payments matter, you are really requesting a clarification on what you understand the Board's position has already been -- further clarification?

Am I understanding you correctly?

DR. WRIGHT: Herman, yes. The doubt in the field -- apparently the auditors and I have some piece of paper that tells me that even the Executive Secretary -- and I apologize to Art that he is not here to respond to this comment -- but in one piece of paper I have in response to a question on this point at some seminar out, I believe, at Kirkland Airforce Base, he stated that CAS 406 was applicable to this situation, so that it may be certain that a clarification would be very helpful so as to leave it to the Department of Defense or any

other agency to determine its own rules for progress payments -- making the distinction that progress payments are a financial thing and not really involved in the matter of cost determination.

MR. BEVIS: The timing of the recognition of costs does affect the progress payments -- progress payments request, of course.

You had a particular illustration on social security. Might there be other costs that are cost accounting in the sense of the timing of recognition and acceptance of those costs for progress payments which, if the CASB standards are not adopted -- shall we say -- for that purpose, somebody else would have to make up some rules on timing and recognition of accruals or deferrals of cost or progress payments?

I don't know too much about the progress payment procedure so I am asking for information.

MR. COOKE: If I may, the payment of progress payments on accruals in the past has resulted in the contractors collecting as progress payment that which they had not paid.

However, within the past several years, the Department of Defense has revised its rules on progress payments so that at least accruals of amounts payable to subcontractors for instance are not required in the progress payments.

This is just another evidence that progress payments are another breed of CAS.

MR. BEVIS: I guess what I am trying to find out, Russ, is if cost accounting standards, to the extent they cover the items are not a guideline for determining the timing of progress payments, will you need another set of accounting or financial rules or something to handle the problem?

MR. COOKE: Well, I would believe that cost accounting standards would be relevant to progress payments to the extent they deal with matters that represent truly paid out costs, but leave it up to the Department of Defense to adjust those rules for anything that did not represent paid out costs or which represent a paid out cost and not required through cost accounting standards.

MR. BEVIS: I think it is fair to say -- at least I feel as a Board member -- Mr. Chairman, that we haven't tried to focus on effects of progress payments of any standard that we issue.

We have had occasional collateral questions about the effects on progress payment, but my memory is that for the most part we have referred those to the Department of Defense.

However, as long as I have you here -- you have got wide experience and very direct experience in the writing of cost accounting rules -- standards, or what-have-you-- and their application:

A suggestion was made earlier that a new device -- an informational device be developed -- staff bulletins -- with the kinds of details as I understand it on the application of standards.

Have you any comment on that, out of your experience?

DR. WRIGHT: Well, Herman, I do, in the basic concept and that is that less is better.

(Laughter.)

(Applause.)

DR. WRIGHT: Getting a little more specific, however, I believe the Board already has the policy that if a particular problem becomes widespread the Board will consider it and will issue a formal interpretation.

The problem I have with the suggestion that was made this morning is that these -- I want to be careful not to use the acronym -- that the Staff Cost Accounting Bulletins would in essence be issued by the staff and probably simply would not receive the endorsement of the Board.

Now, I seriously question: One, the legality of such a process. I secondly question whether or not such a process would violate the Constitutional division of powers between the Legislative Branch and the Executive Branch, because to me these would become somewhat administrative and interpretative in nature and would, in essence, become a part of the legislative history which the Appeals Board would take

cognizance of.

Particularly, whatever the Staff Cost Accounting Bulletins -- regardless of the intent and good will and spirit in which such interpretations or bulletins might be issued -- they are going to get to the Board of Contract Appeals.

It is going to be considered as a part of legislative history as expressing the intention of the Board and the Board has stated in its policy statement that it was endeavoring to say clear of the administration of regulations and also the judicial interpretations and the dispute process.

To me, any such suggestion of this nature would add to the problem rather than helping to resolve it.

CHAIRMAN STAATS: I indicated, in the earlier dialogue on this point, that if it was to be authoritative, it seemed to me it ought to be a matter of contract administration by the administering agency but, it did occur to me also that there might be something here of a non-authoritative character in the nature of research, case studies, perhaps, of the academic community-- which would be educational in purpose.

Do you have any comments on that possibility?

DR. WRIGHT: My basic comment is -- with all due regard and respect for the gentlemen from the American Accounting Association that appeared here this morning and I am certainly not characterizing his depth or degree of know-

ledge -- in my experience, there are few people in the academic world who have any particular demonstrated professional interest in this as an area of research.

Somewhat more critically, perhaps, it takes 20 years in this business before you can get an understanding -- that is with due respect to Bob --

(Laughter.)

DR. WRIGHT: -- Bob is the exception.

(Laughter.)

DR. WRIGHT: But, it takes a long time in this business before you can understand the subtleties and the factors that impact upon a contractor's cost accounting you can rely upon the academic community to come up with things that will be useful, even though you take a significant chunk of task force gudget and set this up as some kind of a research project.

The learning that is necessary in this business is simply too great. Beyond that, informational case studies -- if published -- will be used by contracting officers and by auditors in the field to prove their points.

MR. BEVIS: Contractors also.

DR. WRIGHT: Yes, absolutely. It all depends to whose advantage it is.

(Laughter.)

DR. WRIGHT: And use, it, and that simply adds more

into the dispute process and more things are there to argue about.

While we have not in NSIA taken a vote on this matter -- I am speaking as an individual -- I am sure most of our committee members are in this room and, if I ask for a vote, I think they probably would endorse my comments.

CHAIRMAN STAATS: Bob?

MR. MAUTZ: No.

MR. WALKER: Howard, you talked about abberations in connection with 410 as an example.

DR. WRIGHT: Purely --

MR. WALKER: Could you carry that point further? Are you talking about the materiality of small changes --

DR. WRIGHT: I am not really talking about materiality.

Forgive me, John. I am sorry. I'm stepping on your question. I'm sorry to do that.

I am talking about any operational situation which comes along in the normal course of business:

A contract is entered into. A particular base is selected. You gentlemen approve a cost input base for 410 with an opportunity to use a value added base or unitary base, so there is some flexibility in there.

But, if a contractor adopts, at any one point in time, a cost input base on the basis of the fact that the mix

of his contracts and the cost composition of his contracts is identifiable and predictable by cost composition -- I mean the proportion of subcontracts -- material, labor, indirect costs -- by whatever you gentlemen come up with in the next couple of months -- you then have a change, and we have seen these changes.

For example, you may well come along with a contract for a major weapons system or a significant item -- a major contract -- and your acquisition of material cost is something the contractor has to pay for -- there is a follow-on contract and for some reason the government feels they can procure that thing -- whatever the item -- somewhat more cheaply.

So, they go out -- as they did in one case involving submarines -- they go out and buy the steel from 21 different suppliers, instead of buying it from one, and get all the problems of delivery, etcetera, etcetera.

The basic point I am trying to make is that once there is a major change, a material change -- I'm not talking about the immaterial changes -- once there is a major change in the composition, at that point you have an aberration.

There then is reason to question whether or not the factors you took into consideration when selecting that base in the first place -- whether that base continues to perform the mathematical and distributive functions it is supposed to perform -- and which you expected it to perform when you

adopted that method in the first place.

It is basically my suggestion -- and you may already have cured it with the results of your meeting yesterday -- that change is something which should be dealt with at the local level.

The contracting officer and the local auditor know that situation. The parties can sit down. The government's interest is protected because the contracting officer may not agree that there is a good reason for making that change, in which event there may well be a dispute and there is the mechanism under the dispute clause of the contract to solve this.

Is that too much, John? Is it enough?

As a college professor, it's hard to shut me off.

CHAIRMAN STAATS: Mr. Bodenheimer had a question a while ago.

MR. BODENHEIMER: I want to add to the confusion on the progress payment question and I do it primarily because I think you quoted Art in absentia, and I want to take up on his behalf.

I think as it stands now, and certainly based on my experience years ago with the progress payment statement -- at least at present, it purports primarily to be a cost statement.

It represents costs incurred for a given period or over a period of time and as such seems to me -- absent anything

else -- cost accounting standards first and foremost would have to be applied.

After all, what are cost accounting standards for -- if not determining costs over a given period?

I am sure that is how Art viewed it.

I know that over a period of time there are certain things which have been issued by DOD which really digressed from that, so the accrued cost or cost incurred in accordance with cost accounting standards begin to look more and more like cash flow kinds of statements.

I think that's where we are today. As long as the reports are a statement of cost, I think first you have to determine cost in accordance with cost accounting standards. Then such costs can be adjusted. For example, pension costs, as you well know are not included in progress payments on an accrual basis but actual contributions have to be taken into account.

So, you have today a kind of hybrid thing and I don't think the problem lays with the Board. But as long as somebody else decides they want a cost statement, I think cost accounting standards apply.

If they want a cash flow or a cash outlay kind of a statement, there needs to be a change in the regulations.

I don't know if you want to respond to that.

MR. WRIGHT: Elmer, I suggest you put Mr. Bodenheimer

on the program and let him come down here this afternoon.

But, that is entirely facetious, as you know.

The only point I have to make is that we have to look at the basic objectives of the progress payment and that is financing, and I guess the collateral point there is that if the person in the field administering cost accounting standards recites CAS 406, they are then reciting an official statement of this Board.

Now, if the Department of Defense wishes to write its own prescriptive regulation, I suggest it is their business to do so.

But, I don't think, or at least it is my suggestion, I don't think the Cost Accounting Standards Board is really as I perceive it, that much interested in progress payments as a financing device.

It is a cost accounting device and all I am suggesting is in some subsequent statement the Board not say their regulations are not necessarily applicable, but say that in their perception progress payments and the report submitted under there are not cost reports in the light of the requirement of the regulation.

If the Department of Defense then wants to do something else, we will go over and argue with Mr. Wacker or Jack Kendig or somebody.

I just don't think that a prescriptive theme issued

by the Cost Accounting Standards Board has any particular relevance to progress payments.

MR. BODENHEIMER: One other subject -- a real quick question.

DR. WRIGHT: You want a real quick answer?

MR. BODENHEIMER: I never heard you give a quick one yet.

DR. WRIGHT: That's right.

MR. BODENHEIMER: You had some concern with the structure of standards on .50 and so forth. I think you were looking for a statement from the Board that the .40 section has precedence over the .50 or indicated that you are unaware of such a statement.

I wonder, when you said that whether you were aware that in the statement of operating policies, procedures and objectives, we specifically, really, say to the contrary.

We say: "No one --

DR. WRIGHT: Give me a citation.

MR. BODENHEIMER: Page 18 of our "Golden Rule Book" here.

"No one section of a standard stands alone. All sections must be read in the context of the standard as a whole," and that is preceded by a whole lot of explanation.

I wonder whether you really are objecting to that or want something else or whether -- I don't understand your

recommendation.

Did you want to change that section?

DR. WRIGHT: Would you give me a particular paragraph? I am having --

MR. BODENHEIMER: Shortly before the bold type which says "prefatory comments." Very short.

DR. WRIGHT: No one section of a standard stands alone. All sections must be read in the context of a standard as a whole.

The problem of course I am addressing myself to is the fact that those who administer this standard don't pay much attention -- as a matter of fact, if you look at the .40 section in more recent standards, they come down to about one comment and that is the issue we made in accordance with beneficial or causal relationship.

You compare that for example in the 403 standard for fundamental requirements. There was a conceptual framework, and .50 went on to explain and require it.

My suggestion is you look upon .50 as being the detailed operating rules of procedure under a given set of circumstances and the .40 section would be the section in which you establish the conceptual standard and framework to be applicable in all cases.

That's a long answer.

MR. BODENHEIMER: I'm not sure.

CHAIRMAN STAATS: I think that the point you are making here is you are making a clear distinction between financing and cost accounting.

I am sure this has been in our own minds but have not articulated it in any way.

If there are no more questions, we thank you very much. We are sorry that the other member of your group was not here, but I am sure you did well by all of them.

Your experience may be the same as ours, unless they have added to the staff of this hotel, it is a little slow and so I suggest that instead of our taking an additional presentation at this point that we break for lunch and try to get back here by -- say between 1:30 and a quarter to two.

(Whereupon the meeting was adjourned at 12:00 (p.m.)

A F T E R N O O N S E S S I O N

(1:45 p.m.)

CHAIRMAN STAATS: Several of the individuals who want to make presentations will not be ready until tomorrow, but we have others who are prepared this afternoon.

I would like to say this: That in our Chicago meeting one of the things I think all of us felt was quite useful was the opportunity to have comments and questions from the floor.

So, I am putting you on notice now that a little later on we are going to be asking those of you who have not had an active part up here at this table (indicating) to ask questions, make suggestions, offer constructive criticisms.

We would hope that when you do that, if you wouldn't mind coming up here, because you need a microphone in order for anybody to hear.

We don't have microphones on the floor, so I don't want that to deter anyone.

However, if you do have a real strong, loud voice and prefer to stand where you are, that's all right, just as long as we can all hear you.

Now, I believe we have next in our scheduled list, representatives from McDonnell Douglas Corporation -- who have presented a statement and they are here now and ready to go.

We are ready to listen and ask questions.

STATEMENT OF RAY KLEINBERG

McDONNELL DOUGLAS CORPORATION

MR. KLEINBERG: I am Ray Kleinberg, Corporate Assistant Comptroller for McDonnell Douglas Corporation.

To my right is Bob Jacobs, Director of Government Contract Administration; and on my left is Bob Brand, Manager of Accounting Practices for McDonnell Douglas.

Two years ago at Chicago --

CHAIRMAN STAATS: Would you mind raising up the mike a little bit?

MR. KLEINBERG: Two years ago, at Chicago, McDonnell Douglas expressed concerns about contract administration problems arising out of cost accounting standard rules.

Reaching for a little humor, we then compared CAS rules to love.

(Laughter.)

MR. KLEINBERG: We have come again today to report that -- as we see it -- the same serious CAS contract administration problems remain. Only our sense of humor is gone.

(Laughter.)

At McDonnell Douglas we have had one major CAS problem, and perhaps a dozen or so other serious problems. The major problem arose out of a so-called voluntary accounting change.

Four years ago, after much study and coordination

with Government people -- and after proper disclosure -- we implemented a change to our cost accounting.

The change was aimed to assure uniform accounting practices across our corporation. Non-uniformity existed primarily as a result of the McDonnell and Douglas merger.

We and cognizant Government administrators disagreed on what contract administration actions were necessary following the proper disclosure of our change.

Impact studies demonstrated that though the change shifted some costs from contract-to-contract, it did not increase net amounts to be paid to McDonnell Douglas by the Government. In fact, it caused a net decrease in amounts to be paid. Government auditors agreed.

At no time in the four years we have been discussing the change has anyone suggested that the accounting change in any way harmed the Government.

Nonetheless, throughout these four years, Government administrators have insisted on applying to our voluntary change a-1 of the rules and interpretations applicable to a failure to comply.

These non-compliance rules were intended to constrain violations of CAS rules -- not to constrain management improvements.

Results of applying these rules -- as interpreted by Government administrators -- would be effective dollar

penalties for MDC and corresponding dollar windfalls for the Government.

In our judgment, neither the Congress nor the CASB intended to outlaw or to penalize properly disclosed changes in cost accounting practice if these changes were warranted by business circumstances.

Such changes should not be administered as if they were violations of CAS rules. Our problem includes disagreement as to the meaning of the key CAS phrase, increased costs paid.

As I have noted, the direct results of our accounting change on the current Government business was an overall reduction in amounts paid to MDC by the Government.

This reduction resulted from a shift of costs from our Government to our commercial work. The Government, of course, has accepted this reduction in the form of a net reduction in prices paid on flexibly priced contracts.

Nonetheless, the Government demands additional contract price reductions, to reduce our effective earnings on both flexibly-priced and firm-fixed-priced contracts.

To justify their position, Government administrators tell us that increased costs arise both from performance cost increases and from performance cost decreases.

We aired this problem at Chicago in 1975. On the one hand, we hoped that an airing might stimulate change of

CAS rules or equitable interpretation thereof.

And, on the other hand, we hoped that it might cause a visit from senior DOD and/or CASB personnel seeking to better understand and perhaps help solve a complex, real-world CAS administration problem.

On both counts we have been disappointed.

CAS contract administration rules and their interpretation regarding voluntary changes and increased costs are substantially the same today as they were in 1975, or in 1972.

Nor has the public airing of our CAS problem attracted outside helpers -- it may have had the opposite result. Our problem matured into a formal contract dispute last year.

Because it is a complex issue and could spawn additional litigation, we do not anticipate early resolutions of the questions involved.

Since our accounting change was warranted and since it caused no harm to the Government, we keep hoping that some senior Government executive will see the inequity of what the Government seeks to do and help bring an end to this unnecessary dispute.

This hope, of course, does not delay our continuing preparations for the Board case. Other problems that we identified at Chicago also persist:

Two years ago we noted that it was difficult to distinguish between what is and what is not a change in cost accounting practice -- for purposes of applying the Board's rules on consistency.

We believe that the Board's rules on consistency are intended to apply only to like circumstances. When a contractor encounters changed circumstances -- circumstances unlike those previously encountered -- he may be compelled to change cost accounting practices.

Responses to changed circumstances must be disclosed, but they should not be considered changes in cost accounting practice for purposes of the CAS rules at paragraphs A4 and A5 of the contract clause.

Recognition that unlike circumstances may compel accounting change is necessary to assure that CAS rules on consistency are logical and fair.

Changed circumstance has on occasion been recognized in the administration of CAS, but for the most part, we find Government administrators play it safe -- labeling virtually every action which affects the flow of costs or the contents of a disclosure statement an accounting change subject to all CAS rules.

MDC continues to experience frustration in this area: There are eight or nine MDC actions of the past few years which, in our judgment, constitute warranted responses

to changed circumstances.

Most of these are organizational changes. In each case, implementation has altered the flow of costs to cost objectives.

Cognizant Government administrators have not challenged the propriety of these organization changes. In some cases, they clearly recognize that the Government is the chief beneficiary of the increased efficiency resulting from the changes.

Nonetheless, Government administrators insist that if the flow of costs has changed -- or if a disclosure statement amendment is required -- then a change in cost accounting practice has occurred.

They demand pursuit of all CAS contract administration requirements: Contract-by-contract impact studies, contract price adjustment and so on.

We decline to undertake these actions since we are unwilling to abandon the principle that a contractor's response to changes in business environment should invoke neither automatic financial penalties nor non-productive administrative exercises.

Fortunately, most of these problems are likely to fade away because of their dollar immateriality. While we are pleased to see Government administrators using materiality criteria to help solve problems, we are disappointed that the

principle of change circumstance has not been confronted squarely.

We appreciate that the Board and its staff have been considering this problem since the Chicago conference, but the draft proposals we have seen to-date do not face up to the fundamental problem:

The need to recognize that changes in circumstances can compel accounting changes -- and that if such changes are disclosed and justified, they should not be subject to the potentially punitive rules of A4 and A5.

We have reviewed recommendations regarding voluntary changes and the related subject of increased costs submitted to the Board by many interested organizations -- particularly those of CODSIA, FEI and the AICPA.

Though they differ in detail, these recommendations all embrace the principle that justified reaction to changes circumstance should not be considered an accounting change for the purposes of the CAS rules at A4 and A5.

We strongly endorse these recommendations and urge the Board to take prompt action on them.

Another problem we mentioned at Chicago continues to frustrate us: Treatment of allocation issues in forward pricing. We believe that CAS rules have changed the way Government contracts must be priced and negotiated.

We think that CAS rules require us -- as well as our

Government customers -- to recognize our disclosed cost accounting practices in the pricing of new work.

