4. Fixed-price incentive contracts
5. Non-cost-reimbursable portion of time and material contracts
6. Labor-hour contracts

Contracts awarded by formal advertising are excluded except in the case of terminations for the convenience of the government and possibly when prices require revision because of changes to the contract.

The new Revision makes it clear that "the ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement." and that "cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it." It is also made clear that the policies and procedures of ASPR Section III - Part 8 are governing in the negotiation of fixed-price type contracts.

The need for consideration of costs under varying conditions is also discussed in this Revision. In retrospective pricing and settlements, the Revision states "the treatment of costs is a major factor in arriving at the amount of the price or the settlement." In the area of forward pricing the Revision recognizes that it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Factors such as the technical, production, or financial risk assumed, the complexity of the work, the extent of competitive pricing, and the contractor's record for efficiency, economy, and ingenuity, as well as available cost estimates are emphasized as being important in considering the reasonableness of a proposed price.

Whenever it becomes necessary to obtain specific data on certain cost items, particularly those whose treatment may be dependent upon special circumstances, the Revision states "that contractors are expected to be responsive to reasonable requests for such data."

Applicability to terminations of fixed-price contracts

The new cost principles are to provide guidance in the negotiation of termination settlements for the convenience of the government on fixed-price type contracts. The cost principles formerly set forth in ASPR 8-302 will not be applicable to new procurement after July 1, 1960 and will be replaced by the new cost principles in Section XV.

Applicability to subcontracts

A prime contractor, whose contract binds him to the new Section XV, will be required to justify the allowability of all costs under cost-reimbursement type subcontracts of any tier above the first fixed-price subcontract in accordance with the new Section XV, Part 2 (supply and research subcontracts with commercial organizations), or Part 3 (research subcontracts with educational institutions), or Part 4 (construction subcontracts). In the case of negotiated fixed-price subcontracts, the prime contractor is to use the new cost principles for guidance where an evaluation of costs is required.

Advance Understandings

The new cost principles recognize that criteria for the allowability of the selected items of cost covered in Part 2 apply broadly to many accounting systems in varying contract situations. Since reasonableness and allocability of certain items of cost may be

difficult to determine, contractors are cautioned to seek agreement with the government in advance of incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. However, the absence of such an agreement will not in itself make costs unallowable.

Examples of eight categories of costs are set forth in which advance understandings may be particularly important. However, each contractor will wish to review the entire list of costs in Part 2 as well as these specific examples to determine whether advance understandings are necessary to insure allowability.

With respect to costs that are regularly or customarily incurred, an over-all agreement with the three Services may be necessary to insure equitable and uniform treatment. This is particularly true in the case of indirect costs which may be recovered through the application of negotiated overhead rates. To date no procedure has been established for negotiation by the contractor of over-all advance agreements. However, the new principles do provide that advance agreements may be sought by contracting officers individually or jointly for all defense work of the contractor as appropriate. This provision has already given rise to the promulgation of different clauses by the various agencies in connection with the allowability of research and development costs as well as to the formation of a Tri-Departmental Committee to deal with this matter.

In addition to advance understandings that may be common to all contracts, it may be necessary to negotiate understandings specific to individual contracts such as pre-contract costs and use charges on fully depreciated assets. Advance understandings between prime and subcontractors should also be agreed upon to assure recovery of costs by both parties.

General Factors Affecting Allowability of Costs

The general factors affecting allowability of costs remain unchanged from the previous version. These are (i) reasonableness, (ii) allocability, (iii) application of those generally accepted accounting principles and practices appropriate to the particular circumstances and (iv) any limitations or exclusions set forth in Part 2 or otherwise included in the contract.

In addition to recital of the general factors, reasonableness and allocability are now defined and basic criteria are set forth for their determination. As a practical matter these criteria are the same as used in the past, although not previously enumerated. These are as follows:

Reasonableness - In determining the reasonableness of a given cost, consideration shall be given to:

(i) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;

(ii) the restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and State laws and regulations, and contract terms and specifications;

(iii) the action that a prudent business man would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government and the public at large; and

-405 ~~15-406~~ Examples of Subjects Requiring Special Consideration. The following examples are illustrative of subjects affecting cost which may require special consideration:

(a) costs incurred incidental to work covered by the contract but prior to the execution of the contract, with a specific identification of the types thereof and the period involved;
(b) Government-furnished property, general nature and extent;
(c) indirect cost rates: (i) actual, (ii) negotiated rate or an ouak, or (iii) other;
(d) insurance;
(e) intracompany and intercompany transactions;
(f) liability to third persons;
(g) operation of restaurants and cafeterias;
(h) overtime compensation (see ASPR 12-102);
(i) patents, purchased designs, and royalty payments;
(j) personnel movement of a special or mass [illegible];
(k) plant facilities fully depreciated or amor[illegible] in the contractor's books of account or acquired without cos[illegible]ible consideration for utilization in the form of a use or ren[illegible]arge);
(l) rearrangement or relocation of facilities [illegible]nt plant;
(m) research programs of a general nature;
(n) security measures of a special nature;
(o) sharing of cost of research projects of [illegible] type which an educational or other nonprofit institution [illegible] undertakes as a part of its own educational or research program;
(p) subcontracting, nature and extent thereof and relation to fee or profit;
(q) subsistence and housing of employees;
(r) termination expenses;
(s) tooling and equipment;
(t) traveling expenses of a special or unusual nature; and
(u) wages or salaries of partners or sole proprietors.

Indirect Cost [illegible] 15-[illegible]

Applies 4-2.9(a)

15-406 (Cost [illegible] Plant [illegible] (9)).

(a) Costs of pension and retirement plans, including reasonable incidental benefits, such as disability, withdrawal, insurance or survivorship allowances which are deductible from taxable income in accordance with the Internal Revenue Code and the regulations of the Bureau of Internal Revenue, are allowable except to the extent they are determined to be unreasonable or unallowable under any other provision of this cost interpretation. Costs of such plans established by nonprofit or other organizations not subject to payment of Federal income taxes are also allowable except to the extent they are determined to be unreasonable or unallowable under any other provision of this cost interpretation.

