



DEFENSE CONTRACT AUDIT AGENCY
DEPARTMENT OF DEFENSE
8725 JOHN J. KINGMAN ROAD, SUITE 2135
FORT BELVOIR, VA 22060-6219

IN REPLY REFER TO

PAC 730.8.A.05/2008-04

April 10, 2008

Ms. Laura Auletta
Cost Accounting Standards Board
Office of Federal Procurement Policy
725 17th Street, NW, Room 9013
Washington, DC 20503

SUBJECT: Reference Case: CAS-2008-01S

Dear Ms. Auletta:

The Defense Contract Audit Agency is pleased to have the opportunity to comment on the Staff Discussion Paper (SDP) regarding Potential Revisions to CAS 403 Thresholds – Allocation of Home Office Residual Expenses to Segments, as published in the February 13, 2008 Federal Register (FR 73 8260). The SDP requests public comments on (a) whether the operating revenue thresholds should be raised, (b) the extent the proliferation of intermediate home offices impact any potential revision of the thresholds, and (c) the potential advantages/disadvantages of the two proposals received from AIA and DoD regarding revising the CAS 403 Operating Revenue thresholds. The SDP also contains other related questions to consider, including the type of data currently available for performance of a staff study, and whether the administrative burden of collecting the data is commensurate with the risk. Our comments are as follows:

(a) Should the Operating Revenue Thresholds be Raised?

The Background section of the SDP notes that the number of intermediate home offices has increased since CAS 403 was promulgated 35 years ago. As contractors increase the number of intermediate home offices to manage their segments, residual expenses that were formerly concentrated at a few intermediate home offices are now diffused throughout several intermediate home offices. AIA's proposal to increase the operating revenue thresholds by 400%, based solely on the increases in the Consumer Price Index, does not consider this proliferation of home offices and its impact on the materiality of residual expenses relative to operating revenue. Without knowing the impact, potentially, even the largest contractors may be relieved from the requirement to use the three factor formula, while they still incur a material amount of residual expenses in the aggregate. Accordingly, we agree with the DoD proposal for conducting a staff study prior to considering any revisions to the operating revenue thresholds. Further, we note that the SDP agrees with our opinion when it acknowledges that the proliferation of intermediate home offices should be considered when determining whether to revise the operating revenue thresholds.

The concept of materiality for the allocation of residual expenses and the rationale for the use of the three factor formula base are discussed in Preamble A to CAS 403. When promulgating CAS 403, the Board recognized the three factor formula allocation base is not required when residual expenses are minor in relation to the contractor's total business volume. Conversely, when residual expenses are material, the Board concluded the three factor formula base must be used. This concept is documented in the following language of Preamble A to CAS 403 (see 38 FR 26680, dated December 14, 1972):

The Board recognizes that where residual expenses are minor in amount in relation to a contractor's total business volume, the use of other techniques is unlikely to affect materially the amount allocated to a given segment, and is even less likely to affect materially the allocations to individual contracts. The Board has therefore provided in 403.40(c) that, where residual expenses are no greater than specified percentage of the organization's operating revenue, they may be allocated by means of any appropriate allocation technique....

The Board has concluded that where residual expenses are material in amount, a single allocation technique should be specified. Accordingly, 403.40(c) of the Standard requires the use of the three factor formula if residual expenses are in excess of the specified percentage of total company revenues. ...

When the CAS Board originally set up the operating revenue percentages used to measure the materiality of residual expenses, they based it on actual statistics of various companies and a staff study, as noted in the following excerpt from Preamble A:

“To develop the percentages specified in the Standard the Board considered both actual statistics of various companies and the results of a staff study to determine the effect of the Standard on the home office allocations of a number of companies.”

We believe that the current Board should take a similar approach to determine whether residual expenses in the current contractor environment are material.

(b) Impact of the Proliferation of Intermediate Home Offices

In or about 1975, the CAS Board issued a Staff Paper (Tech No. 35), which evaluated whether the requirement to comply with CAS 403 should be expanded beyond contractors that received more than \$30 million in net awards of negotiated defense prime contracts. As part of this study, a survey was conducted that found 66 parent home offices and 81 intermediate lower-tier home offices were required to allocate their expenses in accordance with CAS 403. At that time, this equated to an average of 1.2 intermediate home offices per a parent office. To

understand how this ratio may have been impacted by the proliferation of intermediate home offices since 1975, we collected data from our Field Audit Offices at several of the largest defense contractors regarding their current organizational structure. Based on the data collected, we found as many as 14 intermediate home offices under a single parent corporate office. On average, we calculated 6.6 intermediate home offices per a parent corporate office, which is more than five times greater than the 1.2 ratio of parent to intermediate home offices in the CAS Board's study in 1975. Accordingly, we believe the modern day contractor organizational structure results in a diffusion of home office residual expenses that 35 years ago may have been concentrated in a corporate home office and perhaps a few additional intermediate home offices. Thus, the impact of the proliferation of intermediate home offices needs to be considered in measuring whether residual expenses are material relative to the operating revenue of the reporting entities. Otherwise, residual expenses that may be material, will be excluded from the requirement to use the three factor formula, resulting in the inequities and controversy that CAS 403 was designed to prevent. We note that in the following excerpt from Preamble A, the CAS Board recognized the three factor formula as a superior base that promotes consistency, reduces inequity, and avoids controversy.