From time-to-time, Government auditors question the acceptability of one or another of our disclosed allocation practices.

This questioning may or may not lead to a formal dispute, or ultimately to revision of that disclosed allocation practice.

But, until and unless the disclosed practice is changed -- or that practice is finally found to be in non-compliance -- we must follow it in our forward pricing.

Unfortunately, when the Government questions one of our allocation practices, we find that Government contracting officers demand that we price work to reflect DCAA's preferred allocation approach.

This demand, if acceded to, causes us to price -- not in accordance with our current disclosure statement -- but rather in accordance with a non-existent disclosure statement that the Government would like to see us adopt.

We believe that attempts to force contractors to price work in ways which differ from their disclosed practices -- even if such attempts are motivated by a desire to obtain lower prices for the Government -- should be strongly condemned by the CAS Board and by DOD management.

Princing all work in accordance with disclosed

practices assures both contracting parties an orderly baseline to return to if it becomes necessary -- one of the few benefits we see that should have resulted from CAS.

Pending resolution of the allocation question, the Government is fully protected by the provisions of the CAS contract clause.

I have addressed problems we see with the CAS rules rather than the standards themselves. At MDC, we do see some significant problems with the accounting content of several of the promulgated standards.

But, as we reported in 1975, at this time the most critical of the problems experienced continue to be contract administration problems.

They are problems which interfere with the orderly conduct of procurement -- and, from our perspective -- create costs to us and the Government far out of proportion to any benefits being realized.

That completes my prepared remarks.

See Appendix I for entire statement.

CHAIRMAN STAATS: All right, thank you.

I appreciate that you have not seen the language that we agreed on yesterday -- which I referred to this morning -- but I hope that you will give it close attention, and give us the benefit of your reaction to the precise language.

I think we are trying to get at the same thing. The question I would like to raise has to do with clarification of the last point you made here -- where you say that the standards have required you to price contracts in a manner which is difficult.

You say that the contracting officer demands you to price work to reflect DCAA preferred allocation approach.

Could you spell that out a little more and maybe give us an example?

MR. KLEINBERG: We have several: Currently, we are having discussions with the Government relative to how we might allocate the costs of our legal department.

We simply include it as a function of Corporate G&A and spread it across the entire Corporation. The Government expects us to charge some of it direct to contracts, some of it direct to the segment, and some of it as residual cost.

We do not agree with this -- we do not have a dispute or a final decision from the contracting officer, but yet, when we submit a price proposal with the intended purposes

of negotiating an agreement -- and corporate expenses -- the Government restates our cost to make it look like the way they thing our cost should be allocated, and that is the way they want to negotiate.

CHAIRMAN STAATS: But they are not going beyond the standards. They are saying you should negotiate in accordance with cost allocation systems prescribed in the standards.

MR. KLEINBERG: It arises from whether there is a difference of opinion as to the appropriate method for allocating a given cost -- whether or not it is covered by a standard.

It may be simply covered by ASPR or partly covered by a standard. We have a similar problem with state taxes.

MR. JACOBS: I understand, sir, in this situation there has been no finding of non-compliance with regard to our disclosed practices.

Where our disclosed practice is under suspicion -- if you will -- and questions have been raised regarding its programs -- and during this gray period, we do not have any way of doing business other than to follow our disclosed practices, and we are getting our arm twisted pretty badly to follow other practices -- other than those we have disclosed.

CHAIRMAN STAATS: Bert?

MR. BODNHEIMER: Ray, in that situation, has there

been any suggestion that you change your disclosure statement; that you put it in terms of the auditor's or Government's request for a change in your rate proposal.

Wasn't there an effort concurrently on the part of Government to get you to change your disclosure statements to reflect what the Government thinks is proper allocation?

MR. KLEINBERG: I would have to answer that yes and no.

There have certainly been times when the Government has requested that we modify our cost accounting practices and change our disclosure statement.

At other times, we found this to be a great surprise when we got to the negotiating table.

MR. WALKER: Is it relevant, even if they had asked?

MR. KLEINBERG: No, I think not.

MR. JACOBS: When you say the Government -- we deal, of course, with a great many governments.

(Laughter.)

MR. JACOBS: I am not trying to be facetious.

One Government may want us to change, while another one is quite happy with them as they are.

MR. BODENHEIMER: I was talking about the United States Government.

MR. KLEINBERG: So was he.

(Laughter.)

MR. JACOBS: Thank you.

MR. McCORMICK: There is an implication here, is there not, in trying to get a single face of government relative to a particular organization or segment of an organization.

Your comment would indicate that at least wherever this particular activity is taking place, that you are having many faces of government presented to you.

Isn't there a single ACO with whom you are dealing, relative to cost accounting matters at the location?

MR. KLEINBERG: We do have corporate administrative contracting officers that are delegated to MDC, but it does not, certainly, preclude inconsistent government interpretation.

As I mentioned in my talk, we did change accounting practices to seek uniformity without our own company and we are fighting like hell to keep them -- simply because one likes one thing and another -- at a different location -- likes something else.

MR. McCORMICK: I was thinking more of the particular ACO. You are not talking about your Corporate ACO. You are talking about maybe an ACO in Long Beach or St. Louis and wherever else you happen to have activities -- that there is a lack of uniformity among these government representatives dealing with you as either a corporate entity or a divisional entity.

I recognize that sometimes the Government doesn't

always speak the same in each location, but the Board tried -- and I thought the DOD had attempted to establish a single ACO to talk to you relative to cost accounting standards matters, particularly, in a given location.

MR. JACOBS: I think a great deal of progress has been made and any problems which we have in that area are certainly not problems with DCAA.

I don't think we disagree.

MR. BEVIS: One of your problems with the accounting system -- as a result of your merger which you mentioned -- do I understand that one of the problems is the extent to which you change practices to harmonize the previously different methods -- Is the problem the effect or recognition of the effect on reductions in allocated costs to firm fixed price contracts as compared with a method that existed previously?

Is that one of your problems?

MR. KLEINBERG: Yes, that is one of the problems. The net result of accounting changes, as I mentioned, was to shift cost from government work to our commercial work.

We have got all kinds of contracts. Some have CAS clauses in it and at that time some did not.

The net effect was to reduce the dollar value in price -- really -- that the Government will pay us on the existing contracts -- if the contract terms and conditions were not modified.

So, that the net result was simply that the Government will get the same goods and services they had under contract for less money than they would have paid had we not made the accounting change.

MR. BEVIS: Right.

I wanted to find out if you had experience and views on what I understood to be a hotly debated topic these days, which is: If a change in accounting practices results in a lower allocation to firm fixed price contracts, than the previous system would have -- whether or not the firm fixed price should be reduced because of the lower allocation of costs.

Is my question clear?

MR. KLEINBERG: Yes, very clear.

I think that certainly, if we have non-compliance situations -- where we fail to price that firm fixed price contract in accordance with our disclosed practices -- then we have a situation where probably, if we made a change, we would need to reopen that particular contract.

When talking about an accounting change as we interpret the CAS rules, what we are looking at is -- whether or not the Government will actually pay us more money, increased costs paid to a defense contractor by the United States Government and look at fixed price contracts as being that there will be no effect on the amount that the Government will pay.

If it increases, they are going to pay us more and if it decreases they will pay us less -- but in a case of our change, if you look at all of these and all of the contracts involved, the Government still will pay us less money and get the same goods and services, than they would have paid had we not made the change.

MR. JACOBS: Can I add one more thing to the answer, as far as magnitude of our disagreement with the Government, and the elements of our dispute is concerned?

Reduced allocations on fixed price contracts do constitute one, but a relatively small part of the problem, and the problem would still be there absent any fixed price contracts.

In fact, most of the dollars in dispute are associated with --

MR. BEVIS: But unless you had some exposure to this question and my broad input is that if there is a so-called voluntary change in practices which results in the allocation of less costs to a firm fixed price contract, than would have resulted from the previous system, what are your views with regard to the effect on the contract price of recognizing this change in accounting practice?

Do you think that the contract price would have been lower in the earlier negotiation had the new practice been envisioned then?

Do you think that a lower contract price would have resulted from a lower allocation of the costs under the new method?

MR. KLEINBERG: Had we known about the upcoming change when we made the original negotiation proposal, perhaps a lower price would have been realized.

I think the question needs to be answered that merely a shift of cost from one place to another -- where did that go to?

Some went to another fixed price contract. The Government will pay you exactly what they agreed to pay in the beginning.

If that cost comes off fixed price contract and goes onto CPFF contracts, certainly the Government will pay increased costs unless the contracts are amended or that cost becomes unallowable.

So, I think it is very important to determine where the cost is going. If, for example, the firm fixed price dollars went to commercial -- again, we didn't reap any earnings from that.

The Government didn't get hurt. They are still paying the price agreed to for services we are going to provide.

MR. BEVIS: So, in effect, if I understand you, you are saying that in terms of increased cost to the Government, as that phrase is used, you look at the whole mix of contracts

and try to figure out whether the total contract price of all were affected by a change -- whether that would be larger or smaller?

MR. KLEINBERG: I think that is the key thing in determining whether or not the actions of the contractor have in any way damaged the Government.

The only damage possibly occurring out of a change in cost accounting practice is the Government is going to pay more money.

I think we ought to look at the entire United States Government in this case.

MR. BEVIS: Just to pursue this, if I may, one further point here on assessing the effects of change in accounting practices:

One readily available measure in fact is the dollars and cents of cost that are shifted. Can you suggest other factors that you think ought to be pertinent in considering whether or not an accounting change is or is not beneficial from the standpoint of Government?

Or give an illustration or two of where you think that non-monetary factor would be important for the Government?

MR. KLEINBERG: Well, if by the change in cost accounting practices we mean, for example, to just change from total cost base for G&A allocations as opposed to some reorganizational activity, I think the only thing is the

monetary effect on the Government.

MR. BEVIS: Let's say running two different systems, after the merger of McDonnell Douglas, as opposed to getting a unified system.

Is there any advantage to an ununified system from the standpoint of the Government; or isn't there?

MR. KLEINBERG: Now you are talking about the cost associated with administering the accounting activity or --

MR. BEVIS: I don't know. I'm just asking if there are any benefits of any kind.

MR. KLEINBERG: We clearly think that there are.

MR. BEVIS: From your standpoint or the Government's?

MR. KLEINBERG: From the standpoing of Government -- to reduce prices.

Before we did make this change we were operating 15 data processing systems -- one for each of our segments. We now operate one and it costs us considerably less than before and, certainly, the Government has benefited.

I think there is a lot more to that, too.

MR. BEVIS: Thank you very much.

CHAIRMAN STAATS: Fred?

MR. WACKER: Yes.

One question: I would like to understand -- I think it is a philosophical question -- on this shifting of cost from the point of view of Government-wide -- there is little

difficulty to make each change a benefit.

Is there a point where that philosophy does not hold; where we are dealing with specific programs -- like this F-15, for example -- and knowing how we operate in the Government in terms of obligations and appropriations -- where that sort of thing could have a significant effect on a contract that applies to a specific program?

Does your philosophy end at some particular point or hold categorically?

MR. JACOBS: I am afraid that I don't understand the question, sir.

MR. WACKER: You have a lot of contracts -- individual contracts -- which would be affected by accounting changes and I thought I heard you saying that it doesn't touch the individual contracts, if from the standpoint of Government-wide position it comes out to zero.

Aren't there times when the individual contracts are important?

MR. JACOBS: Certainly. If we are talking impact of magnitude to ordinary Government budgeting and planning.

MR. WACKER: Like making me go through a reprogramming?

MR. JACOBS: I guess the kinds of changes we experienced in our programs were really microscopic -- a tenth of one percent, perhaps, of an annual cost of the program.

As I recall the base of our study was about \$12 billion worth of work and the total shift was something like \$3 million on that base, and on individual contracts it was probably the predicted shifts -- it was probably within the error in the study.

(Laughter.)

MR. JACOBS: I am serious.

MR. KLEINBERG: I might add to that: The type of accounting changes we made were very extensive, including changes of G&A base and had very dramatic results, even though when we looked at individual contracts it was very, very small.

It staggers my imagination to even think about the insignificance of some of the numbers we are dealing with, even though the change itself may look like one that is very significant.

CHAIRMAN STAATS: That's a case where you and the ACO would have no problem of coming to an agreement; it was a good change.

MR. KLEINBERG: Well, when we talk about one-tenth of one percent on several billion dollars, the absolute dollars are material.

CHAIRMAN STAATS: Well, we thank you very much.

The next speaker on our list has asked to make his presentation tomorrow and they are then followed by -- if you are ready -- CODSIA.

STATEMENT OF PHILIP J. BLATTAU

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS

MR. BLATTAU: I am Phil Blattau. I am the project officer for the Council of Defense and Space Industry Associations, Cost Accounting Standards Project Group, and we do have two such groups:

One for commenting and considering the development of standards, and one on implementation.

And, as a matter of fact, I would think that the associations comprising CODSIA, as well as our Cost Accounting Standards Task Groups, may well be the most loyal of any organizations, Mr. Chairman, in responding to proposals which the Board has put out or its staff.

In fact, some of us said that we can't understand why we didn't get one of your public service awards.

(Laughter. Applause.)

CHAIRMAN STAATS: You keep on trying.

MR. BLATTAU: There was one exception to our regularity of commenting on proposals and that was the 1973 statement which was put out.

We read that, considered it, and made no comment. In retrospect, we probably should have, because some of the material which appeared in that statement later became the parameters of criteria by which a contractor's cost accounting system would be considered for the purpose of deciding what

would be a change in cost accounting practices.

I think, had we foreseen that, we probably would have commented about it. So, therefore, we are in the process of looking carefully at your 1977 restatement.

Now, when read individually, each of these two documents -- the 1973 statement and the restatement of 1977 -- they are well written, comprehensive, and authoritative.

But, there are differences and these differences may well be so significant that the 1977 document should perhaps more correctly be called a new statement rather than a restatement.

It would seem in looking at this document -- and incidentally, I did try to look through not only the main sentences but the fine print as well -- and compare the two of them -- it seems there is a basis for concluding that changes fall into three principle areas.

First, more pursuit and emphasis on uniformity and consistency.

Second -- or, I should say before I proceed with the second -- more pursuit of uniformity and consistency, and perhaps, with less consideration of materiality.

Second, a broadening of the scope and expansion of the coverage of the standards.

Third, because of the assumed benefits of uniformity and consistency, less concern about equity in the outcome of

standards.

Now, the material in which these perceptions are based are principally as follows:

First, as to pursuit of uniformity and consistency: In 1973, uniformity and consistency in accounting were desirable to the extent that they improved understanding and communication, reduced the incidence of disputes and disagreements, and facilitate equitable contract settlements.

In 1977, the increased uniformity and consistency are apparently -- per se -- desirable; because the qualifier to the extent that they improve has been deleted.

In 1973, the objective of uniformity was to achieve likeness under like circumstances. Now the objective is comparability of results of entities operating under like circumstances.

In 1973, the statement said consistency pertains to one accounting entity over a period of time. In 1977 the statement -- it says: Consistency pertains to the use by one accounting entity of compatible cost accounting practices which permit comparability of contract results under similar circumstances.

It goes on further and says: Essentially consistency relates to the allocation of costs, both direct and indirect, and to the treatment of cost with respect to individual cost objectives, as well as among cost objectives

in like circumstances.

Now, these changes in words might well be matters of form, but there is some question which arises with respect to them in view of the fact that the 1977 statement has dropped the subsection on materiality, which was included under the Board's objectives in its 1973 statement.

Now, I would like to turn to the second major point: Namely broadening the scope and coverage of standards. In 1973, the Board said that you establish standards to:

One: Measure the amount of cost which may be allocated to covered contracts.

Now the Board says the standards would be to define and measure costs which can be allocable. Now the word define comes through pretty clearly as compared with the 1973 statement.

In 1973 the Board said in a statement -- determine the manner in which allocable costs can be allocated to covered contracts. Determination of the basis for the direct and indirect allocation of the total assigned costs to the contracts and other cost objectives of these periods; and goes further to say:

The definition of what is a cost for the purposes of negotiated defense contracts and how the amount thereof is to be allocated is a function of Cost Accounting Standards.

The 1977 statement therefore is not just more words to say essentially the same thing that you said in 1973.

Standards now cover definition as well as assignment of costs and moreover, the definition for the purpose of negotiated defense contracts and how such costs are to be allocated is clearly a function of cost accounting standards, as the statement expresses.

In both the 1973 and 1977 statements, the description of what standards will do relate to the conceptual framework of cost accounting systems.

In addition to a more detailed and comprehensive treatment of the conceptual framework, the 1977 statement -- within the context of the conceptual framework described -- indicates that standards will include treatment of the definition of costs, the measurement of cost, whether direct or indirect.

If indirect, what period it will be assigned to and whether it should be in an overhead, service center or G&A pool, and what the basis for that allocation should be.

A very thorough treatment of what standards can be expected to cover.

The third principle point I have is about the words which show reduced concern with equity and outcome. The 1973 statement contains the key sentence: Cost accounting standards should result in the determination of costs which are equitable to both the government and the contractor.

That sentence doesn't appear in that form in the

1977 restatement. The words that are used are to the effect that a cost accounting standard is fair when, in the Board's best judgment, the standard provides for allocating costs without bias or prejudice to either party, and, the 1977 revision adds a qualifier that it is fair if the standard shows neither bias nor prejudice to either party.

Depending on how you read those words, it could be presumed that standards are considered fair so long as they don't obviously provide bias or prejudice.

In 1973, the statement said: Cost accounting standards were fair if they provided data representative of facts, regardless of outcome of the contract.

The qualifier, "Regardless of the outcome of contracts," has now been deleted.

Does this mean less concern about economic effects, effects on pricing of contracts or effects on contract administration or what?

There are different perceptions in other respects: The section on verifiability, which said contract cost accounting systems should provide for verifiability now adds to the greatest extent practical -- where the section formerly said records of contract costs should be reconcilable with the general books of account.

The restatement now says detailed. In 1973, the Board indicated it was persuaded that an exemption from

standards justified, if the administrative burden is grossly disproportionate to the benefits -- or if failure to grant an exemption will prevent orderly economic, timely acquisitions of essential supplies and services.

Those words are not included in the restatement. The 1977 restatement also has a sentence -- standards should serve to reduce the opportunity for manipulation of accounting methods alleged to have existed prior to the establishment of the Board.

Now, from my standpoint, it is difficult to see why that sentence needs to be added at this point in time, when the Board has been in operation for so many years.

Mr. Chairman, the 1977 restatement contains significant changes, uniformity, consistency and materiality, scope and coverage, equity and outcome.

The purpose of my appearing before you today is to recommend and urge and ask that the Board do in this case as it has done in other cases and that is, provide a rational explanation for changes made in your restatement so that we in the private sector can better respond to it.

Earlier, I heard Bert Bodenheimer refer to the statement -- because it is in a yellow cover -- as the Golden Rule Book.

I would just like to say that yellow is also the color of warning and -- is the direction of cost accounting

standards about to change, and, if so, that is the new direction and why does the Board seem headed that way?

See Appendix I for entire statement.

CHAIRMAN STAATS: We thank you very much.

I hope you haven't looked under the bed here for things that we didn't really intend to apply any change on. We thought we were doing editorial improvements on the old language.

I think some of this is of that nature. I would like to say, Phil, that you have been a constructive critic of our operations and we do appreciate the fact that you responded so diligently to all our standards and have taken the interest that you have in them.

Herman, do you have any questions you want to raise?

MR. BEVIS: Not really.

MR. BLATTAU: I am disappointed. I can always count on you for real perceptive questions.