(b) Pension or retirement plans of a contractor which are subject to approval of the Bureau of Internal Revenue must have been so approved before costs under the plans may be accepted as charges to Government contracts. Many plans of nonprofit or other tax exempt organizations are also reviewed and approved by the Bureau of Internal Revenue—when not so reviewed and approved, each such plan will be reviewed, and approved or disapproved, by the Department to which audit cognizance is assigned, using, insofar as applicable, the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. In any case where the Bureau of Internal Revenue withdraws approval of a plan, approval of amounts allocated to contract costs will be withdrawn accordingly.

(c) The approval of a pension or retirement plan by the Bureau of Internal Revenue will, as a general rule, be the only approval required by the Departments; however, the right is reserved to require submission of any plan for consideration by a Department and to disapprove such plan in its entirety or any feature thereof whenever the circumstances in a particular case are deemed to warrant such action. Such consideration will be the responsibility of the Department to which audit cognizance is assigned, and the subsequent action taken by that Department will generally be accepted by the other Departments.

(d) Approval of a pension or retirement plan by the Bureau of Internal Revenue or by the Departments does not imply that the cost thereof for any particular year will be allowable for apportionment to contract costs, except to the extent costs for that year meet all other requirements of the Bureau of Internal Revenue as a deduction for income tax purposes, and are acceptable under the provisions of this cost interpretation and other provisions of this Section.

(e) Pension and retirement costs constitute a part of the total compensation by a contractor to any individual covered by the plan, and accordingly, are subject to the provisions of this Section with respect to reasonableness of the total compensation paid to the individual for the services rendered.

(f) Where contributions to pension or retirement plans are based on profits, providing that provisions of the Internal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year shall be the amount contributed to the pension trust(s) for that year, but not to exceed 15 percent of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan(s).

(g) The allowability of costs of lump sum purchases of annuities or of periodic cash payments made to provide pension or retirement benefits for retiring or retired employees, other than incurred under approved pension or retirement plans, will be subject to consideration on an individual case basis.

(h) Credits which became available or are foreseeable must be taken into account in an equitable manner in determining pension and retirement costs subject to apportionment to a military contract. In some instances, this may require adjustments to costs in anticipation of the realization of credits. For example, such action would normally be appropriate where contractors' organizations are substantially expanded for the performance of military contracts and there is a reasonable expectation that, upon completion of the contracts, the services of practically all or a large number of the additional employees will be terminated with the result that contractors will benefit from contributions made on behalf of these employees, because such personnel will not acquire vested rights under the terms of the plans.

(i) In any current or future contract no cost allowance will be made which would duplicate, in whole or in part, an allowance previously made under a prior contract.

DEFENSE PROCUREMENT

and

CONTRACT COSTS

Public Policy Considerations

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and

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MACHINERY AND ALLIED PRODUCTS INSTITUTE
1200 Eighteenth Street, N. W.
Washington 6, D. C.

FOREWORD

This pamphlet reproduces a recent letter of the Machinery and Allied Products Institute to the Assistant Secretary of Defense concerning The Pentagon's proposal for application of a so-called "comprehensive" set of cost principles to all types of defense contracts and subcontracts.

Defense procurement policy—which would be substantially affected by this proposal—has been of primary interest heretofore only to those directly involved in the process of military buying. This, we believe, is unfortunate. Recent international developments suggest the imperative necessity for a major and long-continuing national effort to secure our defenses. The success of that effort may be advanced or deterred, in our opinion, according to whether the policy governing procurement of defense materiel is such as to release or chain the developmental and productive genius of our system of private enterprise.

A system of private enterprise is energized by the prospect of profit, a reward which normally varies directly with the character of performance. By further extending the principle of reimbursing government contractors for actual cost—with profit, if any, added by an almost inflexible percentage formula—adoption of the proposal here under discussion might, in our view, have a most serious disincentive effect, and in the long run would almost certainly increase the cost to the government.

This built-in tendency of the proposal brings to mind, moreover, the already-imposing machinery of governmental profit limitation in the field of government procurement. This complex of law and regulations now includes broad authority for contract audit, extensive use of price redetermination, specific profit limitations on military aircraft, naval and merchant marine vessels (now temporarily ineffective by reason of renegotiation), and—as the last station in the gantlet run by the defense contractor—the wholly-arbitrary process of contract renegotiation. Nowhere, we might add, is this curious preoccupation with profit limitation better illustrated than in the field of Atomic Energy Commission procurement.

Defense procurement is, we believe, in every sense a major issue of public policy, and important questions affecting such policy require the most careful study by all elements of our society. With this in

mind, the Machinery Institute has thought it desirable to give a broad public distribution to this statement in the hope that it may enlarge interest in an area too long reserved to the specialist.

Although purely an administrative matter, the proposal which constitutes the subject of our statement to the Department of Defense has such far-reaching implications that we have brought it directly to the attention of the Preparedness Investigating Subcommittee of the Senate Armed Services Committee. Our letter of transmittal to Senator Lyndon Johnson, Chairman of the Subcommittee, is reproduced as an appendix to this pamphlet. In a gracious note of acknowledgment Senator Johnson indicates that he has "directed the staff of the Preparedness Subcommittee to evaluate this material carefully in conjunction with [its] over-all investigation."

Very minor editorial changes have been made in the original text of the basic letter for publication in this form.

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 Eighteenth Street, N. W. Washington 6, D. C.

December 16, 1957

Mr. Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
Department of Defense
Washington 25, D. C.

My dear Mr. McGuire:

We appreciate your invitation to comment on the set of contract cost principles recently proposed for application to "government contracts and subcontracts thereunder." The Machinery and Allied Products Institute, representing the capital goods and allied equipment industries of the United States, has the deepest interest in this proposal, representing as it does such an abrupt break with past procurement practices.

It goes without saying that this is a proposal of the utmost importance to government as well as to all government contractors and subcontractors. Moreover, we appreciate particularly the timeliness of this review, coming as it does when Congress and The Pentagon are considering the need for what may be a substantial increase in defense spending and the requirement for expeditious and efficient procurement. This prospect suggests, we believe, a careful look at *all* procurement policies and practices and much of our statement on cost principles may be applied to the broader context. This is not a question of accounting technique but goes to the very heart of procurement policy and efficiency.

