Acquisition Panacea Keyed To Commercial Base Access

by Michael E. Heberling and Tracy J. Houpt

Without significant changes in the Defense Department's acquisition system, specifically the reform of cost accounting standards, the proposed benefits of a shift to greater reliance on the commercial sector may never be realized. Lower product costs, reduced lead times and an access to a larger, more technologically advanced industrial base were all forecasted for the Defense Department as it increasingly relies on the commercial sector to meet its security requirements. A shrinking, traditional defense industrial base has sent the government searching for new suppliers of both commercial-off-the- shelf products and military-unique items. Early findings from an Air Force industrial base pilot program show that cost accounting standards effectively discourage purely commercial firms from seeking defense work.

The call for greater use of commercial products and practices has been a recurring theme of Defense Department procurement reform for more than 25 years. Numerous studies of the military's acquisition practices have concluded that procurement laws and regulations create significant entry barriers for commercial firms seeking federal contracts. The Pentagon could reduce its acquisition costs and lead times by simply adopting commercial practices. A frequent recommendation is to replace the government's cost accounting standards with the generally accepted accounting practices found in the private sector.

In the past with a large defense budget, there was no compelling reason to adopt standard business practices or to use commercial suppliers. Today, there are several critical reasons to do so. First, the military no longer has a monopoly on state-of-the-art technologies. In a number of areas, the technology advances gained in the commercial sector outpace those found in the defense sector. This is true for integrated circuits, communications, computers, software, and advanced materials. The semiconductor market illustrates the dramatic change. In 1965, the Defense Department market accounted for more than 75 percent of all US semiconductor purchases. The Semiconductor Industry Association estimates that those sales now account for only 1 percent of all U.S. company sales. When the military sales represent only a small segment of a market, companies are less willing to seek government business. This is especially certain if government business comes with unique terms and conditions, such as cost accounting standards, that run counter to standard business practices. Finally, in an era of limited budgets, the Defense Department market is unable to sustain a defense-unique industrial base. In the past, defense companies were abundant and willing to accept the additional reporting and compliance costs associated with government work. Today, as work associated with the defense market becomes both smaller and more erratic, the defense contractor pool is disappearing.

A shift to the commercial sector is a way to contain the cost and the time it takes to procure weapon systems. The problems associated with a decreasing defense industrial base become less acute if there is a strong and willing commercial base to draw upon for commercial-off-the-shelf and military-unique requirements. Consequently, every effort should be made to facilitate the Defense Department's access to commercial technology and the adoption of commercial practices. Replacing cost accounting standards with generally accepted accounting practices would be a step in that direction.

The Defense Department cost accounting standards requirements originate from 19 rules established by the cost accounting standards board. The objective of the standards is to provide consistency in cost accounting practices and an equitable cost allocation. Cost accounting standards designate an accounting format for government contracts, and provide guidance on everything from how to account for the cost of money, to depreciation of capital assets, to allocation of general overhead. Supporters of these standards claim that the establishment of a uniform set of accounting principles helps to ensure fair and consistent treatment for the Defense Department in the pricing and performance of defense contracts.

Problems arise because the cost accounting standards requirements impose cost measurement and allocation criteria that are not consistent with generally accepted accounting practices. For example, standard 409 requires contractors to compute depreciation using procedures different from those accepted for tax or financial reporting purposes. Standard 410, which specifies allocation of general and administrative expenses, typically requires extensive system changes to track cost information in areas that industry has little interest. Compliance with cost accounting standards is extremely costly for those contractors who have both military and commercial operations.

The Federal Acquisition Streamlining Act (FASA) of 1994 is intended to simplify the acquisition process and minimize government-unique reporting and compliance requirements. The streamlining act will modify a number of areas that have frequently been identified as barriers to acquisition reform, including the Truth in Negotiations Act and cost accounting standards. The streamlining act also waives the requirement for certified pricing data on competitively awarded commercial contracts and exempts commercial item acquisitions from cost accounting standards requirements.

FASA only addresses part of the cost accounting problem. To be exempt from those standards, an acquisition must fall under the definition of a commercial item. This exemption does not apply to the acquisition of military-unique end items made by a purely commercial firm. The proposed FASA regulations fail to recognize that expanding the industrial base means more than just buying commercial items from commercial companies; it also means using purely commercial firms to meet defense-unique requirements.

The streamlining act presupposes there will always be a captive defense industrial base to meet military-unique requirements, or purely commercial firms will be willing to seek defense work, even if that work comes with extensive compliance and reporting requirements. There are flaws in both of these assumptions.

The first assumption may be true. However, Secretary of Defense William J. Perry has said that the United States can no longer afford the extra cost of maintaining an isolated defense industrial base. Steps must be taken to integrate the defense industrial base with the commercial industrial base to form a national industrial base. Initial findings from an Air Force Pilot Program negate the assumption that commercial firms will blindly seek government contracts. Requirements associated with cost accounting standards effectively discourage purely commercial firms from seeking defense work.

The Air Force has several industrial base pilot programs administered by the manufacturing technology directorate of Wright Laboratory at Wright-Patterson Air Force Base, Ohio. These programs seek to identify and adopt best practices in the acquisition of defense systems. One of these programs, the "military products from commercial lines pilot," seeks to demonstrate military component production on a commercial line at a lower cost and comparable quality to those produced on a military production line.

Demonstration electronic boards satisfying performance requirements of the F-22 advanced tactical fighter will be produced on a commercial automotive manufacturing line. TRW’s commercial automotive electronics group currently tailor-makes electronic products for individual customers such as General Motors and Caterpillar. To TRW automotive electronics group, the Defense Department requirement for electronic boards is similar to its other non-Defense Department customers. For TRW, the principal problem in doing business with the government centers not on the requirement for unique products, but rather on the unique reporting and compliance requirements imposed by the government procurement system.

This pilot shows that in some respects, the commercial sector is becoming more like the defense sector. It caters to single customers with unique product requirements in small quantities. The major difference, however, is that it does this economically. Although TRW has numerous customers, for illustration purposes consider the Defense Department, Caterpillar and General Motors. These three customers are similar in that they all require TRW to produce specific tailor-made electronic products. While the end-item products are different, the manufacturing processes and expertise used in each case are identical.

The TRW pilot shows that in this new era of flexible and lean manufacturing, it is now possible for a purely commercial firm to economically manufacture military-unique items. While this effort is technically possible, the real problem lies in government procurement practices.

The clauses associated with the cost accounting standard provisions of the federal acquisition regulation are not in keeping with customary commercial contracting practices. TRW automotive electronics group has neither the audit support infrastructure, nor a cost accounting system necessary for compliance. Although TRW’s cost accounting system is in keeping with generally accepted cost accounting practices, it is not compliant with cost accounting standards.

To be compliant with those standards, TRW would need to drastically alter its current business practices. The expense of restructuring to a cost accounting system would include a significant increase in the current TRW accounting and business staff. This change would require additional automated data processing equipment, office space, and lead to higher overhead costs.

Acquisition reform initiatives should not ignore programs, such as the Air Force TRW pilot, with military-unique requirements. Without regulatory relief, dealing with purely commercial firms will be difficult. Many commercial firms will refuse Defense Department business to avoid extensive compliance and reporting requirements. This not only runs counter to normal business practices, but it is also expensive and disruptive.

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