MR. BEVIS: Thank you very much.

Then I will go ahead.

(laughter.)

MR. BEVIS: Phil, I guess it was Howard Wright who said it is better to say less. Do I get the impression that you would feel that we would have done a better job if we had written no restatement -- no original statement or restatement?

MR. BLATTAU: Not at all.

I would think with respect to the restatement, that some of the material you deleted just apparently was, you know, time and taken over and it was no longer current.

Now, with respect to the material which was revised, yes, I would think you have added unnecessarily to the statement.

MR. BEVIS: In other words: Say little, but once you have said something, don't change it?

MR. BLATTAU: Not at all, because I think we have -- some of the speakers have been saying that things do change; perceptions change; requirements change.

If the Board is in that situation, certainly, it has to change. I think we have been urging that about accounting systems and the same principle may well pertain to the operations of the Board.

The Board may know things which we don't know. We think that when the accounting system is changed we think there is a requirement for explanation.

MR. BEVIS: That kind of frightens me.

To read your careful comparison, word-by-word, of what was in the '73 and '77 statements, and to try to infer some meaning into the differences in the words, when -- as Elmer said -- maybe all we had in mind was: Let's clarify it, or had some questions indicating that we should clarify this.

Now, conditions change with regard to materiality. Any less reference to materiality in the statement, for example, doesn't -- to my mind, at least -- indicate that we are less than certain of the materiality, but the fact is that

we were coming to a publication of a very comprehensive statement on materiality and that we thought that was a clear indication that we could make that we are concerned.

It bothers me that just language clarifications, as we saw them, could have some kind of sinister implications to you.

MR. BLATTAU: Well, I will admit that maybe I am a Little Red Riding Hood, who has come through the woods under this yellow --

(Laughter.)

MR. BLATTAU: Maybe you fellows don't look like the grandmother that I expected to see.

(Laughter.)

MR. BEVIS: I guess I have no further questions.

MR. BLATTAU: I would like to respond on the materiality question.

It seems to me that when you have that section on materiality under your own objectives and now there is no such section -- but the material costs is in the rules and regulations which other people are expected to follow -- that I don't understand offhand why the materiality section had been dropped in your restatement.

MR. BEVIS: Well, I think the reason -- I think I remember -- Bert can check me on this -- but that change was made because of very specific and rather widespread criticisms

that the materiality items test in the first restatement were not up to snuff, as looked upon in the field.

People said that they were good tests but they were not coming through to the field but would if we had them in a standard.

So, all right. We reacted so that and said we will improve. Now I get from you that we haven't improved at all.

MR. BLATTAU: No, sir. We urged that you put them in the rules.

MR. BEVIS: It was you we were following?

(Laughter.)

MR. GLATTAU: However, we didn't want you to take them out of your own rules.

MR. BEVIS: That is not a rule as you appreciate.

MR. BLATTAU: I appreciate that it is your own statement and is not a rule and that is why we urged the section on materiality be covered in the rules -- which other people had to follow as well.

I would mention, though, I approached this task several times and was afraid I would come up here and people would say: "He's been nitpicking," and yet, there are little things that would be helpful to have an explanation of.

Like your earlier statement said the Board -- and I should know the exact words -- adheres to the concept of full costing wherever appropriate. Full costings -- I take

it back -- another key word -- absorption of full costs.

Now, the word "absorption" has a connotation that of pricing -- wherever appropriate -- it is a pervasive connotation.

The restated sentence dropped absorption, so now the Board says it adheres to the concept of full costings and no longer says wherever appropriate.

It says whenever appropriate -- which has a connotation of pinpointing application.

You know, it could be a typographical error. On the other hand, if the change is deliberate, what does it signify?

MR. BEVIS: Well, we have got to be very careful not to change a word -- even if we don't know what absorption means.

(Laughter.)

MR. BEVIS: Thank you.

CHAIRMAN STAATS: I would like to add this: That very early in the history of the Board we were unanimous in the view that we owed the community some kind of conceptual framework.

I know the FASB had its trouble in developing a similar statement, but we also agreed at that time that circumstances would change and maybe our perspective would change.

Therefore, we thought it ought to be a living document -- ought not to be in the nature of rules -- but a "think" piece which we can publish and say to the community that here is the way we think we are trying to develop individual standards -- along this common conceptual framework.

I suppose it is correct to say that we really hadn't focused on the specific words and phrases in the way that you have -- maybe we should have -- but we weren't thinking of it in that perspective, but in much more substantive terms.

MR. WALKER: Your main point is that you would like to see a commentary, Phil?

MR. BLATTAU: Yes, that is my main point.

In other words, the invitation to the Evaluation Conference said that you appreciate any comments or suggestions on the restatement and it would be easier to do that for anyone -- myself or our professionals or any other group -- if there were some sort of an explanation and rationale.

Otherwise, we run into the danger, perhaps, of overdoing that I may have done. That is: Putting a perception on things that do not warrant a changed perception.

CHAIRMAN STAATS: Well, again, we thank you, Phil. Thank you, very much.

Now Alcoa would prefer to make their presentation tomorrow and the next one on the list is Boeing. Is Boeing prepared?

(No response.)

CHAIRMAN STAATS: Texas Instruments, I believe,
has a statement to present now.

STATEMENT OF GARY HILL

TEXAS INSTRUMENTS

MR. HILL: I don't believe that Howard needs an introduction. My name is Gary Hill and I represent Texas Instruments.

I appreciate the opportunity to appear before you and to comment on the effectiveness of cost accounting standards as applied at Texas Instruments.

As requested by your notice in the Federal Register of May 11, 1977, I will comment on the effectiveness of a particular standard and will recommend ways to improve its implementation, thereby lessening the disruption of the contractor day-to-day contracting cycle.

The standard I wish to discuss is 414 --- Cost of Money as an Element of the Cost of Facilities Capital -- specifically, its effect on consideration for imputed interest on assets under construction.

Department of Defense Interim Guidance 77-18 dated June 14, 1977, removes from consideration in the base for cost of money assets which are under construction.

One of the benefits to be derived from CAS, as stated in the Board's restatement of objectives, policies and concepts is the anticipated reduction in the number of time-consuming controversies stemming from unresolved aspects of cost allowability as well as greater equity to all concerned.

The current controversy created by DOD Guidance 77-18 thereby requires that the Board consider issuing an interpretation as to whether assets under construction are properly includable in the base for cost of money under CAS 414.

We believe that the current DOD interpretation and guidance discriminates against a contractor who finances his own long-term construction work in that it favors those contractors who rely upon others for their financing.

This results not only in inequity but also in a lack of uniformity and consistency. It also fails to achieve the purpose of Public Law 91-379 to establish comparability of Government contractors' costs since imputed costs recognized in determining contract cost will differ depending on the financing involved.

Current expenditures, made over a long-term to finance facilities acquisition before their actual use, have an imputed cost of money conceptually no different from the cost of money incurred while the facilities are in use.

It is likely that in two specific situations the cost of money incurred during the production of the facility is included in the contractors cost. These are:

One: Where the Government contractor acquires facilities by a lump sum purchase.

Two: Where the facilities construction is financed

by others and then leased to the contractor upon completion.

In either event, the lump sum price paid or the periodic lease payment will recognize the cost of financing by the seller or lessor during the construction period.

I consider here only assets that are to be actually used upon completion or acquisition. Longer term acquisitions that are not to be placed in production or in use in the contractor's regular business activity upon completion or acquisition are not considered. The latter category are investments made for a strategic business purpose.

Another inconsistency arising out of DOD's interim guidance has to do with a contractor's selection of one of the two alternative historical or projected methods of determining an asset base.

Under DOD's interpretation, the same asset under construction would be either includable or not includable simply by a contractor's selection of the historical or projected method of determining the asset base.

That is, a building, for example, under construction this year would not be includable under the historical method, but if I planned to place the asset in service the first month of the next physical year, it would be includable under the projected method.

The ability to switch literally means millions of dollars of assets into or out of coverage under CAS 414 should

not be left up to the contracting parties, but should be addressed specifically by the standard in question. The current situation does not lend itself to a sound measurement of costs.

I suggest that there are two methods by which the disruption can be reduced. The first method would be to assign the book value of the facilities investment to the profit center or other organizational unit for which the facility is being constructed or acquired.

The cost of money then would flow down to final cost objectives along with the cost of money of facilities in use in such profit center or other organization unit.

This method has the advantage of meshing into the present CAS 414 computations and procedures in addition, would require no changes in procurement regulations.

A second method would be to follow the practices generally used for public utilities. Such companies normally capitalize in their assets an imputed allowance for funds used during construction.

The allowance is imputed interest of the same nature as the CAS 414 cost. Under this method, the capitalized cost of money would not be included in contract costs until the acquired asset is placed in use. It would be accounted for as additional depreciation.

History shows that imputed interest or self-

constructed assets dates back to as early as 1840 in the case of railroads and the practice was also being used by electric utilities before the 1908 issuance of their first uniform system of accounts.

Also, in 1920, the National Association of Railroad and Utilities Commissioners recommended a system of accounts recognizing imputed interest on funds used during construction.

When you consider the time involved in self-constructing capital assets, imputing interest on funds used rightly becomes a part of the cost of the capital asset.

This procedure certainly follows the generally accepted principle that all charges directly attributable to a construction project should be capitalized.

It is also worthwhile to note that there are companies outside the utility industry which are in fact capitalizing imputed interest on self-constructed assets. I refer, of course, to the real estate industry.

All other things being equal, a company which is constructing its own assets should not have costs treated differently from those of a company which is buying an asset.

From an accounting principle standpoint, a company's cost should not be detrimentally affected by the decision to self-construct an asset.

The capitalization method has the advantage of putting all contractors on the same cost base, thereby

permitting greater comparability.

Its disadvantages are:

One: It would defer cost consideration from the period in which the cost is incurred to those periods over which the asset is depreciated, and;

Two: It would require an additional set of asset and depreciation records over the life of the asset.

This requirement would arise because generally accepted accounting principles do not permit capitalization of imputed interest in asset accounts except in the case of regulated public utilities and certain real estate situations.

Because of these substantial disadvantages, we favor the first method discussed above.

In conclusion, contractors must be permitted the opportunity to recover all costs; certainly no investor would provide an enterprise with capital during a period when there were no earnings, unless he knew that he would eventually be compensated.

The American free enterprise system permits industrial companies to adjust the current prices of their products to recover the equity cost associated with construction but, in a regulated field such as ours -- where prices are based on cost and controlled by regulatory provisions -- the equity cost cannot be recovered simply by adjusting current prices, but must be recovered in future periods based on a recognition

of imputed interest.

Gentlemen, I appreciate the opportunity you have afforded me to make this statement, and I will entertain any questions that you might have at this time.

See Appendix I for entire statement.

CHAIRMAN STAATS: Howard, anything you would like to add?

DR. WRIGHT: I think it might be interesting to the Board to know that Ohio Public Utility Company has now -- within the past year -- made a decision to include in the rate base the cost of assets under construction, which is the solution we recommend as distinct to capitalizing the imputed interest.

This is imply as a matter of information.

There is, I believe, a precedent for this and it is being done and I simply commend it to the Board.

CHAIRMAN STAATS: The alternatives you suggest might be open to us -- do you have a definite preference as to which route we should take?

MR. HILL: Yes. That was our first choice. The same with depreciation.

MR. BEVIS: Capitalize.

MR. HILL: I believe a choice to recognize the assets of construction in progress as part of the asset base while calculating the current cost factors.

CHAIRMAN STAATS: I just extend the asset base to include --

MR. HILL: That's right.

DR. WRIGHT: If I may, in all fairness, I think you are going to have to come to grips with this issue, either now

or at the time the proposed standard on the cost of money as an element of the cost of operating capital comes up, because in the last analysis, you are going then to presumably deal with total cost of capital devoted to government products and you either deal with it now, in connection with 414 or deal with it subsequently.

You either have to consider it as fixed capital or working capital.

SHAIRMAN STAATS: I believe you prefer to deal with it in the context of 414?

DR. WRIGHT: Yes.

MR. WALKER: Howard, from an accounting point of view, why do you select the alternative that you do?

DR. WRIGHT: It's Gary's selection, John.

MR. WALKER: I thought I heard you say that you agreed with it.

DR. WRIGHT: I do agree with it, John, but Gary is the spokesman.

The basic reason is we do not recognize basic subsidiary sets of accounts. It would be, in essence, closer to being in accordance with what the company already does -- not to get into a discussion of imputed interest and capitalizing imputed interest, and putting that in the cost of the asset at that time -- that it is devoted to construction under the contract.

MR. MAUTZ: There is an assumption that you can also impute at the time the asset itself is under construction -- what its final use will be.

DR. WRIGHT: This is precisely our point. I believe -- I am speaking only for myself at the moment -- that it would be necessary to identify the particular facility as to whether it was going to be used in government production or alternatively, was the kind of a facility such as a home office or group headquarters, or something like that, where under the present 414, the imputed cost of money would be computed.

MR. HILL: At the time you made the computation, you would have to make a computation as to what category that asset fell into.

MR. BEVIS: You don't see much practical difficulty in that?

MR. HILL: No, sir.

MR. BEVIS: Among facilities -- as I understand it -- it is difficult enough, as it is to flow the imputed cost of interest under 414 down to a specific contract from a rather general facility?

MR. HILL: Yes.

MR. BEVIS: You don't see any difficulty in putting the construction work -- in-progress investments -- into a category which would have no greater problem then going down to the contract than the existing facility?

MR. HILL: That's right.

DR. WRIGHT: Herman, could I make one point in connection with your last one?

As a matter of concept, I think we have to choose first that which is equitable, and, secondly, if we have to deal with practical problems, let's deal with them as a subsidiary to the problem of equity.

So, let's first not rule out an equitable solution because there may be some practical difficulties. Let's first try to be equitable.

MR. BEVIS: I can't argue with you on that.

(Laughter.)

MR. BEVIS: You almost indicated that I would disagree.

DR. WRIGHT: I wanted to get the point on the record.

(Laughter.)

CHAIRMAN STAATS: Well, it has been very helpful. We talked about this yesterday. We had a little advantage of having a chance to read some of these statements before today so we had a chance to talk about some of these points yesterday.

Howard, could you take a minute to make a comment on Phil Blattau's comments?

MR. HILL: Before we leave the 414 matter, I would like to point out that there are serious difficulties developing over this dispute.

There are non-compliance reports written-- things

like that -- so it is a matter which we would appreciate attention being given to -- to resolving our day-to-day difficulties.

MR. BODENHEIMER: In that respect, what kinds of non-compliance?

MR. HILL: With 414, because of DOD which says assets under construction are not included for consideration in CAS 414.

So, therefore, if you insist in bidding your contracts using that asset base, you are in non-compliance with the DOD interpretation.

So, we are being held to be in non-compliance because we want to include assets under construction.

CHAIRMAN STAATS: Yes, Howard?

DR. WRIGHT: One little point in support of Phil's comments, and I am not unmindful of your desire to improve the language and made editorial changes and things of this nature.

But, I suggest, if I may -- and Bob will recognize this -- that you are not a group of college professors editing a doctorate thesis -- that every editorial change you make should not be made unless the reasons therefore are compelling -- not merely for a change in language or an idea -- somebody likes different words -- because you confuse those who have to interpret your words.

Also, use the same words. If there is already a

word in the state of the art, and that word also has a particular meaning in the state of the art, rather than going to some other word -- because of some desire for personal preference or because the group doing this feels that that which is already said is kind of trite and they have to put their mark on it -- and, therefore, the way to put your mark on it is to say something differently -- I have been carrying on about this -- as Bert knows -- for at least five or six years.

You confuse people who have to interpret them because if you make a change, do you mean something different than you meant before? Do you mean the same thing?

How does a judge in an ASBCA case look upon a change in words between the 1973 statement and the 1977 statement? Are you implying something different than you meant before?

That is my comment.

CHAIRMAN STAATS: I think I would accept your point more with respect to prefatory comments and working of regulations that I do with this.

This was designed to be non-regulatory in nature. It was designed to try to explain the Board's thinking as much as we could.

The overall framework in this would be good. I was not perhaps as sensitive as you and others might be with respect to changes in phraseology here.

Having said that, it seems to me that we ought to

consider the possibility of some kind of an invitation for comments on future changes and I hope there will be future changes in this document.

It is a living document.

DR. WRIGHT: We are not suggesting that there shouldn't be changes. From my own experience, I know that judges in the Board of Contract Appeals look at the yellow sheet -- the Golden Rule Book -- forgive me -- they look at it and it gets introduced into evidence in ASBCA cases.

Changes in wording, certain differences in meaning are ascribed to the changes in wording in court cases. All I am asking is: Be a little conscious of that possible use, even though you don't intend at any time that it be used that way, because it will be used that way.

CHAIRMAN STAATS: As long as we are in agreement that something we wrote three or four years ago shouldn't be engraved in granite and therefore it is no longer possible to change it.

DR. WRIGHT: Thank you for listening.

CHAIRMAN STAATS: Thank you very much.

We are now at the point where we would like to have some additional presentations from others of you, if you care to do so. The floor is open and depending on how strong your voice is, come up here and speak.

Mr. Bodenheimer reminds me that I should explain to

you how to get a copy of the transcript.

The young lady down here is taking stenotype notes and she advises that if you leave cards with her -- or otherwise communicate with her -- that she will be glad to make arrangements with you to get a transcript.

You will get it sooner through the reporter's service. It can also be had in December -- we expect -- through the Government Printing Office.

If you want it that way, there are envelopes up here on the table. If you fill one out and mail it to us, you will get an announcement -- or give it to us -- make it a self-addressed envelope -- give it to us and you will get an announcement as to how to order the transcript from the Government Printing Office.

This will include the complete text of the presentations and not just the summaries which you had in some cases today.

MR. BODENHEIMER: Also, the NSIA asked me to make an announcement that the Contract Finance Subcommittee Dinner will be in the Balcony Derby Room at 6:30 p.m. I'm not sure whether everyone is invited or just --

(Laughter.)

CHAIRMAN STAATS: Who wants to make a statement or ask a question?

MR. BARDEN: My name is John Barden, with Blue Cross

and a couple of things alluded to today-- where Bob has had questions -- regarding full costing, direct costing -- it means different things to people that came into accounting 20 years ago as it does today.

I wonder whether it would be possible, as part of a challenge to the Cost Accounting Standards Board, to work up a comprehensive glossary of accounting terms so that we all know that we are talking about the same things, because as we also discussed earlier, cost is what you define it to be and we frequently find people either think they are talking about the same thing and they are not or conversely, they think they are not talking about the same thing and they are.

I think that would be a valuable contribution to the people in the cost area.

CHAIRMAN STAATS: Bob, do you want to take this one?

MR. MAUTZ: Not really.

(Laughter.)

MR. MAUTZ: The difficulty with our doing that is that we have a very specialized view of cost accounting. We are concerned on this Board with negotiated defense contracts.

We start from that basis. Now, one of the major problems that the staff had on the agenda at the very beginning was that kind of a glossary.

We ran into trouble with it. We tried to work with some of the educators and others to develop that kind of a

glossary or dictionary of terms.

We have found time after time that our fairly specialized interests causes us to think in somewhat different terms.

Now, we do have in connection with our standards those definitions we think are essential for our purposes. If they weren't the ordinary use of the common terms, we define them, but we had to define a whole series of terms for other purposes, and the persons that want to really understand have to become as familiar with those definitions as we are using them.

I think it is a useful service for someone to develop a dictionary of cost accounting terms, but I don't think we are ever going to do it.

CHAIRMAN STAATS: Mr. Bodenheimer would like to comment.

