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American Institute of Certified Public Accountants

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STATEMENT OF THE AMERICAN INSTITUTE OF CPAS  
ON UNIFORM COST ACCOUNTING STANDARDS  
Before the Senate Banking and Currency Committee  
Subcommittee on Production and Stabilization  
April 1, 1970

I am Leonard M. Savoie, Executive Vice President of the American Institute of Certified Public Accountants. The Institute is the national professional association of certified public accountants. It is composed of more than 70,000 members, residing in every state of the Union.

With me today are Louis M. Kessler, President of the American Institute, and LeRoy Layton, Chairman of the Institute's Accounting Principles Board. Although it was not possible to prepare a statement and distribute it by mail to the more distant members of the Institute's Board of Directors in the time between our reading the proposed legislation and today, we have discussed this testimony with several directors.

The American Institute of Certified Public Accountants fills a distinct and important role in our economic system by setting auditing standards which must be adhered to by Institute members in their independent examinations of financial statements. The Institute also sets accounting principles which are followed in the financial statements reported on by members.

Like other earnest tax paying citizens, we are devoted to the idea that the Department of Defense and all other agencies of government, both Federal and local, obtain maximum value for their expenditures. We firmly believe every reasonable effort should be made to avoid excessive costs on procurement contracts. Also, we recognize the need for business organizations to earn a fair profit

in order to sustain themselves as viable productive entities.

It is in the light of these objectives that we greatly appreciate and welcome this opportunity to comment on proposed legislation on cost accounting standards.

We see the concept of "uniform cost accounting standards" not as a radical new idea but as a continuation of one segment of a body of accounting practice that has been developing for a long time. It would be self-deluding to start from a premise that generally accepted cost accounting principles, consistently applied, were nonexistent among Government contractors prior to this time. In fact, there now exists a substantial body of literature on cost accounting. Also, I think we must recognize that there never will be, nor should there be, a finished product of permanent and inflexible standards, no matter how they are developed and implemented; standards will need continual refinement in the light of experience and changing conditions. At all times there will be a need for judgment in their application and in identifying circumstances in which various standards apply.

Before commenting specifically on the proposed legislation, I would like to review briefly the development of accounting principles in this country by way of setting my remarks in perspective.

For the protection of the investing public, Congress passed the Securities Act of 1933 (which set requirements for the offering of new stock and bond issues) and the Securities Exchange Act of 1934 (which created the Securities and Exchange Commission as an independent agency of Government).

The Securities Act empowered the SEC to prescribe accounting rules, but the Commission made it known that it expected the accounting profession to assume the major part of this task. And the profession has been diligent in meeting this responsibility.

A committee on accounting procedure formed by the AICPA to "narrow areas of difference and inconsistency in accounting practice," issued 51 Accounting Research Bulletins indicating preferred treatments of various items and transactions.

The Accounting Principles Board, the successor body to the committee on accounting procedure, and formed by AICPA to carry on the work in a broader and more intensive way, has issued fifteen Opinions and three Statements, and has two proposed Opinions now circulating to businessmen, academic authorities, Government officials and others, for comment.

When the Accounting Principles Board has a topic under consideration, it consults with representatives of the groups most directly concerned. The draft of a proposed Opinion is distributed widely -- more than 50,000 copies in the case of the business combinations Opinion -- and comment is invited. In short, the process is a deliberative one, in the tradition of democratic procedure. In a recent statement before the Senate Subcommittee on Antitrust and Monopoly, Chairman Hamer Budge of the Securities and Exchange Commission, noted that, "The Board's procedures for drafting, exposing and adopting opinions are similar to those for rulemaking required of government agencies under the Administrative Procedures Act."

The reliance on a professional group to meet the responsibility of developing accounting standards is an excellent example of the value placed in American society on voluntary, self-regulatory effort by private citizens.

As background for the Board's deliberations, the AICPA sponsors research studies by its Accounting Research Division and others. Among research projects currently under way are studies on basic cost concepts, inventory pricing, depreciation methods, and research and development expenditures, all of which have an important bearing on cost accounting.

The study of basic cost concepts and implementation criteria, being conducted by a team of Stanford University professors, deals with concepts used in cost determinations for several purposes. The study reflects our belief that further research is needed to refine the inter-relationship between cost accounting principles used for measuring and predicting costs and generally accepted accounting principles used for financial reporting purposes.

The public accounting profession is heavily involved in providing client assistance in establishing cost accounting systems to facilitate managerial controls and to identify product costs. Much of the authoritative literature on cost accounting concepts and applications has been written by CPAs who have extensive experience in developing sound cost accounting practices and in establishing data handling systems to implement them.

This practical experience, together with the Institute's experience in setting standards and conducting accounting research, puts the accounting profession in a position to make a significant contribution to the objectives of this legislation. We earnestly hope that this capability will be used and specifically provided for in the final bill.

In this way, the objectivity of the CPA, concerned with both the purposes of government and the problems of industry can be helpful in developing fair and useful standards.

The AICPA has taken an active interest in the uniform cost accounting standards project since its inception.