Your letter of October 14 indicates that procurement officials have "concluded that it would be more advantageous to have one set of cost principles which are applicable to all types of contracts with industry." One is permitted to inquire, we believe, in what way such cost principles are more advantageous in the public interest.

After the most careful examination of this proposal a broad cross section of capital goods executives have concluded—and the Institute takes the position—that few, if any, advantages are discernible and that the suggestion bristles with possible disadvantages. Although we shall have more to say on this subject later, we want to emphasize at this point our special concern with the possible effects of this proposal's adoption on firm, fixed-price contracting. The

composite of the views of capital goods industries set out herein leads us respectfully to urge a reconsideration of your conclusion.

In our comments which follow we have approached the questions posed by your recent letter—and Mr. Mulit's letter of May 28, 1956, relating to this subject—on three levels:

1. A discussion of certain broad policy questions fundamental to the conclusion that adoption of a comprehensive set of cost principles would be advantageous. (Our discussion of these matters has necessarily involved a review of historical background and a preliminary and over-all critique of the proposal here under consideration.)
2. A brief look at the rationale apparently underlying the suggestion for a comprehensive set of cost principles.
3. A detailed paragraph-by-paragraph review of proposed Section XV of the Armed Services Procurement Regulation as forwarded to us by your letter of October 14.

CONSIDERATIONS OF POLICY

In considering a change in basic procurement regulations of such potentially far-reaching consequences as are involved in this proposal, it seems to us appropriate—indeed, essential—to look first at some fundamental questions. For example, what is the general policy of defense procurement? Assuming the soundness of such a policy, will it be well served by adoption of a comprehensive set of contract cost principles? What consequences may reasonably be expected to flow from the move here proposed?

Basic Procurement Policy

Last February The Pentagon released Part 8, Section III, of the Armed Services Procurement Regulation, entitled "Price Negotiation Policies and Techniques." This important addition to procurement doctrine declares, "It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate over-all cost to the government." [Underscoring supplied.] This same statement of general policy goes on to say that "sound pricing depends primarily upon the exercise of sound judgment by all personnel concerned with procurement."

We think this an excellent statement of broad policy, although we are constrained to observe in passing that it has been reduced, in practice, to little more than an expression of pious hope. We think

the heart of this statement—the proposition that policies observed and means employed shall conduce toward "the lowest over-all cost to the government"—deserves repetition and re-emphasis.

At still another point in this recent addition to ASPR one finds the assertion that "government procurement is primarily concerned with the reasonableness of a negotiated price and only secondarily with the eventual cost and profit." [Here, too, we have taken the liberty of supplying emphasis by underscoring.] And again we say, fair enough.

Having examined these propositions, which are, we believe, central to defense procurement philosophy, it seems proper to consider how the attainment of these objectives may be effected by enlarging the present catalog of allowable and unallowable costs and by extending its application to substantially all defense contracts and subcontracts.

Before discussing these matters, however, and as a means of setting this proposal against an historical backdrop important to its consideration, we should like briefly to review the circumstances leading to the suggestion now before us.

Background

This proposal is, as you know, a hardy perennial. It has been advanced informally for a number of years. Moreover, certain of the foreseeable effects of its adoption were largely achieved for a time by publication of a Munitions Board memorandum on November 15, 1949, which specified mandatory application of ASPR cost principles to certain cost-type contracts and permitted their use "as a working guide" in fixed-price contract negotiations. Because, in due course, the "guide" became an almost inflexible rule in practice, the permissive authority for use of cost principles in connection with fixed-price contract negotiations was revoked by DOD Instruction 4105.11, November 23, 1954.

Now this process has come full circle and the proposal is made that ASPR cost principles "serve as the basis"—under fixed-price contracts—for: (1) development and submission of cost data and price analyses, (2) evaluation of cost information by contracting officers, (3) resolution of questions of acceptability of specific items of cost in restrospective pricing, and (4) audit reports prepared by audit agencies in their advisory capacity of providing accounting information.

The 1954 revocation would appear to indicate that procurement officials themselves were not entirely satisfied with the earlier author-

ity. Industry, we know, was decidedly unenthusiastic. Are we now proposing to re-establish a pattern of procurement practices which—by all evidence—has failed upon trial before? In any event, we urge a careful review of this proposal's long and uninspiring history.

The views of Congress.—Your letter of October 14 implies that Congressional committees require a single set of cost principles applicable to all types of contract with industry. In examining relevant reports and hearings before interested Congressional committees, we find no evidence of the existence of a legislative mandate —in precise and definitive form—for a comprehensive set of cost principles of the character here proposed.

We note in "Hearings Before the Subcommittee of the Committee on Appropriations, House of Representatives, 84th Congress, Second Session" on DOD appropriations for 1956, page 10, that the Subcommittee found "serious deficiencies exist with respect to policy guidance in the basic cost principles applicable to price redeterminable contracts." This recommendation is restated in the report of the Survey and Investigations staff of the House Appropriations Committee in its supplemental inquiry into procurement policies and practices, its findings having been published under date of January 12, 1957.

First of all, this expression of Congressional concern is limited to a single type of procurement agreement—the fixed-price redeterminable contract. Secondly, it is cast in such general terms that it can in no wise be construed to dictate form and scope of application.

We do not believe Congress intended that existing contract cost principles (Part 2, Section XV of ASPR) should be lengthened and their application extended across the whole range of contracting activity, particularly when this step would, in our judgment, tend to frustrate certain other broad policies of Congress in this area. We know, for example, that Congress would concur in your own policy statement which calls for procurement of necessary materiel of war at the lowest ultimate cost to the government. And, judging from the recent hearings before the Missiles Investigation Subcommittee of the House Armed Services Committee, Congress is in no mood to encourage the harassment, the haggling and the hairsplitting that are part and parcel of the cost reimbursement process.

Moreover, there has been increasing criticism from interested Congressional committees of the extensive use of negotiated procurement as distinguished from purchase by formal advertisement and

sealed bid. In brief, Congress is calling for a substantial reduction in the negotiation of defense contracts while the instant proposal would seem to us inevitably to extend the area of negotiation and certainly to complicate its conduct.