MR. BODENHEIMER: I think Bob is quite right.

We have had, since almost the first day, a so-called terminology project.

Paul McClenon has been the project director on that project, and always beseeches the staff before we write a standard to give him the terms we would like to use and he would develop definitions.

Through no fault of Paul's, I think that effort has been kind of a dismal failure because we find that when we go

to use the terms in a specific way, in a particular standard, the definition just won't work.

So, what has happened is that we are, I guess, gradually developing a section of definitions in Section 400 in our regulations, but these are all terms used in the standards in a particular way.

We simply find that to try to develop a definition without knowing how and where they are going to be used has not been successful at all.

But, I think over a period of time all the key terms, included in the standards, will have definitions and will be in Section 400 of our regulations.

So maybe we will get something like you anticipated in the end.

CHAIRMAN STAATS: Perhaps in the nature of a recapitulation -- we will write the standards and then write the definitions.

Who else has a question?

MR. O'HARA: I am John O'Hara and I am the Director of Contract Policies for the Boeing Company.

The question that I would like to raise -- and I am going to have to do this extemporaneously because this is the only chance to bring up the questions -- maybe I am anticipating that something will be brought up tomorrow -- but I don't want to take the risk, because I think it is a matter of widespread

impact.

It is certainly impacting us, prospectively, and I think it is going to impact many others and the Department of Defense, particularly, and has to do with the question of effectiveness of cost accounting standards in subcontracts that are placed with European or other foreign firms in contracts that are either under foreign military sales or are joint procurements of the United States and foreign entities.

There is one particular strange kind of procurement that is under contemplation now -- under which NATO will procure some AWACS Aircraft from Boeing and there is a very extensive co-production plan that is in the process of conception right now.

Now, many, many things have to be worked out with foreign countries -- with, foreign contractors. A dark cloud of uncertainty hovers over us, really. It is dramatic to say that, but if you are close to it, believe me, you get rained on by this dark cloud of uncertainty as to just exactly what is the position of cost accounting standards with respect to this kind of a contract.

There is a resolution for the United Kingdom, but the kind of contracting we are contemplating will have subcontracts in many NATO countries and in France -- which, while a non-NATO country, may be a participant in the procurement.

I don't want to precipitate an answer. I don't want

to presume this is a position on which you are prepared to take a position, but one of the difficulties we are facing is that in attempting to do our forward planning, we are being given to understand from the program management people with whom we deal that they have been advised that no request for exemption will be entertained and that the Board has taken a position of intransigence with respect to this.

I would like to ask that the Board not take such a position -- at least without the opportunity for a presentation which would attempt to delineate some prospective ways of dealing with the fundamental question such as the question of consistency: 401/402 type applications, and also, the question of degree of compatibility or infrastructure, if you will, of the legal and contracting and economic and accounting systems of the nations that we are going to be dealing with -- and of the contractors we are going to be dealing with; and the type of contracting we are going to be doing.

Also, whether or not it is going to be the kind of extensive contracting that would warrant the non-recurring impact of the installation and response to cost accounting standards for this given -- possibly one-time -- purpose.

CHAIRMAN STAATS: Mr. O'Hara, the AWACS arrangements -- which we know about mostly in general terms -- has not been brought before our Board, and we would obviously want to hear your views about if it and when it does come before the Board.

You are familiar with the arrangements on the F-16 with Denmark, Norway, Holland and Belgium?

MR. O'HARA: I have seen that. I don't think it is a precedent. I don't think it is applicable. I think it also contains many problems.

You know, it raises in and of itself a number of uncertainties. It is the kind of a conclusion I know we won't have to continue to live with, but that is looking ahead into maybe the presentation of the question.

CHAIRMAN STAATS: I think we would be interested in having anything in writing on this as to some of the issues, problems, some of the difficulties you see in AWACS.

MR. O'HARA: I think there are many difficulties.

MR. BODENHEIMER: John, I am a little surprised to hear that we are being accused of intransigence. As a matter of fact --

MR. O'HARA: That is my word. An interpretation of the statement that you would not accept the request for exemption.

MR. BODENHEIMER: We are not unaware of the desire. Well, particularly the German subcontractors for an exemption. Representatives of the German Government have been in touch with the staff and indeed, we talked to them a little bit and are going to talk to them some more, to see what can be done in this area.

I mean, we are totally open-minded on the problem.

MR. O'HARA: Thank you very much.

CHAIRMAN STAATS: Thank you.

Yes?

MR. LEVER: Does the Board look down the road for a period to see when it might recommend the sunset on its activities?

In line with what was testified to, I think, in congressional hearings, it seems to me an indication that this is not to be a permanent situation.

I was wondering whether the Board was looking at this question.

CHAIRMAN STAATS: I think you are seeing people up here who are quite agreeable to that.

(Laughter.)

CHAIRMAN STAATS: We do have a number of standards that we still see in the picture ahead of us. I suppose until we get further down the road and see the end of the number of standards that we now see the necessity of developing, we are not going to be addressing that question in very specific terms.

MR. HAGAN: I wonder if you can give us a rough estimate of the release of the so-called overhead standards.

MR. BODENHEIMER: A rough estimate -- we are busily engaged in that area now. Yesterday, the Board met and we took up two of the standards in that area.

I expect that at the next meeting or the one thereafter

we will probably be able to take up one or two more.

That sounds like sometime in December perhaps. I would say somewhere early in the Spring perhaps and some of the staff may kill me -- I don't know, but the problem is in response to industry's desires.

We want to publish all the standards at the same time so that everyone can see the whole package instead of seeing it piecemeal and, my guess would be by early Spring.

MR. HAGAN: Okay.

MR. LANTZ: I would like to ask the Board whether there are any plans to extend your cost of capital concept, which is fairly limited at this point in time -- and whether you are working with the DOD to see the effect that the cost accounting standard is having on particularly research and small contractor operations?

CHAIRMAN STAATS: Well, I am not sure I can respond to your question in those terms. We do have on our schedule for future study the cost of working capital and the cost of money involving working capital, but when you speak of small concerns, I am not quite sure I understand what you are referring to.

MR. LANTZ: The present situation puts somewhat of an emphasis on capital intensive industry -- that certainly is built into some of the justification which the DOD has used in the Profit '76 Study -- and other kinds of testimony before

Congress.

Some of the small research firms find that is very detrimental since they are labor intensive.

MR. BEVIS: Would the cost of money involved in operating capital solve that problem or is there still a different problem?

I'm not too clear.

MR. LANTZ: Well, I think part is tied into what the DOD has done with their pricing profit change, basically, alloweing the same kind of profit in general, causing the switch of profit to be general cost accounting.

Now, that threatens people that are very labor intensive in nature. Perhaps taking in working capital would help.

There are other measures beyond that.

MR. BEVIS: That is exactly the point: What other measures beyond that? I don't think you are suggesting that the Cost Accounting Standards Board should tell DOD what profit margins they whould allow to various contractors. I'm sure you are not saying that.

What else can CASB do?

MR. LANTZ: Well, you made a basic change away from theoretical, generally acceptable accounting. It is a question of how far you are going to go. You could go all the way to measuring human assets.

(Laughter.)

MR. BEVIS: Would you want to put yourself in our hands on that point?

(Laughter.)

MR. WELCH: I am Clark Welch and we have a real problem in implementing CAS 410. We have to -- (inaudible) -- to pull out elements on cost functions that don't belong there and some of these we say belong in what would be a material overhead pool, when we get around to setting that up.

And, have a standard coming out on material overhead pool, so we take it out of G&A and put it into the material labor pool.

Would that change in setting up the second pool at that time be an A4A type change -- to get an equitable adjustment or voluntary accounting change at that point?

Further, in doing this, we analyze material related activities and find that some of those are in the production center, so to purify this new burden center, we are setting up, in compliance with CAS 410 -- we put those in the new burden center before you come out with this new standards.

The auditors, in talking to them about this, generally take the position that these two changes in setting up this new burden center is probably a voluntary change.

Yet, we feel that is not right. We are doing this in compliance with CAS 410, which effects G&A.

Any thoughts that you may have on that will give us some relief during this interim period.

MR. BEVIS: Some of this you are doing in compliance with future--

MR. WELCH: Well, possibly, yes. It could be looked at that way.

We are doing it now to comply with CAS 410 and we are taking a further look because we know we have to pool together suitable procurement activities that are maybe closer in material related pools.

(Inaudible) -- do we wait until the new standard comes out or can we do it now and have all of this change being considered a change in compliance with the standard to get equitable adjustment?

MR. BEVIS: Your dispute with the Government people essentially is that they say 410 doesn't require you to do this; is that the --

MR. WELCH: That's it. They say we are looking forward to a new statute coming out and making a change in anticipation of the statute.

I think that ought to be some relief along the lines of what Mr. Kleinberg said.

MR. BEVIS: Fred Newman is out here.

MR. NEWMAN: I understand the Board took care of that yesterday.

MR. BODENHEIMER: Well, that's true. As a matter of fact -- perhaps the changes we are making to accommodate changes in accounting practices may help.

I am not sure. It is frankly a little risky to try to answer very specific questions in a forum like this, without really knowing both sides of the issue and all the details.

It really sounds like a voluntary change that you are making -- absent a standard -- in anticipation.

MR. WELCH: Wouldn't the first part at least be entitled to equitable adjustment? We pulled it out of G&A and have to put it somewhere. We could put it in production for sometime and then -- it's a real problem, analyzing our costs.

MR. BODENHEIMER: I understand the problem. Putting aside the costs that apparently don't belong to G&A are changes you are making pursuant to 410. If there is anything else outside of that it could well be it is not a change under 410.

I could see that kind of rationale, but again, I hesitate to really give you a very definite answer without knowing more about the case.

MR. WELCH: Thank you.

CHAIRMAN STAATS: Another question here, in the back of the room.

MR. HEALEY: David Healey. This is a bit of a follow-up on McDonnell Douglas' comment on what is increased cost of the Government.

We experienced a voluntary change in allocation of home office expenses. As a result of this change in one segment, in which there was Government business, there was an overall decrease in cost.

This particular segment is about 90 percent cost type business. There is no doubt that the overall cost to the Government in this division has decreased.

That being the mechanism and considering there was also covered contracts -- all the same -- we are being told that this is not so -- that the change -- (inaudible) -- and also, needs more money because of the change in the fixed price.

We are demonstrating an overall reduction in cost to the Government. 90 percent of the reduction is cost type and the Government is back now for the other 10.

This does not seem right when the overall cost to the Government has decreased. Does what I'm saying make any sense?

MR. McCORMICK: I think we understand. I mean it is basically the same position that McDonnell Douglas finds itself in relative to its changes, and the question comes down to whether or not you touch fixed price contracts under the interpretation or the regulations description as to what constitutes increased costs to the Government.

Frankly, I think that in view of the fact that McDonnell Douglas is sitting on a real live dispute in this matter

my recommendation would be that we say what the regulations are and I don't think it would be appropriate for the Board members to make a comment on something concerning a situation which is really in dispute at the present time.

MR. HEALEY: I guess what I am saying is does not a decrease in the cost type offset any increase that may be perceived in the fixed price work?

MR. McCORMICK: I though you said that the totality -- that all the cost -- of all the contracts -- had a decrease in cost relative to the whole division, because, I assume a lessor allocation from the home office.

MR. HEALEY: There are those which were decreased to the Government and with the use of the offsets --

MR. MC CORMICK: Offsets within the division itself?

MR. HEALEY: The one change. I reduced the cost in this division by \$100,000.

MR. McCORMICK: Yes.

MR. HEALEY: 90 percent of that decrease applies to cost type work. That is an absolute reduction in cost to the government.

It doesn't effect the fixed price work and the government is now saying to me that that reduction in cost from a particular price is an increased cost to the Government --"Well take the 90 and we want the 10 too."

MR. MC CORMICK: I think in the regulations, as

currently written -- we define increased costs under fixed price contracts -- if, as a result of a change -- voluntary changes -- you charge less to that fixed price contract than was originally contemplated at the time of the negotiations, due to the accounting changes -- that is considered an increased cost to the Government under our interpretation of the legislation in 331.70.

MR. HEALEY: No offsetting for the decrease in cost?

MR. McCORMICK: Where is the decrease? All the contracts in the organization -- in that division have had a lesser allocation?

MR. HEALEY: Increase in cost, you mean?

MR. McCORMICK: So you look into each contract. I don't know if your figures are absolute or not. It is maybe a question relative to one particular contract.

I am saying that the way Regulation 331.70 defines what is increased cost paid by the Government under fixed price contracts. As I understand your situation -- what the Government is saying falls in that interpretation.

MR. BEVIS: Isn't the Government really saying to you that the fixed price contract price was higher than it should have been and so they are lowering it on account of the lesser amount of costs being allocated to that contract?

Isn't that what they are saying to you?

MR. HEALEY: See, I made a change in my accounting.

It's a little involuntary -- but outright offset. I have reduced the costs in that division by \$100,000. Those costs would have been borne by a commercial division. Okay.

Now, the Government -- in its pocket -- is realizing \$90,000 of that \$100,000 change.

MR. BEVIS: And the Government is saying you short-changed them \$10,000, aren't they.

MR. HEALEY: Yes.

MR. BEVIS: That's the question.

I think the word offset kind of confuses it. Isn't the Government saying that fixed price contract should be \$10,000 lower also?

MR. HEALEY: Yes.

MR. BEVIS: That's really what they are contending.

MR. HEALEY: Yes, correct.

MR. BEVIS: And you are contending that that should result in an adjustment of the contract price?

MR. HEALDY: If my mix was 90 percent fixed price and 10 percent cost type, I could see the problem with the Government only getting a 10 percent reduction, but it's the other way around.

MR. McCORMICK: Well, you are not really talking to principles, you are talking to matters of dispute.

Well, as I say, the definition is there and it is the Government's position that that would be reclaimed, also,

unless it is immaterial.

There is no doubt that people are arguing to the contrary about that definition. But, that is --

(Conversational feedback from the audience.)

CHAIRMAN STAATS: I think we had a very good day and we will see you tomorrow morning at 9:00 o'clock.

Thank you very much.

(Whereupon at 3:30 o'clock, p.m., the meeting was adjourned, to reconvene on Thursday, October 13, 1977, at 9:00 o'clock a.m.)

P R O C E E D I N G S

MR. BODENHEIMER: Good morning. Yesterday we made an announcement about the transcript. Unlike our standards, I guess the announcement wasn't very clear, so I am going to try it again.

A full transcript of the proceedings will be available through the Acme Reporting Company, and their representative is here today. That transcript will be available within a few days, I think, or a few weeks, anyway, and I understand will probably cost in the range of \$200. If you are interested in that transcript within a short period of time, leave your name with the Acme Reporting Company and they will see to it that you get the transcripts.

You may also get the transcript some time in December through the Government Printing Office. The price will probably be somewhere between \$15 and \$20. We are not trying to compete with Acme, but that is the way it works. Anyone interested in information about how to get the transcript in that manner, fill out one of the envelopes on the table up front -- I mean leave a self-addressed envelope there wither on the table or let me have it or let Chris Goodwin, sitting up front here, have it. We will send you the information about how to get the transcript through the Government Printing Office.

MR. STAATS: I would like to welcome all of you

this morning. I trust you all stayed up to the bitter end last night. Bob Keller and I were back at the GAO to hear a speaker who quoted Charlie Brown as his favorite philosopher. I think we may take this as a model for the CASB. He quotes Charlie Brown as saying, "The greatest burden of life is to have a great potential." I suspect that some of you would share in accepting that as our model.

We had invited Lester Fettig, who is head of the OFPP, to talk this morning. I think he is late. I don't believe he is here. So I think we will take the next in order; the Aerospace Industries Association I believe was next up on the batting order.

STATEMENT OF PHILIP BLATTAU

AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

MR. BLATTAU: This is the statement of the Aerospace Industries Association. It was to have been made by Mr. Virgil Pettigrew, the Chairman of the AIA Procurement and Finance Council. Unfortunately, as often happens with people in business, there was an urgent business crisis that took him away from the country, and therefore I am here in his place.

In my role as I guess the senior AIA staff member present -- there is one other besides me here from the AIA staff -- I have with me colleagues who participate as members or as contributors to the work of the AIA Cost Principles

Task Group, and I would like to introduce them, Mr. Bob Brand on my far right, Mr. Chuck Hardinghouse on my immediate right and Mr. Jack Gorman on my left. They will assist me in attempting to answer any questions that you have following the presentation.

The AIA is pleased to appear here in response to the Notice in the Federal Register as well as the invitation which you, Mr. Chairman, sent to our President. We do wish to respond to the suggestion that we provide views on the subject of costs and benefits. This request, however, compels us to make several observations.

The costs and burdens to the Government and Industry of developing, implementing and complying with the Cost Accounting Standards, Rules and Regulations have been significant, and we think that this fact should be accepted, even though every estimate of costs that is made is subject to some question, number one because it is an estimate, and number two because it always isn't supported to the extent of detail and backup and data that people would like to see.

CAS we believe was to help the procurement process. We have not seen that the procurement process has been helped. Is CAS worth the burden? We think there is a need to find out, and we don't believe that CAS can be adequately evaluated on a standard-by-standard incremental basis of either benefit or cost. I think that is consistent with the view I thought I

heard you express yesterday, Mr. Chairman.

To our knowledge, there has been no well organized comprehensive effort to ascertain on a not-for-attribution basis the views of all the people -- not all of them necessarily -- but many of them who are affected by CAS, including Government contracting officers. How do they feel about the effects of CAS on the procurement process? Their opinion may well be similar to ours.

It will be interesting to see what the results of the AIA analysis of its survey show when they are provided. Because no comprehensive overall assessment of CAS has been made, AIA wrote to the Congress in January and urged such action. We told Congress that the burdens of CAS far outweigh the benefits.

The Board did not agree with many of the things which we said and so stated in its June response, also sent to Congress. These two communications, AIA to the Congress and the CASB response, contain material which is helpful in evaluating costs. These documents are available to those interested.

AIA does favor evaluation, and we favor annual evaluation. We are in accord with the objectives of this conference. The Board states that the conference is undertaken to receive suggestions and comments to improve the effectiveness of its Standards, Rules and Regulations. We

think this is an assumption that has not necessarily been established; namely, that Rules, Regulations and Standards are effective.

The Notice also states that suggestions and recommendations are desired to enhance the utility of Standards, Rules and Regulations in contract negotiation, administration and audit. Here again there is an assumption that this usefulness has been established, and we don't believe that its existence has been established.

The Notice goes further in stating, "To the extent possible, each suggestion or recommendation (which is made at the Conference) should be substantiated by examples and data derived from experience." Under these conditions we think that there is a lot of relevant information about Cost Accounting Standards, its effects, its problems and its difficulties that will not be brought out in this conference.

Nevertheless, we welcome the Chairman asking AIA to participate and indicating interest in two matters; first, how to best make a judgment as to cost and benefits of Standards, and second, how costs and benefits can be quantified.

The Board has been criticized most about the fact that people consider it hasn't done an adequate function in evaluating costs and benefits. However, the Board in its statement of 1977, the restatement which I discussed yesterday,

stated that it views costs and benefits in a broad sense. All disruptions of contracts, agency practices and procedures are viewed as costs. "Benefits include reductions in the number of controversies. Benefits will be achieved through simplified negotiations, administration, and audit settlement."

While recognizing that it would be extremely difficult if not impossible to quantify the benefits from Standards, nevertheless the Board considers total benefits relative to costs.

The Board's view is sound. Why then should there be such a dichotomy between the Board and its Staff on the one hand and the views of Industry on the other as to how the function of comparing cost and benefits should be performed.