In a letter to the General Accounting Office last August, we reviewed the applicability of Section XV of the Armed Services Procurement Regulations for use in the feasibility study. On October 31, we commented in detail on the draft report circulated by the General Accounting Office. While not objecting to the major conclusion of the draft report that uniform cost accounting standards are feasible, we did point out the continuing uncertainty as to the meaning and impact of these proposed standards.

New requirements of disclosure may have been over-emphasized in the Comptroller General's report. Many contractors already disclose to the Government their cost accounting principles and the basis upon which they project costs. Also, the report appears to have concentrated too heavily on the problem of overhead allocation, without giving balanced attention to labor, material, and capital costs.

Several members of the Institute who reviewed the Comptroller General's report observed that the case examples presented were not a representative sample, and that the bad effects illustrated in these cases were caused not by the absence of standards but by the contractors' failure to adhere to cost accounting standards already prescribed by Section XV of the Armed Services Procurement Regulations. As the report itself acknowledges, (and

I quote) "cost-accounting standards could not, by themselves, ensure that contracts will be effectively negotiated, administered, and settled or, for that matter, that costs will be determined in accordance with those standards."

As indicated in my comments to this point, the impact of legislation on cost accounting could have far-reaching effect. While the report of the Comptroller General on this subject recognizes that "it is not feasible to establish and apply standards in such detail as may be necessary to ensure uniform application of precisely described methods," the practical problems of delineating between those standards which have general application, and those techniques or concepts appropriately applicable to a given situation are likely to be especially difficult.

By way of illustration, we note that the Comptroller General's report expresses the view that "the essential function of cost accounting is to allocate direct and overhead costs to individual orders." This assertion, in our view, is an unfortunate oversimplification and inadequate statement of the true objectives of cost accounting. While identification of costs applicable to particular products or product lines is one of the usual functions of cost accounting, it is, by no means, the only one. In fact, product cost determination for many commercial products often utilizes approximations, based upon certain conventions of planned or normal costs, as distinguished from incurred or "actual" costs. The emphasis, in these situations is given to measurement of functional costs -- the costs incurred by a department or other organizational unit as compared with budgeted costs. In addition to the basic process of matching costs and revenues, this is the prime means of exercising control over costs and serves as an effective way to monitor operations and to direct managerial attention to problem areas.

The documentation on cost accounting standards to date does not give consideration to one of the most important aspects of cost assignment, or cost allocation, which is the inter-relationship of total costs between products and activities. This applies to a mixture of commercial products, a mixture of governmental products, or a mixture of both. The fundamental problem is proper and equitable allocation of costs according to their real causes and benefiting sources regardless of the cost type or origin.

Many of the major problems stated in the Comptroller General's report are not necessarily founded in the method or concepts of cost accounting. Often cost determination is but a symptom, whereas the real problem is insufficiently defined contracting procedures.

Two of the major problems, (1) presenting costs in the same format as original contract estimates, and (2) changing cost assignments after a contract is in process, can be corrected without cost accounting standards but with appropriate cost accounting specifications expressed in the contract terms.

In defining standards, it may be appropriate for the framers to consider what should be covered in contract negotiations as well as how to account for the contract. Also, for practical reasons it may be prudent to concentrate initially on a specific industry or a limited number of industries because the standards may vary for different industries. For example, Defense Department contract problems may be quite different from medicare contract problems. After the concepts of cost accounting standards are proven in a given application, they can be expanded to a wider spectrum of government procurement activities.

Overall, however, our general impression is that the Comptroller General's report of January 19, 1970, sets forth a reasonable conceptual basis on which cost accounting standards may be developed. Unquestionably the time and effort spent by the General Accounting Office staff

and consultants have contributed greatly to the understanding of the problems involved in setting cost standards.

We direct attention to the "Definition of Terms" contained in Appendix I of the report which departs from a literal interpretation of the words "uniform cost accounting standards". At the time that Congress directed the feasibility study, we thought that the choice of the words "uniform cost accounting standards" was unfortunate and we believe this has been borne out by the Comptroller General's report. Substitution of other words in the proposed legislation could reduce misunderstanding and thereby assist in achieving the desired objectives. We recommend the term "cost accounting principles."

Regardless of terminology, however, the emphasis should not be on uniformity, since this often leads to misapplication and attempts to apply similar procedures to unlike circumstances. We caution, therefore, against emphasis on uniformity and encourage emphasis on codification of broad standards, recognizing myriad circumstances in which they will be applied. The experience of agencies that set rigid uniform charts of accounts has demonstrated that needs change but reporting requirements persist long after they are obsolete.

The matter of prime concern now should be to ensure that the standards to be set are rational and sound, workable without imposing undue burden on those charged with putting them into practice, not disruptive of accounting in other areas, and fair to all in their results.

We concur in the statement in the Comptroller General's report of January 19 that cost accounting standards for contract costing purposes should evolve from sound commercial cost accounting concepts and should not be incompatible with generally accepted accounting principles. Cost accounting standards will inevitably have impact far beyond government procurement; therefore, they should have broad applicability and usefulness for commercial as well as government business.