The Armed Services Procurement Act of 1947, as amended, restates the long-standing preference of Congress for fixed-price contracting—and, indeed, in the formally advertised form. This proposal, in our judgment, will take defense buying still further away from announced legislative policy. Moreover, this basic policy of Congress must, we think, take precedence over any remarks in Committee hearings on special aspects of military buying.

"Decision Making in Weapons Development."—Although obviously not authorized to release its full text, we have been privileged to review an advance copy of an article by this title scheduled for publication in the January-February 1958 issue of the *Harvard Business Review*. Its author, Dr. J. Sterling Livingston, whose experience in and out of government qualifies him to speak authoritatively on problems of government procurement, has some illuminating comments that are germane to the background discussion of this proposal.

A quotation from Dr. Livingston's article is particularly apropos. "Since we are relying on private corporations for the design and development of new weapons required for our survival, it is urgent that profit policies be revised at an early date to assure that the incentives to undertake weapons research and development work are both adequate and sound so the work will be carried out efficiently and economically. There is considerable reason to believe that present profit policies provide an inadequate incentive for research and development work and are contributing to waste of scientific, engineering and production manpower."[1]

The author's emphasis on research and development contracting seems especially instructive. It is in this area that cost-reimbursement type contracts are peculiarly appropriate, although we endorse completely Dr. Livingston's reservations about their use. If cost contracts have produced these results in an area where their use is probably unavoidable, why multiply the effect of these ills by extending the underlying principle across the whole range of defense contracting?

So much for background. Let us turn now to a consideration of

[1]Livingston, J. Sterling, *Harvard Business Review*. Graduate School of Business Administration, Harvard University, Boston, Massachusetts, January-February 1958, in press.

the over-all effects of the current draft of a comprehensive set of cost principles.

The Present Proposal

Although certain questions of interpretation remain, the meaning of the subject draft of Section XV, ASPR, is plain enough: its provisions are to be incorporated by reference into all contracts; it will serve to determine acceptability of claimed expense under cost-type contracts and in termination settlements; and it will serve as a guide—and, in some cases, a final arbiter—in fixed-price contract negotiations.

Adverting now to those statements of broad procurement policy quoted above, how will they be affected by adoption of these cost principles?

Lowest ultimate over-all cost to the government.—Acknowledging—as we do—the soundness of this over-all objective of procurement, just how will it be attained by establishing a comprehensive set of cost principles applicable alike to cost-reimbursement and fixed-price contracts?

Unquestionably, there are many procurement situations in which cost reimbursement is the only practical means of contracting. Yet, any cost-reimbursement contract has built-in features which tend to increase the ultimate over-all cost to the government. Such features include the reduction of competition, the added cost of administration, the impairment of cost-reducing incentives, lessened responsibility on the contractor, the problems—and the cost—of extensive contract audits, etc.

Despite these shortcomings of the cost-type contract—all of which are expressly or impliedly recognized by ASPR itself—we are now confronted with a proposal that cannot fail, in our judgment, to distribute these disadvantages much more widely by converting many so-called fixed-price agreements into cost-type contracts, in fact if not in law. Once a single standard of cost determination is published, it will become, we predict, an "infallible yardstick" for contract administrators and auditors. Its specifications of cost allowability will be substituted for that "sound judgment" which this policy invokes, and the distinction between "cost-type" and "fixed-price" contracts will—in large measure—have been obliterated.

As we have already observed, we are greatly concerned over the apparent intention to apply the dead hand of cost reimbursement to fixed-price contracts, including presumably negotiated purchases of

standard commercial items of equipment, prices of which are established competitively in the market place. This is particularly true of capital goods and allied equipment with which the Machinery and Allied Products Institute is so familiar.

The exercise of sound judgment.—The proposed regulations declare that, in price or termination negotiations, "the finally agreed price or settlement represents something more than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process."

This perfectly proper statement seems, unfortunately, to be in the nature of an afterthought since the proposed regulation has theretofore prescribed the use of cost principles "as a basis for the development and submission of cost data and price analyses, etc."

The inference is clear that contractors should omit from cost or price analyses those items of expense which proposed cost principles hold to be unallowable as contract costs or, if so submitted, that they will be disregarded by contracting officers in negotiating a price or a termination settlement. As a practical matter we feel that publication of a comprehensive set of cost principles for general application "wherever cost is a factor" will lead to major emphasis upon cost regardless of the facts of the individual case and that the result almost inevitably will be formula pricing. This means, in most cases, a complete stultification of the "exercise of sound judgment" and an increase in ultimate costs to everyone concerned—and especially the government.

Increasing demands for cost analyses.—We are absolutely convinced upon the basis of reports from numerous capital goods manufacturers engaged in government contract or subcontract work that publication of the comprehensive set of cost principles now proposed would result in a proliferation of requests—or demands—for cost analyses as a preliminary to price negotiations. Such demands will become routine.

Quite aside from the question of propriety of requesting information which by its very nature is a business secret in commercial relationships—and this bears with special force on smaller companies, which are characteristic of the capital goods industries—the multiplication of requests for cost analysis which we foresee raises, in our judgment, at least two very serious problems. The first is both an ethical and a practical question. We refer to the situation where the government serves as transmission agent for confidential

cost information between individual companies who regularly transact commercial business. The inevitable dislocation of normal commercial relationships is compounded in such cases (some of which have been called to our attention) where the recipient of this information is a commercial competitor of the company originally preparing the cost analysis.

Second, cost is piled on cost. The company must prepare the analysis, the contract administrator must evaluate it, and—probably—an auditor will insist upon examining the underlying books and records. Does this tend to produce the goods required at "the lowest ultimate cost to the government?" We doubt it.

Responsibility of the contracting officer.—The increasing demand for cost analyses and increasing reliance upon a published list of allowable and unallowable costs can only result in a very substantial increase in contract audits. Experience would suggest that once detailed definitions of cost are established as a guide, they become in practice an inflexible standard, the auditor becomes the enforcement agent, and, as we have said on other occasions, procurement presently becomes the servant of audit.