From the Board and its Staff come the emphasis that the only costs that really should count are the "verifiable, incremental costs of implementation." From Industry comes the emphasis that the Board should somehow develop mathematical cost/benefit ratios.

Probably neither of these views is very realistic.

The Board may be a unique Government agency. Nevertheless, its activities do affect the use of resources -- people and time. We think that the Board has the responsibility to know how its programs are working, what they are producing and what the results are. Private Industry itself

has limitations. Companies aren't established just to do cost accounting, and are not always able to produce information about the effects that would be considered adequate in the views of those in Government to the need for and use for cost accounting information.

There is no ready solution to the problem of evaluating costs and benefits, and we would state again that we recognize the difficulty of quantifying the benefits which are sought from Standards. We shall not attempt to suggest how the benefits can be quantified.

Although there is no ready solution for the Board's problem, there are some changes in its procedures and practices which would enable the Board to better judge whether or not a Standard should be promulgated, and after promulgation whether or not a Standard should be amended or other changes made.

Once a topic has been selected as a candidate for a Standard, a statement of need should be prepared. That statement should be published and comments invited. This step would provide better information and specifics about the benefits expected.

Research, analysis of alternatives, and staff drafts of approved topics are followed by publication of a proposed standard in the Federal Register. Past practice has been to ask for estimates of cost in one or more of these stages of

development. Any such estimates are therefore prepared in relationship to an interim proposal. The finally promulgated standard is always different. Therefore the Board doesn't now obtain estimates of costs or expected effects related to a standard to be promulgated.

A further step is needed in order to have better information about costs. The finally revised standard which is to be promulgated should be published with a request that those who will be affected provide information about the actions required and the concomitant costs and what the effects are likely to be. That action will provide better information about the expected costs and effects of the Standard.

The Board now sends Standards to Congress for its review at the same time that promulgated Standards are published in the Federal Register. The Standard would then, under this suggestion, not be sent to Congress for review until after the Board had information about the costs and effects in relationship to a final Standard. The Statement of costs versus benefits that the Board submits at that time would therefore be more comprehensive, specific and authoritative than the present procedure provides.

As to post promulgation review, that Board states that its principal sources for information about the experienced effects of its Rules, Regulations and Standards are

the annual reports from Government agencies and industry views from evaluation conferences. We think that a realistic continuing Board consideration of the costs and effects of CAS cannot be accomplished with primary dependence on these sources.

AIA studies, which we previously referred to, indicate the burdens of CAS outweigh the benefits. However, we are communicating at this conference to be constructive in terms of the future and not to argue or debate the material in the AIA Study and the Board's response.

The first perceived difficulty in the way of a realistic post promulgation costs and benefits evaluation of CAS Rules, Regulations and Standards is the current environment. We think that many in Industry are reluctant to voluntarily express, or otherwise provide, views and information which may be considered critical of CAS.

There were seven companies who voluntarily provided the Board with the estimates of costs to comply with CAS that they had submitted for the second CODSIA Survey of the Economic Impact of Cost Accounting Standards. In each case the CASB asked the General Accounting Office to review the estimate. Visits from the GAO are not something that companies welcome, especially when the purpose is to make an audit examination of estimates. A realistic post promulgation evaluation of CAS, therefore, requires, we believe,

believe, something else. Once a Standard has been promulgated it should not be assumed that the expected benefits will be achieved and that there will be little disruption in cost and implementation. The Board should act positively to determine the effects on Government and Industry.

Within a stated time, or whatever time is appropriate, after the Standard becomes effective the Board should initiate a study project to obtain information about the effects, including costs and benefits. The study should include review of an adequate sample of contractor and Government Auditor and Contract Administration locations. We think that such a study could obtain and collect a lot of information which is not now ascertained in relationship to promulgating standards.

We think that the objective of such studies would be to find out what was done, how it was done, and what were the effects. These recommendations for changing procedures, for evaluating costs and benefits, of course relate to individual Standards, and in summary, we recommend that the Board consider revising its procedures to that the costs and benefits information can be solicited in respect to a proposed final Standard and the results can be summarized in the material which the Board sends to the Congress for its review of the Standard, that a post promulgation study be made of the effects of each Standard,

and the study results provided to Congress and published.

That is the end of my presentation, Mr. Chairman.

Note: (See Appendix I for entire statement)

MR. STAATS: Why do you stress the need for the study on the basis of promulgated standards as against the first publication in the Federal Register. We are trying to get as best we can the reactions of the entire community to the costs and benefits of a proposed standard. As you know, if there is any major departure from that first publication, then we republish. I wondered why you stressed the final promulgation as against the first publication?

MR. BLATTAU: We stress that because each of the estimates that are made are in relationship to something not really final. There always are changes that are made, and therefore an estimate of what the effects might be is made in relation to something that is interim.

Let me illustrate by pointing to some of the standards which I think will better explain why we make this point. Take CAS 406. The Board concluded that the standard as published herein has for most contractors and for the Government almost no cost impact. The only expressions received in response to our requests have been answered by changes.

Take another one, 409. A number of the administrative problems described in the comments have been reduced

or eliminated by changes to the standard.

Or another one, 410, G&A expense allocated to final cost objectives. As indicated above, a number of the potential administrative problems described in the comments have been reduced or eliminated by changes in the standard being promulgated today.

This illustrates that when you do make the final promulgation to the Congress, this doesn't really provide a realistic assessment of what the effects of cost of implementation will be, because no estimate has been received in relationship to that finally proposed material sent to the Congress.

MR. STAATS: I would like to assure you that many changes are made based on evidence that we get from the responses. I don't know whether it would be feasible for us to separate our in our prefatory comments precisely the changes made in each one, line-by-line, based on that kind of a judgment. I appreciate what you have said here about the difficulty of quantification, and I suspect that we are in no different position here in this decision than we are in many other types of federal operations.

I know you have watched the debate on natural gas deregulation, as I have, and even there where you can put a price tag on it, the range of cost benefit analysis is just all over the landscape.

It is even more difficult if you get into the field of environment controls, water pollution, air pollution, safety, and health. In the GAO we have worked with this a great deal because of a mandate to make cost and benefit studies of programs. We recently assembled a group of people, the best we could assemble from anywhere in the country, including two circuit court judges who have a lot of these kinds of cases before them. It is a very, very difficult problem of assembling the evidence, which makes it conclusive to all the parties concerned that you have made the right decision.

I think really what we are faced with here is a very similar problem in this Board. Now maybe we are not articulating as well as we could the basis on which we make a judgment. This point was made yesterday, and I certainly think it is a fair point.

But I want to assure you that we try, and we can only act on the basis of the best information we can get resulting from the responses that we get from people like yourself. As you know, the GAO was recently called upon to make an assessment of the costs of administering the Renegotiation Act. I think we made the best effort that could be made under the circumstances, but the result I think had to be inconclusive as to whether or not the cost that was presented by the contractors was the same as what we had ascertained. No question about it; we had access to all of the information.

But you get into incremental costs here, and then you have to raise a question of what are the costs in relation to what. In that case, without renegotiation, then you have reporting under Vinson-Trammel. In this case, if you didn't have these standards, you would have something else. So that is another factor in the problem.

I am trying to emphasize that from our side of the table we are faced with a very, very difficult problem of making these judgments, but we are not going to give up trying.

Herman, do you want to say something?

MR. BEVIS: Phil, as you well know from your experience, any Board that tries to prescribe in the interests of more consistency or uniformity some kind of rules is going to require somebody to change something. We get a lot of objection from industry as to what we are doing and how we are doing it. I think there were objections before the Board was formed, because there were rules, accounting rules before this Board was formed.

What do you think that your companies would prefer to have in the cost accounting field? Would they try to contend there ought not to be any cost accounting rules, or would they accept the fact that in the nature of this negotiation process there have to be some accounting rules; and if so, what would be their plea as to how to improve the

situation?

MR. BLATTAU: I don't know that we have ever presented that kind of question for a consensus vote or establishment of some sort of unified view with respect to cost accounting standards at this point in time. So I will speculate a little bit, and I guess I will speculate on the basis of the question that I heard asked yesterday, which was to the effect that the Board has done a lot of things.

They have issued a number of standards, and there has been a point of view expressed which says that in relationship to the topics which were outlined after the Board was established that it has either treated or is about to treat practically every one of those standards that were outlined after the Board got into operation. Therefore there is some point in time in which the Board should have substantially completed its work, and that as it proceeds further, the additional standards that are promulgated can almost perforce be on less and less important topics. Therefore I would think that were we to ask for a view from our member companies, it would likely be to the effect that at some point in time the Board should have decided that it has completed its role and mission and responsibility.

MR. WACKER: Be quiet and go away?

MR. STAATS: That is a different question. I guess the point that I would emphasize is that the world has changed

in the last ten years. The kind of regulations we have all across the board, health, environment, safety, and many, many other fields, have come about in the last ten years. It has been about ten years since this issue was raised in the Congress.

I think you have to ask yourself the question that if you didn't have this Board and this statute, what would you have in its place?

You are not suggesting that you don't need any rules at all for cost accounting, as I understand you?

MR. BLATTAU: No; I haven't suggested that there be no rules. I do believe, as was expressed yesterday, I believe by Howard Wright, that you do have a splendid conceptual framework for a cost accounting system in your restatement. So there are rules.

I don't think if we poll our member companies that they would recommend repeal of all the Board's rules and regulations. I don't think they would realistically recommend that. On the other hand, there should be some limit to the extent to which rules and standards are necessary to attempt to circumscribe the cost accounting for each individual company, and we always stress that companies are different. They are like people.

MR. STAATS: You are really talking about how descriptive and how detailed -- this is the point that you are

really making, then?

MR. BLATTAU: I guess the perception of our member companies would be that they think that this is a burden, and if Mr. Pettigrew were here -- in fact, he told me this. He said, "You know, I can't tell those fellows how much it costs in my company to contend with cost accounting standards." He said, "But Phil, every day I am working on cost accounting standards to some degree." So I think that our member companies would perceive that here is something they must contend with. Here is something that is a burden. Here is something which they don't feel has helped the procurement process.

They hope and feel that something should be done about it.

MR. BEVIS: Just continuing what Mr. Staats said about your recommendation, that you get an attempt at cost and benefits on the final promulgation as opposed to the initial publication, and echoing and elaborating a little bit on this point, I can remember on almost every standard where we were considering changing something in the initial publication to the final, that many of the changes were made because someone pointed out undue burden in some area, and we softened that burden in the final promulgation.

Now our reasoning, then, in not going back was that we have made it more livable, and therefore if the initial assessment of burden didn't seem to be undue, then

the final promulgation would be easier on industry.

On the other hand, in a couple of cases we have made drastic changes and were not sure of what the final effect in terms of administrative burden might be, and then we have republished those. I think we have had your point in mind, but have tried to carry it out in a different fashion than republishing and asking for costs and benefits.

And for all your company members -- they tell us that responding to these things is quite a chore, and if we ask them for one more letter of comment on something that has been revised slightly, we might get some criticisms on that score, too.

MR. BLATTAU: You could very well get some criticism on that score. I am not sure that every member company would agree with the recommendations that have been embodied in this statement. However, this was developed in an effort to be constructive on the basis that the Board is being, somebody said, assailed, for not having done the kind of job expected here, and therefore the Board might very well be able to do a better job if it had more information.

And these suggestions are made in the interest of the Board obtaining more information about the costs and the effects of CAS. On that basis, it is even conceivable that with more information there might be some way to quantify benefits. We don't imagine how it would be now, but it is

conceivable that with more information about the effects of standards, it well might be practical to quantify benefits in some useful fashion.

MR. BEVIS: I appreciate the spirit in which the recommendation is offered. We will have to continue to try to balance the trade-off of getting another set of letters from industry versus the burden on them of preparing such letters. Thank you.

MR. WACKER: I would like to ask Phil a question or two that to me gets at the matter and substance of this conference.

You indicate that many in industry are now reluctant to voluntarily express views and information which may be considered critical of CAS. Somehow I haven't really had that impression the past two days. Mr. Kleinberg yesterday didn't pull too many punches there.

You stated there is a lot of relevant information about cost accounting standards that will not be brought out at this conference, and that seems to get at the framework for the conference. I wonder, just to help me and continue my education, Phil, whether you could expand on that a little bit? What am I not hearing that I might otherwise be?

MR. BLATTAU: I guess I would have to say this. Every time there is a meeting of the top management of AIA, represented at Mr. Harr's meetings, cost accounting standards

is a subject. It is always on the agenda. The AIA Cost Principles Task Group meets maybe three or four times a year, and usually one of our topics is to discuss concepts, methods and techniques and ways to implement cost accounting standards.

In addition, we have two, as I mentioned yesterday, two CODSIA Cost Accounting Standards Task Groups. They have been meeting month after month. What I hear sitting in those meetings is a lot more information about cost accounting standards than what is being presented to you gentlemen at this Evaluation Conference.

And I also think that in terms of the amount of time that you have provided for this conference, there are relatively few people that have shown up to speak to this. I guess that is the best way I could respond to that question.

MR. WACKER: I spoke to your AIA group on the West Coast recently. I talked with Mr. Pettigrew, so I think I have a fair idea of what you are talking about. I wanted you to expand on that a little bit.

MR. BLATTAU: I have been asked to point out that -- and I am not quite sure about this -- but doesn't your invitation to appear at this conference also extend to the government agencies, this Evaluation Conference? I am not sure on that point. Does it?

MR. BODENHEIMER: Yes.

MR. BLATTAU: I haven't seen any of them here.

MR. STAATS: I think there is a good explanation for that. We haven't taken a poll and we haven't put pressure on anybody to come, but I think the reason for that most likely is that they do have a channel now of communicating to the Board through an interagency group set up initially at the Board's suggestion. That group meets with the staff of this Board, and I think they feel they have an adequate channel of communication to the Board. I think we would have to say, though, that the primary thing we are interested in with this kind of a conference is the kind of thing that you have been expressing here this morning, the Standards as they impact on the private sector.

MR. BLATTAU: I want to make it clear, Mr. Chairman, that we were not criticizing having these Evaluation Conferences. Perhaps, however, the format could be changed somewhat, which would make it more encouraging for people to appear before this group and speak to you.

MR. STAATS: Do you have a suggestion on how it might be done?

MR. BLATTAU: Perhaps if you didn't have to put your material in 45 days or so in advance so it could be critically analyzed and you will be prepared to ask us all kinds of questions, it might be easier.

MR. STAATS: I don't think we had any reason for

that except that it is always better to have the material available. We got some material here yesterday for the first time, and it will be used. So I don't think you ought to pay too much attention to that particular point. It is not unusual for any conference to ask that statements be made available. I think you will find that a regular procedure.

MR. WALKER: Back to the cost benefit question, Phil, on page 4 of the material you submitted there are some, although not necessarily quantifiable factors, nevertheless very specific sorts of factors that might be taken into account, and there could be a difference between being specific and necessarily having to be quantitative.

In your thinking about the subject, can you elaborate at all on perhaps some systematic use of these sorts of factors, even though quantification might be difficult? It might aid in the conclusions to look at these sorts of things.

You listed, for example, equity to the two parties, the effectiveness and efficiency of negotiations and the like.

MR. BATTAU: Yes. What Mr. Walker is referring to is that in the statement that we submitted we did refer to a letter which had been sent previously, a number of years back, on the subject of costs and benefits, in which we suggested that the Board consider such things as overall economic cost and not merely contract costs, government as well as industry manpower and work load, cost accounting

practices and cost measurement in the procurement process, equity to government and industry in conduct of negotiations, contract adjustments, contract settlements, contract litigations and disputes.

And I think inherent in the suggestions we made regarding the post-promulgation review would be to ascertain -- maybe we shouldn't use the word "cost and benefits" -- maybe we should use the word "effects." What were the effects? What followed? What happened as a result of the standard? And then maybe from more information you would be able to get at some systematic, organized way of looking at and accumulating and reaching a better conclusion regarding the costs and benefits.

MR. WALKER: On the cost side, some of it can be quantified, and you made the point about the GAO coming in and verifying this. It is not unreasonable, it seems to me, that costs be verified. If a public accounting firm did this, would this take away the onerous part of it, do you believe?

MR. BLATTAU: Mr. Walker, it is my perception from, I guess, looking and reading and evaluating and having heard during the era of the Department of Defense about the assessment of different kinds of weapons, that there are methodologies which are used in order to aggregate on a best reasonable way possible what costs are, and I don't think these are the kinds of costs that can be verified and established by a public

accountant of the General Accounting Office, but I think these are the kinds of estimates that have to be made to evaluate a governmental program. And that we don't see has been made in relationship to cost accounting standards.

Now at the AIA meeting that Mr. Wacker referred to, we had an individual come there from the Federal Paperwork Commission, and he had figures that he stated which he understood to be aggregate estimates of what paperwork was costing the United States of America, and I think that there are ways to aggregate in reasonable fashion an estimate of what cost accounting standards cost.

MR. STAATS: I would have to say as a member of that Commission that those figures are off the seat of our pants.

MR. BLATTAU: We would think some better figures could be gotten. There might be certain degree of pride in it, but in our CODSIA surveys of the economic impact of cost accounting standards we approached it on the basis that there are ways to estimate the cost of functions.

Now, the cost of functions some of them show up in accounting ledgers, some of them are aggregated and collected for the purpose of knowing what a function is, but there are many, many functions that are performed in companies or in government that are evaluated on the basis of estimates.

People say, well, you know, I divide my time up

this way. And we see, you know, many people who have programs and seminars and training courses, and the government has one that goes on, I gather, almost continuously on cost accounting standards. We think that there is lots of information on cost accounting standards that hasn't really yet been attempted to be collected in an organized fashion.

MR. STAATS: I certainly don't think that any of us here would want to quarrel with the notion that we ought to get as much information as we possibly can. Where we have a difference of opinion is how far you can go in quantifying that in a way which is conclusive. There is no clear cut answer to the problem. I have heard the same criticism made with respect to the Truth in Negotiations Act, but I don't know how you would go about evaluating the cost and benefits of the kind of information that is supposed to be made available under the Truth in Negotiations Act.

It seems to me that that is the kind of problem we have. You are sitting down across the table and negotiating a contract; how do you quantify the value of the Truth in Negotiations Act in terms of the information available that otherwise wouldn't be available? I think that is the kind of problem that we are facing here.

MR. BEVIS: I am a little puzzled, Phil, about your approach on this cost and benefit thing. As an old has-been accountant, I am entirely familiar with the extent

to which estimates and assumptions go into a calculation of costs. I am also a little bit familiar with those global estimates that come out of the Pentagon at times.

It seems to me what you are saying is that your members are clear that the costs are outweighing the benefits, suggesting that they know what the costs are. Now I know that those are estimates, and often roundhouse estimates, but assumptions that go into the computation or estimating or a cost are extremely important, and other people checking into it, be it GAO or anybody else, might use different assumptions and come out with a radically different estimate of costs, and it seems that you wouldn't like to have those assumptions questioned that go into the calculation of costs.

You didn't say here that -- somewhere in your paper you said that you agree that you can't get an accurate estimate of costs or benefits, but it almost sounds as if you are saying industry knows that the costs outweigh the benefits, but to have someone double check their reasoning is something that they wouldn't like. Now what am I missing here?

MR. BLATTAU: If I understood your observation, I would have to say that we recognize that in the surveys we make -- this is from a perception of people in the industry -- but on the other hand, this perception comes from those who are engaged in and part of the buying and selling which represents the procurement process, and therefore it is an authoritative thing.

MR. BEVIS: However, not calculation.