Stated another way, our concern is that development of cost accounting standards in an environment apart from generally accepted accounting principles could lead to a lack of conceptual harmony between the whole and one of its parts. Therefore, we recommend that pronouncements of the Accounting Principles Board be the starting point for development of cost accounting standards in all areas in which the Board has spoken.

To ensure that there is no conflict between cost accounting standards and the larger body of generally accepted accounting principles which includes principles of cost compilations, it will be highly desirable to draw on the services of practicing public accountants who are well-informed as to cost accounting principles used in industry. It will also be desirable to involve the cooperation and participation of industry representatives.

The proposed legislation before your committee consists of one bill, S.3302, and two alternative proposals. S.3302 would have uniform cost accounting standards set by the Comptroller General. The bill does not, however, define the "new machinery" that would be required or how it would operate. We believe that, in the public interest, any proposed legislation should be more specific as to the handling of a new function which will have so great an impact on a broad segment of American business. Furthermore, the requirement in S.3302 that standards shall be promulgated within eighteen months is unrealistic for such a comprehensive undertaking. A progress report, however, in eighteen months would be a realistic requirement.

We approve of that feature of S.3302 which calls for the Comptroller General to "consult with representatives of the accounting profession and with representatives of that segment of American industry which is actively engaged in defense contracting." It is only prudent that consultations be held with those most knowledgeable of cost accounting.

The two alternative proposals, while containing more details than S.3302, provide only a sketchy framework of the nature, function, duties, scope, and limitation of an agency for setting cost accounting standards.

While the two alternative proposals contain similar language in several of their respective sections, a significant difference between them is that Alternative One, like S.3302, vests total authority in a single person -- he, who at a given period of time, occupies the post of Comptroller General of the United States -- and Alternative Two vests authority in a board of, presumably, five members.

The occupant of the post of Comptroller General at a particular time might exercise his authority under the contemplated legislation not only well but with conspicuous excellence. But we think you may agree that any legislation that may be adopted in this field should be regarded in terms of the principle involved rather than of persons.

Both the alternative proposals refer to a board of "no more than five members" and permit a number of combinations of Federal and non-Federal members.

Alternative One provides for the establishment of an advisory board composed of members from both inside and outside the Federal Government. The members would be chosen by the Comptroller General. Their number is described as "no more than five", and this could be any number from two to five. The ratio of Federal members to non-Federal members in a five-man board could be one-to-four, four-to-one, or anything in between.

Under Alternative Two, which provides for an independent cost accounting standards board, there could be no more than two non-Federal members and possibly only one.

We believe that the Congress should be concerned not alone with the source of members of the board but, even more, with their competence. The likelihood of attaining that competence would be greatly enhanced by a provision that the members be selected from among professional accountants inside the Federal government and outside the Federal government, with competence in the field of cost accounting.

Both alternative proposals imply that members of the cost accounting standards board would be serving only part time in this capacity, and neither proposal specifies a term of board service. Whether the functions of such a board would require full time service can be determined as experience is gained. But we can be certain its functions will require continuing attention. Therefore, members should serve for a specific term, with only one term expiring in each year, thus providing continuity of service.

Paragraph (d) of Alternative One and Paragraph (j) of Alternative Two give government representatives the right to examine and make copies of contractors' documents, papers, and records. The government's purposes would be served and contractors' privacy would be respected if this right were limited to pertinent or relevant documents, papers and records.

Alternative Two, Paragraph (i) provides for exclusion from the operation of the Administrative Procedure Act. It is our understanding that the Comptroller General is already excluded from this Act. Therefore, it would appear that a significant feature of the democratic process is bypassed by both proposals, and this is worrisome in an operation like that contemplated. We believe it is important that rule-making authority be exercised through processes which provide for public announcement, and for hearings that would give interested persons an opportunity to comment on issues before rules are made which have the full force and effect of law.

Alternative One would seem to strain further the democratic process by making the cost accounting standards board merely advisory. Alternative Two is more in tune with the system of checks and balances inherent in most of our government operations. The cost accounting board called for in this proposal would be patterned after many other independent governmental agencies which carry out regulatory functions effectively.

We are sure the accounting profession would be glad to cooperate actively in helping to establish a cost accounting standards board that is well conceived and constituted. Within the AICPA there is a wealth of professional talent that can be made available to such a task.

An example of the constructive force of the accounting profession lies in the administration of the securities acts. From the beginning, the Securities and Exchange Commission has looked to the AICPA to develop accounting principles.

Similarly, a properly constituted cost accounting standards board might well look to the AICPA to do the bulk of the work in setting standards.

We can summarize our major conclusions and recommendations as follows:

1. The "new machinery" preferably should call for an independent agency appointed by the President, consisting of a small number of members, such as five, all of whom should have competence in cost accounting.
2. At least two members should be drawn from outside the Federal government and at least one of them should be from the field of public accounting.
3. The law should not exempt the agency from provisions of the Administrative Procedure Act.
4. The law should require the agency to consult with the accounting profession and industry representatives.

The American Institute of CPAs stands ready to aid in considering more specific legislative provisions in implementing cost accounting standards. In closing, we wish to express our appreciation for the opportunity to appear before you today. Thank you.