The contracting officer is fully empowered to negotiate as the sole agent of the government. Nevertheless—and regardless of his abilities—an agent faced with layer upon layer of higher authority and with the possibility of audit after audit of his conduct is almost literally forced to rely upon the cozy certainty of a fixed standard. Across-the-board application of cost principles will largely destroy his choice of contract selection with the result that the bulk of government procurement sinks to the dead level of cost reimbursement—and the ultimate cost to the government is increased.

In sum, we believe that adoption of this comprehensive set of cost principles will certainly not result in the lowest ultimate cost to the government, that its publication will lessen substantially the exercise of sound judgment by contracting officers in procurement negotiations, and that—unwisely and improperly—it would make cost, and not price, the primary factor for consideration.

Application of Cost Principles to Different Types of Contracts

Thus far we have dealt with the proposed cost principles as they might apply to all types of procurement agreements without attempting to distinguish between differing types of government contracts and the possible effects, as we see them, of an across-the-board application of such cost principles. Not only do we have strong reserva-

tions about any use of the present proposal but we have even stronger reservations concerning the application of any set of cost principles of this type to firm, fixed-price agreements. Let us now consider the application of proposed cost principles to different types of procurement agreements.

Cost-reimbursement contracts.—The reimbursement of costs is a contractual matter under cost-reimbursement type contracts and we recognize, of course, that such agreements must include a clause providing specifically for reimbursement and including or incorporating by reference some standard such as the present Part 2, Section XV, of ASPR, to which both parties may refer as a statement of contractual rights in this area. This is not to say that we endorse Part 2, Section XV, of ASPR in its present form insofar as it denies reimbursement for a variety of legitimate costs of doing business. However, so long as the application of these cost principles has been limited to cost-reimbursement type contracts the contractor has retained the right to choose one of several risk-type contracts where applicable, with the expectation of making a fair and reasonable profit if his price is competitive and he performs efficiently and satisfactorily.

Indeterminate price contracts.—Intermediate between the cost-type contract and a firm, fixed-price contract are certain combinations of the two known variously as redeterminable fixed-price contracts, incentive-type contracts, etc. Without commenting on their numerous defects their virtue has been that they permit fixing of a final price on the basis of experience under the contract where costs of production are relatively uncertain at the time of entering into the agreement.

Insofar as determination of a final price under such contract depends upon an analysis of costs in contract performance, they are like cost-reimbursement contracts; insofar as they shift risk to the contractor and offer him the incentive of greater profit in recognition of superior performance and efficiency, they partake of the character of fixed-price contracts. It is in this very area that Congress has specifically recommended application of cost principles, and the proposal now before us would, as we read the document, effectively convert such agreements into purely cost-type contracts. This, in our judgment, is not the objective of Congress.

It seems to us that a number of distinct disadvantages—over and above the natural shortcomings of cost-type contracts to which we have already referred—may be expected to result from the application of a single set of cost principles to indeterminate price

contracts in the twilight zone between pure-cost type and firm, fixed-price contracts. The cost reduction incentive of greater profit based on superior performance will have been largely dissipated. The allowance or disallowance by rote of individual contract costs will replace the exercise of sound judgment in price negotiation and, at one stroke, the effect of such Armed Services Board of Contract Appeals' decisions as *Swartzbaugh, Wichita Engineering, Gar Wood* and others will have been nullified. In short, the benefit, to government and industry alike, of redeterminable, fixed-price and incentive-type contracts will have been largely destroyed.

The rationale of the Swartzbaugh case is worth recalling in the present circumstances. As contrasted to cost-reimbursement type contracts, this case holds that price revisions under a fixed-price contract with a redetermination clause depend upon negotiation and compromise rather than a strict cost analysis formula. Swartzbaugh specifically holds that the now-existing statement of cost principles is not controlling in price revisions under a fixed-price contract. The beneficial effects of this landmark decision will, in our opinion, almost certainly be overturned if the current proposal is adopted.

Firm, fixed-price contracts.—We oppose completely the extension of cost principles in any form to firm, fixed-price contracts. One may infer from Paragraph 3-803 of ASPR that the firm, fixed-price contract is the preferred type of procurement agreement. With this we agree completely. If the further statement, appearing in Paragraph 3-807 of ASPR, that "government procurement is primarily concerned with the reasonableness of a negotiated price and only secondarily with the eventual cost and profit" is to be taken at its face value, we can see no reason for the application of an inflexible set of cost principles to firm, fixed-price contracts.

Where competition is lacking or where experience in procurement of the item in question is absent, a preliminary cost analysis may be necessary for protection of the government's interest. To admit this, however, is not to admit that standards used for the determination of cost allowability under cost-type contracts should serve as the basis for evaluation of such preliminary analyses. The ultimate question in such negotiations—as ASPR itself recognizes—is a reasonable price, and the combination of price elements by which the contractor arrives at that figure is a matter of judgment.

AN APPROACH TO CONTRACT COST PRINCIPLES

We have attempted thus far in this statement to restrict our observations to questions of broad policy and to general effects—as

we see them—of the adoption of a comprehensive set of cost principles. One thing more remains to be done before we undertake a detailed review of the draft proposal forwarded to us by your letter of October 14.

We think it not too late to call attention once again to the inconsistency between the title and the form and content of this proposal. In ordinary understanding the word "principle" is defined as "a fundamental truth; a primary or basic law, doctrine, or the like." While it is true that contract cost principles now found in ASPR and the draft here proposed for wider application contain a general statement of principles consistent with this definition, the fact remains that both contain an extended list of specific items of cost held by the regulations in question to be allowable or unallowable.

We think, moreover, no one familiar with the facts would argue seriously that the specific has not taken precedence over the general in practice with the result that "cost principles" have become little more than a precatory recital, and the really effective portion of these regulations is the simple catalog of allowable or unallowable costs. We have no reason to believe that a repetition of the regulations in substantially the same form—and in fact with a very considerable extension of the listing of specific costs—will have any other results in practical contract administration.