MR. BLATTAU: Opinions. If there were to be by the government an organized project to widely obtain the information about costs, and they develop certain assumptions, I guess we would say so much the better. Let's proceed.

We recognize that we have limitations in being able to do this, because we have to look at the industry side. But the government is in a position to do this project, perform a study, which we think is important and necessary, and look at all of the aspects of it, with whatever reasonable assumptions they choose to adopt. I don't think we would quarrel with proceeding on the basis that we may not necessarily agree with all the assumptions that might be used in such a study.

MR. STAATS: Would you agree with the proposition, or statement of the question, rather, that the question is not whether you have standards, but what kind of standards?

MR. BLATTAU: I guess it is expressed that way in recognizing that, you know, we have what we have. We can't go back and start over again and say in the light of what we know now, would we have taken a different direction or should a different direction have been taken with respect to standards.

I think from now on in the future you would have to agree not whether to have standards, but what would be the

standards.

MR. HARDINGHOUSE: In answer to your last inquiry to Phil, we in the industry see the costs. It is not assumptions. We see it every day in our daily working routine.

Now we don't see the benefits, and the benefits are intended to be directed as us, industry; I am sure of that. I think it is natural that we don't, therefore, see the benefit. However, we do see what is stated to be the benefits when a standard is promulgated; it is going to improve negotiations, and it is going to improve administration and what not, and we do not see that in our daily working routine with our government counterparts at the working level.

There are increases in the problems of administration of government contracts. There are new problems. Maybe they are not added -- I am not sure of this -- in the negotiation of government contracts. There are new and additional problems in the auditing of government contracts because the Auditors now have a whole new set of ground rules which they are working to, and our audits are increasing, and I am sure our government representatives can attest to these facts.

I personally take some question at least -- I was going to use the word "objection" -- to the broad statement of benefits, when we don't see them at the working level; and I am not talking about benefits to us. I am talking on the government side; what we see the government people

involved with. And I am also raising a question for your consideration, it seems, and maybe because you are accounting oriented gentlemen, that you want support. You want conclusive support for the costs. You keep reaching for that and suggesting in absence of that you can't draw conclusions as to cost -- you don't have the same standards for your benefits. You don't keep asking for conclusive support of your benefits.

Go out and make a post-evaluation by some means. Talk to the Government Accounting people at the working levels if necessary, not necessarily the top policy makers that may have some reason to give you a policy statement of the benefits to be derived, but search deep enough and use the same standard of measurement for support of benefits as you are asking for.

If you want to talk about incremental costs, then talk about incremental benefits. But don't --

MR. BEVIS: Let me just follow up on that. Does your experience go back to the pre-CAS period?

MR. HARDINGHOUSE: Yes, sir.

MR. BEVIS: Could you give us in a nutshell the difference at how costs were arrived at and the cost rules and cost disputes and so forth in the pre-CAS period and then the CAS period, and what in your judgment accounts for that difference?

MR. HARDINGHOUSE: That is a difficult question, I think, to answer. We had generally accepted accounting principles. Someone said it didn't exist, or we don't understand what that means, but I think we were all following -- I won't say we were all following, because you certainly had problem areas. We had asked for it and we went to -- we were taught what cost accounting was supposed to be and what we were supposed to do, and I think we had principles being followed in those days.

Generally speaking, I believe we were following them. There are exceptions, and those were problems, and those problems should have been corrected either under ASPR or by some means, if necessary, by cost accounting standards. So we are still following those principles, except to the extent that now we have some more specific guidelines that are being provided in certain specific areas of cost, and one area that comes to mind is CAS 403 and the allocation of home office expenses. There wasn't much in the way of specific guidelines in that regard as far as ASPR and as far as what was taught in cost accounting concepts, and we were following those.

This necessitated some changes, so I think that is a change brought about by cost accounting standards. We have more specific guidelines, and in general we are following them.

MR. BEVIS: Your options or latitude has been

narrowed through CAS over what existed before? Is that a fair statement?

MR. HARDINGHOUSE: That is a fair statement.

MR. BLATTAU: I would like to add something responding to your question, Mr. Bevis. I think a fundamental difference is, before there were rules, there were regulations, there were manuals. In fact, I had something to do with maybe drafting the first pricing manual in the Air Force. Now we have a new dimension, a whole body of laws which govern parts of the process, and there is a different perception as compared with complying with rules, regulations and manuals as compared with complying with what is required as law. I think that adds to the complications almost immeasurably.

MR. BEVIS: That is what I wanted, really, to pursue. What, as a practical matter, is the difference at the firing line level between applying a CAS standard which has the force and effect of law and applying the equivalent thing in ASPR? What is the practical difference?

MR. HARDINGHOUSE: At the firing line, there seems to be a feeling by all parties concerned that we are now dealing with a law, and everybody is afraid of using any kind of reasonable judgment in the application. You take the government Procurement people -- they read the words and feel they are obliged to follow the literal words, which is

necessarily in normal operations what has largely gone out the window in those situations. They are afraid to render a decision.

MR. BEVIS: So it is a battle over the wording and what action the wording leads to, then?

MR. HARDINGHOUSE: To the extent the wording appears to be specific, and there is some concern at the working level that that is exactly what the Cost Accounting Standards Board intended, and no one really knows that well precisely what the Cost Accounting Standards Board intended at the working level. They are afraid to have deviation, so they say, this is the way it should be, and if you don't do it that way you are in non-compliance.

We don't find the element of judgment that truly should be there as a practical matter. It should be there being exercised by the government people in the administration of this. They don't feel they can do this. I don't say they should, because again it is a law, is stated as a law, and they recognize it as a law and they hang right in there.

MR. STAATS: To what extent would the change of definition of cost accounting practices we discussed yesterday bear upon this matter of willingness to exercise judgment at the firing line level, as you refer to?

MR. HARDINGHOUSE: I am sorry; I don't understand the point about yesterday.

MR. STAATS: We discussed here yesterday -- you were not here -- the change which the Board has now proposed for publication, which would redefine the effect of a change in cost accounting practice, so that there could be some exercise in judgment as to what is a desirable change, without any detriment to the government. That could be an exercise of judgment made by the contracting officers.

MR. HARDINGHOUSE: I think I recall what you are referring to, and I am sure that if we can get a situation there where it is clearly indicated that if the government representatives agree with a certain change as being appropriate and proper and what is not, that is bound to improve the situation.

MR. BEVIS: This is interesting to me, because it suggests to me that a lot of the problems you talk about emanate from the fact that we are a legally constituted body by statute to promulgate standards, and it is that fact alone, regardless of the quality of the standards, that may cause a lot of trouble at the firing line in comparison with the old system where the promulgations may be just as specific, but were not a law.

MR. HARDINGHOUSE: Yes, sir. I think that is right. I don't know how we can change that. We all have the law and are attempting to live by it. You asked what it was at the firing line, and that is the way it works.

MR. BEVIS: Thank you.

MR. STAATS: We didn't hold you to that restriction, Phil. You had a whole hour. Thank you very much.

Les Fetting, as you know from the introductory remarks yesterday, is the new Director of the Office of Federal Procurement Policy, which was created by the Congress pursuant to recommendations of the Federal Procurement Commission, and we have invited him to come here this morning.

I hope you will particularly focus on your role as Chairman of the Interagency Advisory Committee, and your well known interest in the question of trying to get as much uniformity in the regulatory system in the procurement field as you can. You are free to say what you like at this point.

STATEMENT OF LESTER FETTIG

OFFICE OF FEDERAL PROCUREMENT POLICY

MR. FETTIG: Let me apologize for being a few minutes late. I should have expected that the Board that issued Cost Accounting Standard 409 on costs of compensating personal absences would have started precisely on time. My apologies. I'm sorry -- that is 408.

Secondly, I have to say that it turned out to be a valuable rescheduling for me. Listening to the prior debate on the problems of calculating out under Circular A-76. I hope you feel as you have said in the past that we can do a good cost comparison job in that area. It strikes a lot of

people as equally difficult, and we are going to try to do our best there.

I have general comments. My main purpose for being here is to demonstrate the interest and active dedication of the Office of Federal Procurement Policy to meeting our respective responsibilities under the law.

I do want to say as a matter of opening, to express publicly my best wishes for Art Schoenhaut's recovery. I don't think he modelled himself to be a State Department diplomat, but is an aggressive advocate to the job he is trying to do.

Overall, I do take the role as Chairman of the Interagency Advisory Council very seriously. I have only been in the job for about four or five months now, but we have met once already and I would like to state publicly that the Office will take an active and constructive interest, particularly in implementation of standards.

The Cost Accounting Standards Board is constituted in an awkward way, as is the OFPP; yet I feel without question the role of the Office of Federal Procurement Policy as laid down in PL93-400 gives us a direct responsibility to try to interface with the Board and work out the impact of standards on the Procurement community. It is a basic responsibility.

I want to state publicly that we intend to pursue it and be active and constructive in that area. The anticipated

role I see us playing goes to two points.

First, as you mentioned, the essential purpose for the Office as laid down in the Procurement Commission Report was to get about the business of streamlining, consolidating, and otherwise making more efficient the Federal accounting system. Central to that purpose is the establishment of uniform regulatory systems government-wide, namely uniform procurement regulatory systems. We are moving actively on that score.

OFPP's interest in uniformity extends directly to current issues that the Board is grappling with; the civil agencies as well. We have a direct interest there, and we want to work constructively and cooperatively.

Secondly, I see us offering -- as you know as well, the Office of Federal Procurement Policy is closely tied in its reporting and advisory provisions to the Congress, and I would expect to fulfill the intent there by actively trying to offer the advice and assistance of our office to Congressional committees. Specifically, we did just write to our Oversight Committees supporting the Board's promulgation to raise thresholds. This is an example of cooperation I would like to continue in appropriate areas.

If I might make a few general observations, not to make any particular points or to establish any particularly specific positions, but just to lay out a perception of our

related roles, first and foremost I would say that the Cost Accounting Standards Board and the Office of Federal Procurement Policy share a number of common features and common problems.

First off, we both are based in law and we have considerable authority to work for the good or the detriment of the contracting community. I am learning day by day just how large an authority that is. I am sure the Board recognizes the impact it can have as well.

We are both politically buffeted. The expectations are high on each of us that a job be done, and the interest groups that are affected have intense views on both sides. I hope that we can all be sensitive to all factions.

I am making a concerted effort to listen not just to one interest group or another, nor any one segment of the Congress, but to try to be impeccably balanced in attentiveness.

Third, I would like to make just a general observation, an extension of your remarks earlier, about the ten-year trend we have seen in the demand for regulatory accountability. I tend to agree, it has been a dramatic rise over the last decade. The rise in regulations, paperwork, Federal intervention, Federal Standard-setting, has come about for good reasons. There is a public demand to increase accountability, increase integrity in expenditure of public funds. There is unquestionably a retraction of public sentiment today. There is unquestionably a moderation in that

demand and a back lash against some of the burdens that have been imposed.

You see that expressed not only here, but the Government has seemed to become less responsive in that sense. We get the same reactions from state and local governments as you do at the General Accounting Office. We get the same sentiments from universities and colleges and from the general public. We have a regular stream of mail from small businesses, large businesses and average citizens who express this sentiment.

I suppose all we need to say for the time being is, I certainly hope we can be sensitive to that and be responsive and move with the public expectations that we can perceive. Whether we come up with a specific dollar figure of a cost benefit or other comparisons, I think the sentiment is rather clear, and I think we can be adequately responsive.

The final point I would make is that the OFPP, like the Cost Accounting Standards Board, does not exist in isolation. I am learning that an agenda I would like to pursue personally is not feasible, because we don't operate in isolation. In many respects, what we do is shaping at least one strong element of the confidence that business feels, and in turn shaping the impact on the economy, and I guess in a small way accounting for the dips and dives in the stock market. There is that real effect that I perceive in our actions.

Beyond that, I just want to say thank you for allowing me to come here this morning. For what it is worth, there is at least one Federal agency, mine, that was given an open invitation and an opportunity, and I look forward to cooperating in our joint venture, as I see it. I don't need to take any further time, but obviously I would be glad to answer any questions.

MR. STAATS: Thank you very much, Les. I wonder if any of my colleagues here would like to comment or have questions?

I think it is very helpful to have this expression of interest on your part. I might say that I was a member of the Federal Procurement Commission and worked closely with Mr. Fettig in that endeavor, and one of the major areas that he had a great deal to do with was the area of the acquisition of major systems that has now emerged as a joint issuance, A-109, which we in the GAO applauded and think over time this will have a major influence over the way Government contracts for development of major weapon systems.

He has had the experience of being on the Hill for four years with Senator Chiles' subcommittee. A good deal of the language that is in the legislation which is now being formulated in that committee goes back to Les' work. So I know that all of you join us in wishing him well in his new assignment. It is a very tough one. We look forward to

working with you, Les.

Our next presentation will be by WEMA, and following that we will have a short break.

Please introduce yourself and proceed as you like. We would like your names first.

STATEMENT OF HOWARD TEETER

WEMA

MR. TEETER: Mr. Chairman, we would like --

MR. STAATS: Would you give your name?

MR. TEETER: I was going to do that. You are trying to regulate me before I get started.

(Laughter.)

MR. TEETER: My name is Howard Teeter, Executive Vice President of Beckman Instruments, Incorporated, of Fullerton, California. While my company has an active interest in the cost accounting standards program, I am appearing today primarily in my capacity as a member of the Board of Directors of WEMA

On my right is Jack Gilpin of Varian. He is the Chairman of the WEMA Government Affairs Committee. And on my left is Mr. Bob Lineberger, Vice President of Finance of Beckman Instruments.

WEMA is a trade association of over 900 companies engaged in electronics, scientific measurement and information technology. Our membership is concentrated in the West, but now includes companies in 35 states and 176 Congressional

Districts.

MR. STAATS: Might I say that we have heard from most of them.

MR. TEETER: Although the Association's membership includes a number of large firms, the bulk of its members are small-to-medium-sized companies serving both commercial and government markets. Typically, WEMA members supply sophisticated electronic components, instruments and equipment to industrial users, and relatively similar products for government end use.

For most companies, government markets represent well under 50 percent of total sales. A large portion of such sales are through subcontracts, often at a second or lower tier.

My own company, Beckman Instruments, currently employs 8,000 people, with sales of about \$300 million a year. Our government sales are about 7 percent of that, mostly commercial products sold through the GSA Federal Supply Schedule or out of a commercial catalog. Less than 2 percent of our sales are subject to cost accounting standards.

Mr. Chairman, we would like to commend you and the Board for holding this conference. We think that it represents a very positive effort on your part. Today we would like to briefly discuss four points: exemptions, organizational location of the CAS Board, CAS Board communications, and zero base budget review.

With respect to the exemptions, as you know, WEMA did not believe the February proposal went nearly far enough, and we recommend its expansion. Our views on the September 12 promulgation are mixed. The exemption of all qualified small businesses is fully responsive to our recommendations. It provides appropriate relief for WEMA's many small company members to whom CAS is an onerous and unnecessary burden.

The retention of the \$10 million/10 percent threshold and the modified coverage concept for profit centers of larger companies also falls far short of our recommendation of full exemption to \$10 million per year of CAS covered contracts. The 10 percent threshold represents a serious constraint, we think, and should really be eliminated.

As described in my own company's letter to the Board on April 18, 1977, Beckman feels very strongly about the importance of this exemption. Our diverse products are manufactured by 13 autonomous profit centers. Each is responsible for its own profit or loss and has its own cost accounting procedures which best fit its particular product lines. At the present time only our advanced technology operation, which we call ATO, is covered by CAS. It is a small business, about \$8 million to \$10 million in total sales, of which about \$4 million is CAS covered. This operation has deliberately been kept small by conscious corporate management decision. ATO has a policy of not accepting more than \$10 million dollars a year in defense business. It has sold to the government for

over ten years prior to CAS and had no audit problems.

It has incurred substantial costs in complying with CAS, and sees no benefits to the government. Unfortunately, CAS coverage of this small unit will invoke CAS 403 -- Corporate G&A -- and thereby create CAS obligations at the corporate level. This appears to be a clear cut example of how covering a small unit of a large company forces it to become the tail that wags the corporate dog. I respectfully ask you to expand your general exemption so that the dog can have a little peace and quite.

Our units, including ATO, operate like small businesses. They need flexibility to respond to market changes. They need to hold down administrative costs to retain their competitive position in commercial markets. We urge that the Board reconsider this exemption at the earliest opportunity.

Without such an exemption, we at Beckman will be reluctant to take more CAS-covered government business. Foregoing defense business would not be new to Beckman. Ten years ago, Dr. Ballhouse and I joined the company -- it was probably a little over eleven years ago -- and 30 percent of Beckman's sales were to the space defense market. Through a conscious effort on our part, this has been reduced to below or about 5 percent. One of the goals was to relieve the commercial segments of our business from having to indirectly

carry the administrative and financial burdens attendant to space defense contracts.

The essence of my three additional points is based on our considered opinion -- and this is not criticism of the Board, the personalities or anything else -- that the Board, the procurement agencies and the contractors are victims of a very poorly-written law. We really believe that.

Our first recommendation is that CAS be transferred to the Executive Branch and integrated with the policy functions of that branch. This, of course, is not a new idea.

Mr. Chairman, you will recall that when PL 91-379 was under consideration, in your capacity as Comptroller General, you recommended placing this responsibility under the President's direction.

In addition, the President himself in his signing statement also agreed, and in our prepared text we have two pages and several examples of data to support this position, and I won't refer to it here.

We believe the time for transfer is here and that the vehicle is at hand in the form of S. 1264, the proposed Federal Acquisition Act of 1977. Since CAS is designed to improve the procurement process and is a supporting function to cost analysis under PL 87-653, which is being incorporated into S. 1264, the transfer could be accomplished through this bill.

An off-the-cuff remark here -- we think that the Board has authority without responsibility, and I am not an expert in this area -- I am a manager, a commercial man, and I have had considerable experience in the aerospace industry, and we in the corporate family think an authority without responsibility is really premeditated failure. It is like in my corporation. I will take the Vice President of Employee Relations, and I will say, you be responsible, and you issue policy for design for the Scientific Instruments Division, and I will jump straight in the ocean. There is no way I can succeed and there is no way that you can succeed.

That is the way we feel about it. That may be extravagant, but that is the way we look at it.

WEMA's second recommendation is that the Board supplement its present communication channels by employing outside organizations to collect data for its deliberations. Our perception of the situation is that the Board does not have good information about the impact of CAS on procurement at the working level from either the government or contractor side of the procurement interface.

I won't go into that any more. It has been quite extensively discussed already this morning here. There were several points made here in the prepared statement.

Mr. Chairman, our third and final major proposal flows from the same problems that led us to recommend transfer

of the CAS function to the Executive Branch; the need to relate CAS to the procurement process.

When CAS function is transferred to the Executive Branch, or even if it is not, WEMA believes the time has come for a full scale study of the CAS program from the ground up by a competent outside body. We are suggesting a zero-based review of the total CAS program -- legislation, promulgation and implementation. This is consistent with the reform mandate of the new Administration.

During its deliberations Congress concluded that some form of government-imposed CAS would contribute to a more effective procurement process. It then apparently devoted its entire attention to the structuring of the CAS Board and its duties and authority, with little consideration of the relationship of such standards to the procurement process. The resulting legislation treats CAS as an end in itself, rather than a means to improve the procurement process. This appears to be the time to undertake this study, zero-base study, because of the numerous changes that are taking place in the procurement process today, largely as a result of the Commission on Government Procurement.