“...if residual expenses exceed such specified percentages, the Board believes that its objective of **reducing controversy** and **avoiding inequity** would best be served by selecting a single allocation technique to be used. Its research in this connection has led the Board to conclude that for this purpose, a three-factor formula is **superior to other allocation bases** and techniques for the allocation of residual expenses (emphasis added).”

Considering the original Board's view that the three factor formula is “superior to other allocation bases,” any decision to increase the thresholds needs to be carefully studied so as not to exclude those residual expenses that are material.

(c) Potential Advantages/ Disadvantages of the DoD and AIA Proposals

Advantages of the DoD Proposal

The DoD proposal for a comprehensive study provides the Board objective data to understand the impact of adjusting the thresholds on companies subject to the three factor formula. This is a significant advantage, given that the proliferation of intermediate home offices is a contributing factor in determining whether residual expenses are material relative to the operating revenue of the reporting segments. When residual expenses are material, the CAS Board recognized in Preamble A that the three factor formula base is superior to others.

Another advantage of the DoD proposal is that the data accumulated will allow the Board to measure the relationship of residual expenses to operating revenue for a representative population of contractors. This type of evaluation is consistent with the logic employed by the Board when it originally determined the threshold operating revenue percentages for companies subject to the three factor formula base.

Disadvantages of the DoD Proposal

We agree with the SDP that the DoD proposal for a comprehensive study will require time and effort to compile and evaluate the data. However, we believe that such effort is time and effort well spent, since the Board can make an informed decision when determining whether to issue an ANPRM to revise the thresholds.

Advantages of the AIA Proposal

We see no advantage of arbitrarily increasing the thresholds by an inflationary factor of 400% or any other factor, based on increases in CPI or any other inflationary indices, without knowing the impact to contractors. In fact, we believe it would be imprudent to increase the thresholds without a study of the impact.

Disadvantages of the AIA Proposal

Increasing the three factor formula thresholds by 400%, based on increases in CPI or any other inflation indices, is arbitrary. It is not prudent for the Board to increase the thresholds without knowing the magnitude of companies no longer required to use the three factor formula base. Potentially, many intermediate home offices would no longer be subject to the three factor formula while still incurring a material amount of residual expenses in relation to the revenues of the reporting entities. This may lead to less uniformity and consistency in contractor allocation practices for residual home office expense. This would be inconsistent with the objectives of the Board cited in Preamble A, which was to create a uniform practice for allocating significant residual home office expenses, to avoid inequities, and reduce controversy. Additionally, the three factor formula base was recognized by the Board as superior to others. Therefore, it would be a significant disadvantage to arbitrarily exempt intermediate home offices without knowing whether the residual expenses remain material under the contractor's current organizational structure.

(d) What type of data is currently available for performance of the staff study?

Important data required for the staff study would include the total operating revenue of the segments reporting to each of the contractor's intermediate home offices, the residual expense amounts at each intermediate home office, and the contractor's disclosed practices for allocating residual expenses. We believe this data is readily available since contractors use this information to prepare and support annual incurred cost proposals to the Government. This information could be used to evaluate the impact of raising the thresholds by 400%, as proposed by AIA, or by any other factor, compared to the current thresholds.

(e) Is the administrative burden of collecting the data associated with the staff study commensurate with risk?

Yes. We believe the administrative burden of collecting the necessary data is immaterial when compared to the significant risk of raising the thresholds without knowledge of its impact on the contractor's allocation of residual expenses. It is important that material residual expenses continue to be allocated by the three factor formula to promote uniformity and consistency in the charging of home office expenses to Government contracts. In addition, as noted in our comment in item (d) above, we believe the necessary data for a staff study is readily available without placing significant burdens on the contractor.

We appreciate your consideration of our comments. Please direct any questions regarding this memorandum to Ms. Fran Cornett, Chief, Accounting and Cost Principles Division (PAC) at (703) 767-3250.

/s/ Frances T. Cornett
/for/ Kenneth J. Saccoccia
Assistant Director
Policy and Plans