If it were possible to limit a statement of cost principles to *principles* and nothing more, certain of the reservations heretofore voiced in this statement would disappear. With that in mind we should like to reiterate our prior suggestions with reference to the form and nature of an appropriate set of cost principles. These observations first appeared in our letter of September 13, 1956, to Mr. Robert C. Lanphier, Jr., and intervening experience convinces us that—if The Pentagon continues to regard adoption of a broadly applicable comprehensive set of cost principles as desirable—they would provide a basis for a brief and workable set of cost principles.

Proposed principles.—As a minimum, any comprehensive set of cost principles should take into account the following:

1. A statement of comprehensive cost principles should rest upon a concept of reasonableness and allocability, rather than allowability or unallowability.
2. Comprehensive cost principles should recognize that "generally accepted accounting procedures" include a variety of acceptable methods of expense allocation.
3. Assuming a system of accounts which adheres to "generally accepted accounting procedures," a comprehensive set of

cost principles should emphasize the consistency of its application by an individual contractor.

4. The express reimbursability and nonreimbursability of individual items of cost should be omitted completely from a comprehensive set of cost principles. If protection of the government's interest requires such precise definition of cost items, they should be covered by separate ASPR contract clauses for use in appropriate contracts.
5. Comprehensive cost principles as such should never be incorporated into a defense contract by reference but should serve rather as a guide to assure equity as between the government and the contractor in infinitely varying contract situations.
6. A comprehensive set of cost principles should recognize all legitimate costs of doing business.
7. Any revised set of contract cost principles should give full recognition to doctrines propounded in the decisions of the Armed Services Board of Contract Appeals. That is to say, the spirit of such cases as the Swartzbaugh case and the Wichita Engineering case should be preserved.

SPECIFIC RECOMMENDATIONS

We have approached your invitation to comment on the proposed comprehensive set of cost principles on three levels: a review of broad policy, a discussion of cost principles as distinguished from a mere listing of allowable or unallowable costs, and a paragraph-by-paragraph review of the draft regulation.

In order to be fully responsive to your letter of October 14 we have set out below comments on the introductory passages of the draft proposal as well as on many of the specific items of cost dealt with. We should like to make it clear, however, that our detailed review of the proposal is in no way to be construed as approval of an across-the-board application of contract cost principles and many of the suggestions appearing below serve to extend and support observations of a more general character heretofore made in this statement.

We turn now to the specific proposal itself and we are confronted immediately with many of the same ground rules to which we have so consistently objected in the past.

The King Canute Complex

There is, for example, a curious attitude on the part of government procurement officials that might be called "the King Canute

Complex." Canute the Great is said to have rebuked the flattery of his courtiers by demonstrating that he—powerful as he was—could not stay the advancing tides. Similarly, we submit, The Pentagon cannot through administrative fiat abolish a cost of doing business by declaring that for contract reimbursement purposes such a cost does not exist.

Apparently, certain elementary truths require restatement. Ours is a profit economy. Business enterprises prosper, grow, pay taxes, and continue able to manufacture materiel of war only if their operations are profitable. To achieve a profit the business first must realize enough from the sale of its products or services to pay all its costs of doing business. To the extent that it fails to recover all its legitimate costs incurred in performing work for a single customer it is subsidizing that customer.

This is precisely what has gone on for years under cost-reimbursement type contracts. Advertising expenses, selling costs, charitable contributions, research and development expenditures and a long list of other expenses, as to each of which we shall have more to say later, are disallowed and, of course, absorbed or passed on to other customers. It is not sound economics and it is not sound public policy in the government interest.

Applicability of Proposed Cost Principles

By now it must be clear that we do not favor an across-the-board application of cost principles to all types of defense contracts and subcontracts. In brief summation, we repeat that differing types of contracts require differing approaches in price calculation and cost determination. The proposal for a single set of cost principles carries with it an illusion of logic and symmetry—but if all contracts are to be handled by the same mechanical rules, why have different types of contracts?

We recommend, therefore, that advertised and firm, fixed-price contracts and subcontracts be specifically excepted from coverage.

We recommend further that contract administrators be directed by appropriate language in the subject regulation to apply its provisions to redeterminable and incentive type, fixed-price contracts in the spirit engendered by Part 8, Section III, of ASPR, "Price Negotiation Policies and Techniques," and that they be admonished that use of cost principles is a last and not a first resort in price negotiations.

We recommend finally that the status of subcontracts under these regulations be spelled out more clearly.

Use of cost principles in retrospective pricing and settlements.—We note that language of the proposed cost principles makes the treatment of cost a *major* factor in arriving at a final price or settlement in negotiating firm prices under indeterminate price contracts or final settlements on termination for the convenience of the government. It seems to us that this emphasis upon cost is inconsistent with the theory of negotiating a fixed price and with the spirit of established Department of Defense price negotiation policies enunciated in Part 8, Section III, of ASPR. Cost is but one of several factors for consideration in the negotiation of fixed prices and by no means a major one in every case. We urge that this emphasis upon cost in such negotiations be removed by appropriate amendment of Subparagraph 15-101(b).

Basic considerations in application of the proposed cost principles.—In examining the "Definition of Reasonableness" appearing in the proposed regulations, one is struck immediately by the inconsistency between the apparent intention that the government shall bear its fair share of the contractor's cost of doing business and its subsequent denial of item after item under "Selected Costs." In addition to this general observation, we have a number of specific recommendations to advance.

A cost is said to be reasonable if in its nature or amount "it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business." As now stated this sentence fails to recognize that the contractor often is required by the government to perform a contract in a way that no ordinarily prudent person would perform it in the conduct of commercial business. For obvious reasons speed may be given precedence over economy. To protect the contractor who finds himself in this position, we urge that the last part of the first sentence in Subparagraph 15-201.3 be changed to read substantially as follows: ". . . a prudent person in the conduct of competitive business or in performing a contract as required by the government." As a corollary to this suggestion we recommend that Subparagraph 15-201.3(i) be revised in part to read ". . . for the conduct of the contractor's business *and/or* performance of the contract."

By the same token, we assume that the full amount of expenses incurred by reason of government direction is considered to be reasonable for purposes of reimbursement. If our assumption is incorrect, we urge that appropriate language make this clear.