In summary, we are recommending that the Board ask Congress to transfer its functions to the Executive Branch; that it take steps to improve its communications with both industry and agencies; and that it initiate a zero-base review

of the total cost accounting standards.

In addition, the Board might wish to Commission independent studies by organizations such as the Conference Board, with perhaps the assistance of a public accounting firm. For our part, WEMA will gladly encourage our members to furnish whatever information is required to any such independent third party studies.

Thank you for permitting us to make these few points, and we will try to answer whatever questions there are.

Note: See Appendix I for entire statement.

MR. STAATS: I suppose any time you start requiring changes in accounting practices you are touching on as sensitive an area as you can touch on in the operation of a business. This is what the Accounting Principles Board found, and now this Board is finding the same thing, so there is no question about the nerve that we are touching here.

I wonder, with respect to your overall point about authority with no responsibility, whether you couldn't say the same thing about SEC or any other regulatory operation? I know the automobile industry feels that way about some things being imposed on them; but I wonder if your point really doesn't extend beyond this?

MR. TEETER: I think you are probably right. When I make statements, they are somewhat extravagant. I really --

MR. GILPIN: I was going to observe that it seems

to me that the procurement function has been assigned clearly to the agencies and the Executive Branch. It is not as clear to me that the other independent agencies in government are thus divided, that their own job is clearly their own job rather than a piece of somebody else's job. CAS is just a part of the procurement process and is picked up and put off somewhere else and runs completely independently.

MR. STAATS: I guess we would have to say that is the way Congress wanted it. Am I right with respect to my recommendation on this -- but this is one of many times where the Congress didn't agree with em.

MR. GILPIN: We feel quite strongly that the Board should take the initiative on the transfer. It is obvious if we go there our motives will be questioned, and they will say, "You are not getting a good deal from the CAS Board over there, so you want to move it somewhere else;" so I think Congress will be suspicious of our motives. We view the Board as a Board of experts on accounting matters, as it was originally set up, and it is supposed to understand all these things, and I think it is entirely appropriate to advise Congress on how it would work better.

MR. STAATS: I guess I would have to add with respect to the point about the original recommendation, there has been a lot of water under that bridge or over that dam since that time. I frankly don't think it is realistic at

this point in time to do it.

MR. MAUTZ: I guess I would summarize your position as that we ought to give a blanket exemption and go out of business.

MR. TEETER: Not at all. You are supposed to -- you are not supposed to do anything.

MR. MAUTZ: Indeed we are supposed to do something.

MR. TEETER: We would like for you to help the procurement process, and you are off at the side, and you are not in the direct line function. When I look at a staff function telling a line function what to do I am a loser; have been for 30 years.

MR. MAUTZ: I think it is true that you are looking at this from a line function point of view.

MR. TEETER: You are interested in technique and not end result, and that is very, very dangerous.

MR. MAUTZ: We are much interested in end result.

MR. TEETER: It is not apparent.

MR. MAUTZ: You haven't looked hard enough. Let me get at this point that you make so much of about the location. I had no part in the decision of where this Board should be located. I would like to think I can look at it a little differently.

I think of any accounting standard much like a tax. It is a burden on some people for the benefit of the others.

Taxation is a legislative function and it ought to be in the Legislative Branch, because that is most responsive to the people affected. We do hear from your Congressional Districts. When we get a letter from a Senator or Congressman who says, "I have this letter from one of my constituents, and how do I answer it," that is the way the letters run -- I don't know that we have what you would think of as political pressure from the sense, "Do it this way;" it is political pressure from the sense, "Account for yourselves."

I think we are held accountable better through Congress than any other way. We accept the criticism and point out where we are. We have to be able to demonstrate to those people who would hold us under budgetary control that we know what we are doing and where we are for a good purpose.

I would say not only is it a legislative function, but a responsible one. The position where we are in the Legislative Branch of the government, we are not directly involved with either of the contracting parties. We are in between them. We are not in the procurement process of the government; we are not in the procurement process of industry.

I think from the standpoint of legislating the kind of laws that Congress is concerned about, in getting the kinds of information that it feels people ought to have, we are really in the best possible position, and I would be disturbed, really, to see us considered as nothing more than a part of

the procurement process.

MR. TEETER: You make the statement that you don't enjoy a good position. You enjoy a good position, because you are not responsible.

MR. MAUTZ: We are responsible.

MR. TEETER: For the procurement process.

MR. MAUTZ: We are not responsible for the procurement process. Congress is ultimately responsible for the spending of taxpayer's funds, and it wants to be sure the costs are determined properly. It has taken this means of getting at that. I think it is a sensible solution. We have a real difference of opinion.

MR. GILPIN: If you look at the role of Congress as it is designed, at least, we think of it as a policy body. It is like a Board of Directors in our companies in that sense. It has some oversight functions to keep a general eye out, and this is kind of an audit role. In various times the Congress gets more interested in operations, and we think in this case this is an example.

For instance, by definition, cost accounting standards are either cost accounting principles or cost accounting practices. We hold that ever since 402 you have been writing cost accounting practices. These are essentially on allocation.

When you take these and they lie before Congress,

by definition these are not policies; not even principles. Here is Congress looking at a bunch of practices. This is so far from their policy job it is inconceivable that they have the competence or the interest to do a good oversight job. It really is terribly misplaced.

MR. BEVIS: Mr. Teeter, we are all here because there are a lot of contracts being priced with some relation to cost. In other words, the price is arrived at with cost as a heavy factor. I am an accountant by profession, and I have made this speech many times. I hold no brief whatsoever for using costs as the basis for arriving at price. I would think that a procurement process in which other more relevant factors are used to arrive at the price, where that can be done, is a far better means of arriving at price.

Now, nonetheless, we have an awful lot of contracts that bring cost into consideration, and that is our field; that is what we deal with. I have often wondered whether a lot more procurement couldn't be priced without relation to cost, and why is it, and is it mostly contractor-originated or government-originated, that we have so much procurement where the price is based on cost.

I recognize that there are some high technology situations involving large amounts with long leadtimes and contract terms where nobody, contractor or government, really knows what the cost is going to be, and what a fair fixed

price would be. Have we gone overboard in contracting where the price is set on cost, and if so, whose fault is it?

Now, this is not a cost accounting question. I am asking for information from a businessman.

MR. TEETER: We share your view there, of course, because Bob in his role as Vice President of Finance, we watch the accounting structure even within a corporation. We try to get them to report as quickly as they can. We are very careful about having staff functions promulgate any kind of regulation on the line.

Maybe we are overworking the point, but we are sensitive to it because we work it every day. I wouldn't recommend no cost control or no cost standards or this sort of thing. I think that is an impossibility. There has to be that sort of thing. I think we are quibbling about the line/staff relationship.

MR. BEVIS: My question was really off your main point with organizational relationships and why there isn't more procurement where the price is determined so that our standards or the costing of it wouldn't apply at all?

MR. TEETER: I would speculate that it has to do with the contracting officer. Some gentleman mentioned that before, here. He is under tremendous obligation to comply with rules and regulations and statutes and this and that, and his personal authority to use his own judgment in buying

\$50,000 worth of goods I think is very small. He is reluctant to exercise personal judgment like our people do in our corporation.

MR. GILPIN: I will send you a copy of the WEMA testimony on the Chiles' bill. We addressed this rather directly in the following sentence, that the only way you can have prices determined without cost data is through competition, where you have two or more people seeking the job and the government has a good enough idea of what it wants to buy so that it can make a value judgment based on price.

The only way you keep competition is to keep people like Beckman in the business. The more regulation you have of the commercially oriented companies, the fewer competitors you have and the fewer competitors you have, the more sole source you have. Senator Chiles is making an attempt to unravel the circle. 409 is a distinct step in this area. The sections on the use of price analysis rather than cost analysis with some definitions of what price data is a good step forward.

We think the only way to get out of the circle downward is to try to get it up again, get Beckman back in the government business.

MR. LINEBERGER: As I understood your question, I would like to see considerably more procurement done under competitive pricing conditions without regard to the cost, and that is how the open market economy operates. One of

our divisions, which is not now CAS-covered but does get into revealing costs when dealing with a government customer, produces as an ordinary thing custom microcircuits. We do this with hundreds of private sector customers, and we wind up quoting for his configuration a price.

In the private sector we demand of our own procuring agents that they get three competitive bids and select from those. The low cost bid may not be the low price. If at the same time we do the same job now with a government-controlled procurement source, this man may be procuring, looking through several procurement possibilities, but when we finally deal with him he now -- what I would really say seems to be a protection device, coming out of this set of regulations to do the right thing with public monies -- says, "I would like to see your declaration of estimated costs."

The answer probably comes in the tremendous pressures in the government procurement to do the right thing with public monies and cover yourself. I am not sure I know the solution, but it is pervasive. This does affect us and we have to go through that exercise.

We undoubtedly are giving the best product for the value, but he makes that choice at that time. I don't know how it relates to our costs, but we are put in that position.

MR. BEVIS: Whenever I see a company that says its business is 95, 97 percent commercial, and that the sales to

the government are of an item that is substantially like ~~what~~ it makes for the commercial field, but it is painted blue instead of gray or something like that, I wonder whether the difference between what the government buys and what is sold commercially is great enough to have to introduce the cost factor into it. That is my accounting question to businessmen.

MR. LINBERGER: It gets involved, although it is a routine thing. Somebody wants a shaft 2 inches long and he wants his 2-1/8. We deal with that ordinarily. The other sector, which is an off-the-shelf kind of an item, will occasionally require government specifications that put a different twist on it. Then the government contracting agent wants to see the costs.

MR. BEVIS: Are you people in industry working on that kind of a situation to try and turn the procurement method around to the point where you don't have to worry about cost accounting standards?

MR. LINEBERGER: Sure. We are going out of the government business. That is our response over ten years of time, and it truly is.

MR. TEETER: We don't want to say that in a malicious way. We do it on the basis of economics. It does not represent to us a business opportunity.

MR. BEVIS: Thank you very much.

MR. LINEBERGER: One further comment in that regard. This letter Mr. Teeter sent in in April. There is an interesting letter from the Manager of one of our large divisions that is not now covered. He is a commercial division. We are very sensitive as to how large his contracts can be in order not to fall under these and the questions have been raised here with respect to costs of doing these kinds of jobs. Remember, this gentleman is running a \$40 or \$50 million operation. He is commercially oriented, but he does serve from time to time into this sector. He is concerned, Mr. Teeter is concerned, we are all concerned as to whether he is going to be cast into this while new set of language.

I liken it to, he has an accounting system and we certainly know that there are many ways of allocating and so on that are reasonably good that we have adopted in the corporation for his unit. It is as if he were accounting in the language of Greek.. You look at the methods and say, those are reasonable, and so on. If he must be cast into the CAS system -- incidently, I think you gentlemen have done excellent cost accounting here, but it is in Greek language or in Latin, slightly different than what we are doing.

He looks at this proposition and says, "I am accounting for all of these things under Greek. If I get too large, I have to be able to convert over to speaking now in Greek."

Let me give you the specifics. Let me just quote this. "We have already devoted over a man-year to the investigation of provisional revisions which would be necessary for us to operate under CASB guidelines. Instituting compliance would require additional staff and would detract from the day-to-day accounting effectiveness essential to financial management of these product lines. The cost of complying would be (extensive) and would require expertise available only at an unreasonable cost. Based on investigations to date and inputs from others knowledgeable in government accounting, total costs in excess of \$200,000 per year would have to be incurred to satisfy all CASB requirements;" accounting staff, three people is our estimate of what would be required to make those conversions and carry out these compliances. Additional computer time. I didn't read the paragraph where he notes that he already has an accounting system in the Greek language which is highly automated with many sophisticated computer programs and so on, the conversion over to speaking in Latin required by referenced CAS, additional computer time, \$30,000, manufacturing systems/documentation, four persons, \$70,000, additional negotiations, \$30,000, consultants, \$10,000 to make their conversion, total, \$200,000.

"In summary, we feel strongly that an accounting system such as we have, approved by independent auditors for a primarily commercial business should be acceptable for

government contract costing in view of the amount of government business we perform. A threshold of \$10M would exempt us from CASB regulations. If this portion of our business is not exempted and considering the cost of implementation and loss of flexibility of our cost accounting system, it is unlikely that we could continue to participate in the government contracts arena. On the other hand, an exemption would allow us to continue making a contribution, both technically and competitively, to government programs."

There is a letter from one of our operating managers.

MR. STAATS: You are familiar with our exemption standards?

MR. LINEBERGER: Yes. We are unhappy with the 10 percent or less aspect of that exemption.

MR. STAATS: We were trying in that case to make a cost benefit type of a test in doing so. People disagree whether our cutoff is exactly the right cutoff, but I guess we have to say we are always in the position of taking another look. That was the best judgment we could come to at the time.

MR. LINEBERGER: That underlays Mr. Teeter's first recommendation; 10 percent or less of an operating unit is your level now. We very much would like to see the 10 percent or less element of that deleted. It is a practical matter, and it is a problem.

MR. STAATS: I certainly appreciate your coming here this morning. It is always helpful. We have had many contacts with WEMA and have had useful dialogue with you.

We will take a 15-minute recess now.

(Recess.)

MR. STAATS: We are happy now to hear from the Alcoa representatives. Please introduce yourselves.

STATEMENT OF DAVID J. MAHRER

ALUMINUM COMPANY OF AMERICA

MR. MAHRER: Mr. Chairman and members of the Cost Accounting Standards Board, it is a pleasure to be here today to present oral testimony and to be a part of this program.

My name is David J. Mahrer. I am a Senior Assistant Controller for Aluminum Company of America, and with me today is Mr. John H. Lersch on my left, also a Senior Assistant Controller for the Company, and Mr. Robert T. Hartman on my right, a Manager in the Cost Division of our Accounting Department.

A copy of our written statement has been conveyed to you earlier, so today I will briefly summarize the main points in that statement.

Alcoa has enjoyed a long-term relationship with members of the CAS Board's staff. We have cooperated with the staff from the beginning in most of their activity. However, our principal interest has consistently related

to the development of exemption provisions for commercial companies like ourselves. This is the subject to which our written statement and this oral testimony are addressed.

Alcoa's role in the defense procurement chain is that of a supplier of basic mill shapes to those of our customers who are higher-tier sub or prime contractors of the government. Our current CWAS rating of 99.6 attests to the fact that we do our business on a firm, fixed price basis (the next time we file, we expect it to be up to about 99.95). As an integrated aluminum producer, Alcoa is capital-intensive and uses common production facilities for both commercial and defense-related business, with total output very heavily oriented toward the commercial market.

An example of the type of product we make, serving both the defense and commercial markets, would be aircraft sheet. This product must meet standard aircraft specifications and our facilities process an order for aircraft sheet the same, whether it is intended for an Air Force C-141 tanker or for a commercial L-1011 aircraft.

Another product we make would be aluminum forging that becomes part of an aircraft landing gear assembly. This forging part also must meet aircraft specifications, and the manufacturing process is again identical, whether the part is destined for an Air Force B-52 or a commercial 707 aircraft.

Alcoa's cost accounting systems are oriented to

product and responsibility reporting rather than to the segregation and allocation of historical costs by type or kind of contract. Our systems are geared to budget and standard cost analysis, variance measurements, and other requirements of our management.

Alcoa's cost accounting procedures are an integral part of our Sales, Marketing, and Finance major systems package, which has evolved as a product cost control and management reporting tool over a period of many years. Just the computer programming effort, associated only with those programs currently in use, required 158 person years at a cost in excess of \$4 million valued at today's salary costs.

The annual cost involved in operating and maintaining these programs is nearly \$2 million. Since it has been and still is impractical to alter this intricate system to accommodate certain government accounting needs applicable to a very small part of our business, we have developed memorandum accounting procedures to satisfy such obligations.

In June 1975, after careful analysis of a Board proposal to change the disclosure statement threshold, and a meeting with the staff, we formally requested the Board to issue to Alcoa a blanket exemption. In August 1975, we were advised by the Defense Contract Administration Services that CAS compliance problems existed within our system. The following month, the CAS Board's Executive Director, certain members of

the Board staff, and members of the Defense Contract Audit Agency met with us in an attempt to resolve the problem. As a result of this meeting, we modified our memo procedure.

After such modification, it was agreed that, while neither Alcoa's commercial nor memo system was in complete compliance, the effect or consequence of any non-compliance with standards promulgated at that time was immaterial and had no bearing on the price established. Accordingly, we withdrew our request for a company exemption.

Our withdrawal letter stated in part -- and we quote, "We hope that studies by the Cost Accounting Standards Board now in progress relative to possible modifications of the existing exemption levels will result in changes that will provide a class exemption that would encompass Alcoa...".

As each of the draft standards and exemption thresholds has been released, we have responded, usually directly to the Board and occasionally through associations. We have provided input to members of the Board's staff who are familiar with both our normal commercial and memorandum systems and have met with them in the Board's Washington offices, at our production facilities, and at our home office in Pittsburgh.

We have reviewed very carefully the September 12, 1977, release which relaxes the terms of contract coverage but eliminates the threshold for allocation of Home Office

expense and makes no change in the disclosure statement threshold. These revised requirements, if they become effective, present additional expense and compliance difficulties for us, with no offsetting benefits.

Thus, instead of helping Alcoa, they leave our situation about the same with respect to CAS coverage and disclosure obligations and create a CAS 403 problem that we didn't have before.

The adaptation of our memo accounting system to accommodate CAS becomes more unwieldy with newly promulgated and proposed standards since some of these standards may not lend themselves to memo procedures and may impact our basic system. In addition, the preparation and, in particular, the maintenance of disclosure statements represent unwarranted expense.

Although these expenses may not be material when measured against our total company business, they become somewhat more significant when related to the fractional percent of government business subject to cost accounting standards. Our main concern is that such effort, regardless of cost, cannot be justified, since there is no offsetting benefit accruing to anyone.

We believe that where a price is negotiated based purely on cost elements, CAS requirements may be meaningful, but that where cost is only one of many elements in price

determination, conformance with CAS requirements cannot be justified.

Our suggestions, most of which are in greater detail in our written presentation, are as follows:

(1) Redefine a negotiated subcontract subject to CAS as one negotiated subsequent to the submission of Cost Data and the issuance of a Certificate of Current Cost and Pricing Data by the subcontractor.

(2) All contracts of less than \$500,000 should be exempt from all CASB requirements.

(3) Any Business Unit whose annual CAS-covered awards are \$10 million or less should be exempt from all Board requirements.

(4) Disclosure Statement thresholds should be as recorded at the business unit level, and only those units whose annual CAS-covered awards exceed \$10 million should be required to furnish a disclosure statement. (We would prefer a higher limit, but in all candor do not feel this would be acceptable to the Board at this time.)

(5) CAS 403 (Allocation of Home Office Expense) should be applicable only to a business unit with annual CAS-covered awards in excess of \$10 million. As it now stands, a single contract greater than \$500,000 could subject a small business unit to CAS 403 as well as all the other standards

In summary, we are convinced that no useful purpose

is served by the continued imposition of Cost Accounting Standards on the predominately commercial firm such as Alcoa. In our case, they require additional administrative effort, with no offsetting benefits to the Company; neither do they benefit the government, our customers, or the general public.

This concludes our prepared statement. Thank you for listening to us, and we would be happy to try to answer any questions.

Note: See Appendix I for entire statement.

MR. STAATS: What is your total volume of government business that comes under the definition of CAS-type contracts -- that comes under the definition of the statute?

MR. HARTMAN: That would be approximately \$8.2 million.

MR. MAHRER: The company has over \$2 billion of sales and revenue.

MR. STAATS: You do come into the exemption?