Under "Definition of Allocability," 15-201.4, we recommend that the word "or" be inserted between Subparagraphs (i) and (ii).

Direct costs.—The language of this Paragraph, 15-202, as well as that proposed under the succeeding Paragraph, 15-203, appears to ignore and, perhaps, deny contractors' use of costing systems based on standard costs and variances. We recommend that a paragraph specifically authorizing this type of cost accounting be added.

It is noted that the proposed definition of direct costs is to be applied to all significant items of cost regardless of the established accounting practices of the contractor unless it can be demonstrated that application of the contractor's current practice achieves substantially the same results. We suggest that the emphasis in this paragraph be placed on acceptance of the results of the contractor's established accounting system subject only to such limitations as may be required by the test of reasonableness and by special circumstances.

We believe that the basic definition of direct costs should be amended by insertion of the following language at the end of the first sentence: "or group of cost objectives when such costs can reasonably be allocated on a direct basis."

Indirect costs.—A careful reading of Subparagraph 15-202(b) can readily lead to the inference that—in order to accommodate its provisions—changes in generally accepted accounting principles and practices will be required. We suggest that the language employed seeks to achieve too great a degree of precision with the result that it approaches inflexibility. We think the rigidity of this approach might be appropriately modified by interjection of language somewhat on this order: "accumulations of cost, cost groupings and distribution of indirect costs shall be acceptable if the results are reasonable and in line with generally accepted accounting principles and practices."

We suggest that the third sentence of Subparagraph 15-203(c) be amended to read "the base should be selected so as to permit allocation of the groupings in accordance with the relative benefits received or other equitable relationship (see ASPR 15-201.4)."

One further comment is in order on the proposed draft's treatment of indirect costs. Subparagraph 15-203(e) implies that the base period for allocation of indirect costs will, or should be, a year when contract performance extends over a year—or the production period, if less than a year. We should point out that overhead costs are incurred at the same time labor is expended. In our view, if a contractor's cost system distributes overhead on a monthly basis,

the government should accept this method and not require allocations on a yearly basis. Material and labor costs fluctuate depending on when they are used, and so does overhead. We recommend that this subparagraph be amended to authorize acceptance of monthly overhead fluctuations in the absence of evidence that the contractor has employed an inequitable means to assess excessive costs against government contracts.

Selected Costs

Consistent with our prior observations, we do not favor inclusion of a list of "selected costs" which are held to be reimbursable or nonreimbursable. At most, nonallocable costs only should be considered where costs are a factor in the determination of prices in fixed-price negotiations. However, since the draft of comprehensive cost principles includes a formidable list of specific costs, and in order to be fully responsive to your request of October 14, we have included specific comments and recommendations on most of the costs included. Those comments appear below.

Advertising costs.—As in past versions of this proposal, advertising expenses, with the minor exceptions of help-wanted ads and institutional advertising in trade and technical journals, are declared to be unallowable. Presumably, the government's consistent refusal to allow all but minor advertising expenses is grounded upon the theory that advertising expenditures are unnecessary in order to obtain government business, or as a matter of general policy it is inappropriate for the government to recognize these costs. Acceptance of either of these propositions represents, in our view, a very short-sighted view of the matter.

Tangible as well as intangible benefits accruing to the government can readily be demonstrated as a result of a firm's ordinary advertising expenditures. To begin with, it is well accepted as a legitimate and reasonable cost of doing business, and its disallowance under a set of principles adhering to a general test of reasonableness is palpably absurd. Increased business of the advertiser which enlarges the scale and the volume of his operations and thus reduces his costs of production is a direct benefit to the government.

Advertising which informs the public on matters of general interest or stimulates interest in the pursuit of careers in science and engineering, or contributes to the improvement of employee relations, constitutes another example of such activity which directly or indirectly is beneficial to the government. We note from Subpara-

graph 15-204(kk) that "selling costs are allowable to the extent that they are reasonable and are allocable to government business," provided the extent of allowability of such costs is agreed to contractually in advance (15-204.1(b)). At the very least, general product advertising should be allowable on the same terms as selling expenses to the extent properly allocable to government business.

Bad debts.—Bad debts under the terms of the proposed regulations are made unallowable without qualification. It is true, of course, that the government pays its bills, but subcontractors and suppliers may very well incur bad debts in connection with government contracts. Since the government normally has title to protect its interest in the end product, the supplier may be prohibited even from recovering its apparatus or materials. Thus we urge that reimbursability of bad debts should be concerned with proper allocation rather than with allowability.

Civil defense costs.—The wording of this subparagraph would seem to represent a clear encroachment upon the prerogatives of management. It does not seem to us that the contractor's judgment of necessary civil defense measures should be questioned, if such costs meet the general test of reasonableness in the circumstances. We recommend, therefore, that the words "to suggestions or requirements of civil defense authorities" be deleted from the second sentence of Subparagraph (i).

As for the disallowance of all contributions to local civil defense funds and projects, we disagree most strongly but we shall reserve our comments on this matter until we take up the broader question of contributions and donations generally.

Compensation for personal services.—In general, compensation for personal services is made allowable to the extent that the total compensation of individual employees is reasonable for the services rendered. As now written, the proposed regulations amount to a determination in advance and with no factual situation in mind that certain payments are unreasonable. We are inclined to think that the determination itself is unreasonable.

For example, profit-sharing plans "of the immediate distribution type" are flatly disallowed by the terms of the proposed regulation. This can result in absurd inequalities. For example, suppose Company "A" pays its president a straight salary of $28,000 with no bonus, etc. Company "B" pays its president a salary of $20,000 and under an additional incentive-compensation plan "of the immediate distribution type" he realizes an additional $8,000 if a certain level of company profits is attained. Is it reasonable to

allow the $28,000 figure in the first case and restrict allowance to $20,000 in the second?

We are aware of the problems confronting the writers of regulations in this area and we appreciate the desire of the military services to prevent abuses. We believe, however, that the general test of reasonableness of total remuneration is as applicable to this type of cost as to any other. Profit-sharing plans generally are established to encourage employees to aid in cost control with a view to an increase in profits. Obviously, government contracts held by the employer share in the benefits of the over-all cost savings accomplished by employees participating in this type of plan.