MR. MAHRER: We have a problem with the 10 percent rule. This would give difficulty for particular business units. We have a world-renowned research and technical center that has an annual budget of about \$40 million. In the last five years they have done a little bit of business for the government, for prime contracts, averaging about \$700,000 a year. This is the only outside business they do, and they do it because they have some unique capabilities. They are

currently contemplating one contract that they might take, which would run a little over \$500,000.

Obviously, that is going to be more than 10 percent of their total billings, and would subject that entire unit to all the cost accounting standards. It would involve 403 for the entire corporation, and so we may walk away from that business because of that 10 percent requirement.

MR. WALKER: Some of your segments now -- are they more than 10 percent?

MR. MAHRER: Yes. We have one and possibly two.

MR. WALKER: So the exemption does not cover you today; the proposed one?

MR. MAHRER: Does not; that is correct.

MR. WALKER: Could I assume Herman Bevis' point in the WEMA presentation having to do with the pricing of your business? You indicated in the submission that most of them are fixed price contracts based on cost and marketing information.

MR. MAHRER: Generally, cost is one of many elements.

MR. WALKER: Could you describe that process a little more and the role of costs? Are they exempt from PL 87-653 or not?

MR. MAHRER: We have some subject to Public Law 87-53, and where a cost breakdown is required, we will provide one, but most of our business is competitive. We do not

provide a cost breakdown. Therefore, any negotiation with our customer, who generally is not the government but is either a higher tier subcontractor or a prime contractor, the negotiation revolves around price, delivery, specifications; but not cost. Cost does not enter into those discussions.

Does that answer your question?

MR. WALKER: Yes.

MR. BEVIS: I think John Walker really asked my question. I am always interested in whether or not companies get into the CAS problem because of the nature of the procurement process and an emphasis on cost in the procurement process, when perhaps there should not be that emphasis on cost.

I don't know if you have any further comments other than an answer to John.

MR. MAHRER: Well, we would like to de-emphasize it as much as possible, but it is our customer and the interpretation of the requirements that flows down this. We scrutinize that very carefully, and we only accept CAS whenever we are convinced that it is applicable. Our general interpretation has been that it only applies where we have to get a cost breakdown under the public law. Other than that, we don't get into negotiations that involve cost.

MR. BEVIS: Thank you.

MR. HARTMAN: I am Bob Hartman. We did mention that the CAS-covered business was about \$8.2 million, we

thought, and one of the difficulties that a company such as Alcoa has as a subcontractor is the identification of CAS-covered costs.

CAS comes to us in the form of a flow-down. It is not a purchase order. It is a standard term and condition. And we look it over, 100,000 orders. That is what our people are looking at in order to find the CAS clause.

As a matter of fact, in order to find one of 47 CAS-possible flow-downs to us, our order people look for 71403. They look for \$100,000. If we kept score every time we saw a CAS clause we would have a \$36 million figure. That is what we term "CAS suspect business."

Now we go from the \$36 million, you see, down to the \$8 million and we screen out -- remember, we are only counting things over \$100,000, because we see the CAS clause on \$10,000 orders. We only count over \$100,000. In that we pick up things straight out of the schedules. We pick up competitive things. If we applied CAS only in those instances where we signed the certification, we have a million dollars worth of CAS business, not 8 and not 36.

There is a big problem for people like us who don't do contracting, sit across the table from each other or sign the document. We get a purchase order that flows down to us. So the mere identification of CAS is a problem.

One of the proposals in your February proposal was

to not count under \$500,000 orders. That would make a big difference to us, because our instructions to the people who do our accounting would be "Start at \$500,000." We eliminate 75 percent of our business according to the CAS scoreboard. That is a big difference; not a million dollars worth, but it is just something that we do to -- that we don't think we should have to do.

MR. MAHRER: What Bob is pointing out is that we incur considerable administrative effort doing all the screening and boiling out from the \$36 million to \$8 million or \$1 million. We wouldn't try to evaluate that, because we have got these people and would be using them in something else, something we think would be more useful and productive rather than weeding out \$28 million out of \$36 million or \$21 million out of \$36 million that we eliminate when we look at them very carefully. But this is part of the burden that we incur, even though we are primarily, principally a commercial company.

MR. STAATS: We certainly appreciate the specificity of your suggestions here. It is something that the Board will want to take a careful look at. I guess all I can say is, we are having a hard enough time getting the present exemption standard accepted; but this is very specific and very helpful to us.

Are there any more questions? If not, we thank you very much.

Our last presentation is by Litton Systems, Incorporated, Data Systems Division.

STATEMENT OF PAUL ANDERSON

LITTON SYSTEMS, INC., DATA SYSTEMS DIVISION

MR. ANDERSON: Mr. Chairman, members of the Board, good morning. My name is Paul Anderson. I am Manager, Government Liaison Finance, at Litton's Data Systems Division. With me is Bud Lisle, our Director of Pricing. We took literally the stated purpose of this conference, which is to provide the Board with an opportunity to receive directly from all interested persons their evaluations of the effectiveness in promulgated standards and regulations.

Mr. Lisle and I are here today because our responsibilities cover a wide spectrum of activities and functions which are directly affected by or performed solely because of our contractual obligations to comply with cost accounting standards, rules and regulations and standards. We have both been deeply involved in CAS matters over the past five years and speak from our own experience rather than second or third hand information from workers in the field.

We are a couple of the workers in the field who are trying to cope with CAS requirements and make them work. I emphasize our role in the scheme of things in the hope that our evaluations and criticisms will not be brushed off as routine objections by big business and the defense industry

to any new actions taken by the government to establish fair and reasonable bases for defense contractor, nor as theory or suppositions.

In our written statement, in our remarks this morning, we are dealing only with the problems caused by or related to the Board's rules and regulations, and not the problems related to specific standards. This should not be construed to mean that we do not question the effectiveness of various standards. It only means that we had to draw the line somewhere.

To get right to the point, it has been our experience working cooperatively and in good faith with our government contract administrators and auditors that the very rules and regulations which were intended to provide for the administration and settlement of CAS matters are not only ineffective, but they are hindering us from reaching agreement and resolving matters, matters which should present no problems whatsoever to those of us who have been working for many years in the pricing, negotiations, administration and settlement of defense contracts.

Except for those changes where there was agreement that there was no impact or immaterial impact on contract costs, costs paid by the United States or "costs to the government," we have yet to reach agreement on how and to what extent CAS-covered contracts are to be modified to provide for

adjustments to prices and/or cost allowances.

Some of the changes go back as far as four years. In trying to reach agreement and to resolve these matters, we have spent a considerable amount of time studying and analyzing the Board's rules and regulations. We didn't just read them. We studied and analyzed the contract clause and other provisions in Part 331. We found that we could not reach agreement as reasonable and responsible men because of the specific wording found in Part 331, as made worse by unofficial and non-authoritative guidance.

We characterize much of 331 as being poorly written, ambiguous, incorrect, providing mininterpretation, and in one instance directly contrary to Public Law 91-379.

In our written statement I have tried to make clear the problems involved in twelve of the specific paragraphs of 331. There is not time now to discuss fully the problems involved in even one of the major bottlenecks. I will try to cover briefly or at least mention some of the more significant problem areas.

Perhaps I should start by identifying the provision which I say is directly contrary to Public Law 91-379. That provision is found in 331.70(b), which specifies how increased cost in the United States must be measured in cases where the contractor has not complied with applicable standards or followed his established disclosed practices. The specified

measurement is the difference between the cost estimates used in negotiation and the cost estimates which would have been used had the contractor proposed on the basis of the practices actually used during contract performance.

In other words, the difference between cost estimates actually used, which fully complied with applicable standards, and estimates based on non-compliant practices. The unavoidable result is the repricing of the contract from a price based on cost estimates and practices which complied with standards, to a price which would have been negotiated had the contractor and the contracting officer agreed that the contractor would not comply with all applicable standards in estimating and accumulating costs.

Of lesser importance, but nonetheless indicative of the lack of attention paid to the working of the rules and regulations, are questions and problems related to 331.30(b)(8) and 331.70(g). Paragraph 331.30(b)(8) provides "for the purposes of this paragraph (b)(8), an intra-corporate transfer shall be considered to be a subcontract." Nowhere in the rules or regulations or anywhere else, for that matter, can we find anything to indicate what an intra-corporate transfer is considered to be for purposes other than for paragraph (b)(8), nor is there a definition of a subcontract.

In 331.7(g) we find that if the contractor has not notified his contracting officer of failure to comply and such

failure was inadvertent, whatever that means, he may be allowed to repay the government with interest only the difference between the increase in costs paid under one or more contracts and the decreased costs paid under one or more other contracts. Pray tell what happens to the good guy contractor who does notify his contracting officer of a failure to comply? Some people would have us believe that he would be faced with the unconscionable penalty of repaying any and all real or imagined increases in payments on individual contracts without regard to the real world decreases in costs paid by the government on other contracts.

Then there is the ambiguous 70-plus-word sentence in 331.70(f), which, when boiled down, provides that the government will not require price adjustment provided the contractor and the contracting officer agree on how the price adjustments are to be made. Why not say that the contractor shall not be required to comply with standards on contracts of \$100,000 or less provided the contractor and the contracting officer agree on how the contractor will comply with standards on those exempt contracts? This provision is somewhat similar to a railroad regulation I heard about. I must first say that the regulation was established with all good intent to protect lives and property.

The regulation, as I understand it, provided that when two trains approach a crossing at the same time, each

shall stop and neither shall proceed until the other has passed.

They can always back up, though; we can't.

In our opinion, the biggest problems which we have faced and which are still a major roadblock on reaching agreement on contract adjustments and modifications are caused by the rules and regulations, interpretations and "guidance" concerning increased costs, increased costs to the government, increased costs paid by the government, and the offset of decreased costs against increased costs and of decreased costs paid by the United States to the contractor against increased costs paid by the United States to the contractor.

Given the far-out definition of increased costs to the government under firm, fixed price contracts which is provided in 331.70(b) and (c), the field is wide open for all kinds of interpretations of what constitutes an increase in cost to the government.

We have been told that a decrease in cost allocable to a cost type contract -- let me repeat that -- a decrease in costs allocable to a cost type contract results in an increase in costs to the government. Honest to God. I am not kidding you. The gentleman is here, in fact.

At another time we have been told that an increase in costs allocable to a firm, fixed price contract could cause an increase in costs paid by the government. If you are interested, I will explain later as best I can the

reasoning involved in these interpretations.

In short, if that definition in 331.70(b) and (c) remains, then any increase or decrease in costs allocable to any type of contract can be construed by someone as being an increase in costs to the government. How can we convince someone that their interpretation of increased costs to the government is unreasonable, when in fact it is no more unreasonable than the interpretation adopted by the Board?

Then there is the case where one action, whether it be a failure to comply or a voluntary accounting change causes a change in the allocation of a cost from a firm, fixed price contract to a cost reimbursement contract. In this case, the nature of the cost reimbursement contract and common sense tells us that, without regard to any contractual limitations, the increase in costs allocable to that contract will result in increased costs paid by the government.

At the same time, and with regard to the same failure or voluntary accounting change, we are told that pursuant to 331.70(b) and (c) the decrease in costs allocable to the firm, fixed price contract is also an increase in costs paid by the government. Thus, two increases in costs paid by the government are perceived where in reality there is only one and the amount of increased costs paid by the government is construed to be double that of the actual real world increase

On the subject of offsets, I will try to be as

brief as possible. Things are pretty screwed up. I guess I should say a little more than that.

Many people have lost sight of the purpose, assuming that they knew what it was to begin with. Paragraph 331.70(f) isn't all that bad, except for a steady decline in specificity, starting with increased costs being paid under a particular contract, and ending with increases under certain contracts and decreases under the remaining contracts.

While a careful reading and analysis will clearly show that paragraph (f) provides in its entirety for the offset of decreases in costing paid under one or more contracts against increases in costs being paid under other contracts, this paragraph has been taken to pertain to offsets of increases in allocable costs on one or more contracts against decreases in allocable costs under other contracts, or vice versa.

The parenthetical statement in paragraph 331.70(b) certainly does not help to keep the terms used in paragraph (f) in their proper context with the intended meaning. If ever there was a case which could be described as a contractor ripping off the government, it is where the contractor has failed to comply, and such failure results in a decrease in costs allocable to a firm, fixed price contract and an increase in costs allocable to cost type contracts, and yet in this case the parenthetical statement says that paragraph (f) shall apply.

Unless I understood some of the questions and discussions -- misunderstood some of the questions and discussions yesterday, I get the impression that some or all of the members of the Board do not fully understand what is wrong with the interpretation on fixed price contracts and the real consequences of changes in allocation of costs to different types of contracts.

If that is the case, I feel that it is imperative that the matter be further discussed so that there can be a better understanding of the fundamentals involved and that some reasonable resolution of the problems can be made. I know that in the short time allowed I have done a very inadequate job of covering the subjects that I wanted to talk about, covering the problems that I see every day out there in the field.

As you know, the statement which was submitted is very complicated and rather long -- 20 pages of single-spaced typing. I hope you have read it. It is not something that can be skimmed over and say, that's right or that's wrong or whatever, but I certainly would offer whatever I can do to explain the points that were being made or anything that I have said this morning.

Note: See Appendix I for entire statement.

MR. STAATS: Thank you very much. My impression is that a good many of the problems that you have outlined here

have to do with contract administration, changes in accounting practices. The other problem it seems to me that you are focusing on is where you have a mix of fixed price and cost type contracts.

The first point, it seems to me is, the proposed change in regulation that we agreed to publish for comment at our meeting day before yesterday ought to help a great deal. We are trying to give a great deal more discretion to the contracting officer to come into agreement on changes that are desirable. I hope you will give us the benefit of your thinking on that proposal in the light of the specific points that you have outlined here today.

I don't think I have any questions.

MR. LISLE: May I say, Mr. Staats, in that regard, that will be a big step forward, but I think that some of the fundamental problems will remain on the question of measuring increased costs in those instances where a measurement is still required after the change you have described.

MR. STAATS: Please point all this out in your comments.

MR. BEVIS: Mr. Anderson, I am one of those who read all 20 pages single spaced, as well as the attached 25 pages, double spaced. And I guess I am the one that has been raising the question about adjusting firm, fixed price contracts where there occurs a change in accounting practice

which results in lower costs being allocated to the fixed price contract under the new system than would have resulted from the old system.

What is your view as to whether the contract price, which is firm, fixed price, should be adjusted at all for change in allocation of costs from those contained in the original estimate, whether there should be a change in the contract price at all, and if so, how it should be computed?

MR. ANDERSON: My view is that there should be no change whatsoever in the contract price unless the negotiation of that contract price was based on cost estimates, which either did not comply with standards or which did not follow the contractor's disclosed practices. One of the things that I think has not been brought out, which I think is the key to the whole question on here as to the different types of contracts we have -- the firm, fixed price contract, the risk is with the contractor, now -- you know, all contractors, irrespective of what a couple of people may think, weren't out ripping off the government and saying, "Today we are going to change our accounting practice so we can collect some more money. Tomorrow we will change it back so we can get some more there." We didn't do that, and yet there were accounting changes.

When the contractor and the government entered into a firm, fixed price contract, they did so with all the

available information they had at that time, projections of what we thought might occur, and they entered into a contract and the contractor took the risk of making accounting changes, having to make them, and for other reasons that the cost would be much higher than he anticipated and that he would incur a loss. That is his risk.

The government, if you will, might be construed as taking a risk that all of those things weren't going to happen, that maybe the cost would be less than both parties anticipated and he would make more profit. That is another subject. That is not always real.

We got along fine. We didn't have to worry -- as a matter of fact, the contention that the parties entered into a firm, fixed price contract with the understanding that the costs would be based on the cost estimates used in negotiation is really, in my opinion, a figment of someone's imagination. We didn't do that at all. They used the cost estimates, a lot of times unwillingly, because it was required, because it had something bearing on what they expected to happen in the future in the performance of that contract. It was one element in arriving at the firm, fixed price contract.

Having used that for whatever purpose it served, they agreed to a price which both parties felt was fair and reasonable based on the information they had, and that was it. The contractor went out and did the work, no matter what it

cost him; or if he didn't, he had a default termination, and that was that.

Now I think that if we can get back to the fundamentals or get to the fundamentals of government contracting, the reason for different types of contracts, all the way from a firm, fixed price contract to a cost reimbursable contract, and we modify some of these, what I think tried to be sophisticated provisions in the rules and regulations, we can get to the fundamentals of what the charter of the Board is and what the Congress expected the Board to do. We can get on and do this job without having to have a guidance group, a working group, an implementation group and people all over the country trying to figure out how we can make these things work.

MR. BEVIS: I would like to get to the fundamentals of my question. I am assuming cost estimates furnished in the negotiation of a firm, fixed price contract, the cost estimates being based upon a company's established accounting practices. Subsequently, the established practices changed, which results in lower actual costs allocated to that contract than under the procedure in the estimate; and my question was, do you think that should affect the price, the fixed price, of the contract at all; and if so, how would you measure the effect?

MR. ANDERSON: Okay.

MR. BEVIS: I didn't get the answer, speaking

about fundamentals, to my question.

MR. ANDERSON: I thought I did, but then I made a speech and I think I got lost.

The answer is that the price should not be affected by the circumstances you describe. A change in accounting practices neither increases nor decreases costs to the contractor or costs incurred unless you consider the administrative effort required in accomplishing that kind of a change. So let's disregard that.

MR. BEVIS: Then would you apply this regardless of order of magnitude? For example, if the cost estimate was a million dollars based on certain practices and the practice was changed to allocate only \$500,000 of that contract, would you still say that the original contract price should not be reconsidered?

MR. ANDERSON: Absolutely.

MR. BEVIS: You would?

MR. ANDERSON: Yes, and I will tell you why; because if there is really something wrong, if there is something detrimental to the government that happened there, it will be on another contract; not on that firm, fixed price.

MR. BEVIS: Not necessarily on another contract.

MR. ANDERSON: I am stating my position is it will be.

MR. BEVIS: Suppose they have only one contract?

MR. ANDERSON: Where did the costs go?

MR. BEVIS: Commercial.

MR. ANDERSON: The contractor was not unjustly enriched. He didn't make any more profit. This profit by contract, again, to a large extent is something in the minds of the beholder.

MR. BEVIS: So you contend, then, if a \$500,000 figure had been before the negotiating parties instead of a million that the contract price would have been the same?

MR. ANDERSON: I didn't say that.

MR. BEVIS: I thought you did.

MR. ANDERSON: Well, I didn't.

MR. BEVIS: Do you think it would have been different; and if so, how much?

MR. ANDERSON: If the parties knew all of the things that were going to happen, including that accounting change, at the time they negotiated the price, that negotiated price without question would be the actual final cost incurred plus some amount for profit. But we don't know those things.

MR. BEVIS: So really what you are saying is that there are several factors in negotiating a firm, fixed price besides the estimate of cost?

MR. ANDERSON: Absolutely.

MR. BEVIS: I think we all know that.

MR. ANDERSON: One other point. If the cost is that

important in this procurement, it shouldn't be a firm, fixed price contract to begin with.

MR. BEVIS: I can't argue with you on that, because you are a negotiating party and I haven't been.

Thank you very much.

MR. STAATS: Thank you very much.

This concludes the presentation. If there is anyone from the floor who has a burning desire to ask a question, we will take it, but otherside, we thank you all very much for coming. It has been a very helpful conference to us, and I assume the transcription here is as good as I think it will be. We will be looking at that very carefully.

Thank you all.

(Whereupon, at 12:00 o'clock noon the hearing was concluded.)