We urge that, at the very least, the flat disallowance of this type of compensation be reconsidered and that it be made allowable, subject to the general test of reasonableness, and that consideration be given to such factors as the purposes of the plan, its acceptability to the Internal Revenue Service as a source of tax deduction, comparison of the employee's total compensation with employees of other companies similarly situated, etc.

Subparagraph (d)(5) makes the cost of options to employees to purchase stock of the contractor or an affiliate completely unallowable. There is, of course, the question as to whether or not any costs are incurred as a result of a stock-option plan except for direct cost of the plan's administration. Again we suggest that the cost of stock options—now a well-recognized and generally accepted method of individual compensation—be made allowable as one portion of the over-all compensation paid to the employee subject, of course, to the overriding test of reasonableness.

Finally, we note that auditors are directed particularly to scrutinize payments in closely-held businesses which may represent distributions of profit. This we take to be the apparent intent of the caveat appearing in Subparagraph (f)(b), but item (iv) thereof could be construed to permit attack on compensation payments even where arms-length dealing between employer and employee is clearly evident.

Contributions and donations.—In all candor, we see no basis whatever for the disallowance of reasonable contributions and donations to charity and education. Business and industry have assumed a major share of the responsibility for the support of eleemosynary institutions, such contributions having long been considered a normal cost of doing business and—if the principal test of allowability or unallowability is benefit to the government—it seems to us such expenses must qualify for cost reimbursement.

Obviously, the government benefits directly to the extent that industry's contribution to charity and education reduces the drain on the public treasury. Indirectly, but nonetheless powerfully, important ends of national policy are served by industry's substantial and long-continued contributions to education at all levels. At a time when government itself seeks to improve the standard, and increase the rate, of education of scientists and engineers, to disallow voluntary contributions toward that end would seem to indicate that one branch of government is unwilling to support policies espoused by another.[1]

As for contributions to local charities and welfare programs, individual corporations have long recognized their responsibilities as citizens of their communities and have given generously to such programs. Moreover, state, federal and local governments encourage such contributions as a matter of public policy. Subject to a percentage limitation—pegged at such a figure as to make the effect of such contributions on pricing virtually insignificant—federal revenue laws recognize the propriety and desirability of such contributions.

We strongly recommend, therefore, that properly allocable portions of contributions and donations be made allowable items of expense under the proposed cost principles, subject always, of course, to the general test of reasonableness applying to the reimbursement of any cost.

Overtime, extra-pay shift and multi-shift premiums.—Restrictions on the use of overtime pay are cast in such language as to throw the burden of proof of necessity on the contractor and to require—in the absence of a specific contract agreement—advance approval of the contracting officer. This we submit is a wholly impracticable requirement. A certain amount of emergency overtime is frequently necessary and the propriety of ordering overtime work should, in our opinion, be left to the judgment of the contractor subject to the test of reasonableness.

We think it unfortunate that overtime work has become synonymous with waste, excessive cost, etc.; it is, in fact, frequently cheaper to employ overtime than to hire extra employees. The provisions of the proposed regulation, in their present form, discourage economies of this type.

Our comment in this regard may well be conditioned by the fact that the great bulk of capital goods and allied equipment manu-

[1] See attached "Statement of Principles on Education and Utilization of Technical Manpower" adopted by the Board of Trustees of the Council for Technological Advancement, MAPI's affiliate organization, October, 1957.

facturers are principally engaged in commercial production and their products when sold to the government are frequently indistinguishable from those manufactured for sale in normal commercial channels. In view of this, we suggest that consideration be given to an amendment of this provision so as to require advance approval of the contracting officer for the use of overtime only in those plants the output of which is solely devoted to government contracts.

Plant reconversion costs.—Where the conversion of an industrial plant to war production makes the cost of reconversion to civilian production abnormal, we believe the government should consider reimbursing excess costs involved in the reconversion process. To do otherwise would seem to us to impose a distinct penalty upon the contractor for placing his facilities at the service of the government.

We recommend, therefore, that the allowability of plant reconversion costs be made a matter of negotiation and contractual agreement.

Recruiting costs.—Obviously, no two businesses are identical in their policies, including recruitment policy. Accordingly, we recommend that the last sentence of this proposed paragraph be changed to read ". . . offered to prospective employees which are in accordance with the established policies of a contractor and allowable if they withstand the test of reasonableness."

Rental costs.—We urge the deletion of Subparagraph (3) appearing in this section of the draft regulation. We think it unnecessary in the light of the test of reasonableness laid down by Subparagraph (1). Taken together, the effect of Subparagraphs (1) and (3) as now written is to penalize companies which have sale or lease-back arrangements in contrast to companies holding conventional leases. We think it would be rare indeed to find a conventional lease where the rental cost was equivalent to normal costs such as depreciation, taxes, insurance and maintenance expenses attributable to the facilities leased. We believe that the general test of reasonableness appearing in Subparagraph (1) is adequate, and we repeat our suggestion that Subparagraph (3) be deleted from the regulation.

Research and development costs.—We are pleased to note that the Department of Defense has given favorable consideration to certain of industry's previous comments on this aspect of cost principles by removing the requirement that contractors must disclose the purpose and results of independent general and related research as a condition of cost allowability. We have further suggestions to make along this line. We recommend that the last sentence of Subparagraph (2) be amended by addition of the following: ". . . but

this does not mean that it is unreasonable to increase the scope of past programs." This addition, in our opinion, would eliminate any possibility of restricting industry's effort in the field of research and development to the scope of past programs.

We suggest further that the last line of Subparagraph (3), the import of which is that general research and development expenses are not allocable to research and development costs, be deleted. In our judgment, as much benefit accrues to a research and development contract as accrues to a production contract—to which R and D expenses are properly allocable—and we feel that no distinction should be made as to the allowability of costs.

We recommend that Subparagraph (4) be deleted. Research and development costs are expenses generally recoverable through general and administrative rates and should not absorb G and A expense themselves.

We suggest also that Subparagraph (5) be amended by striking the words "are unallowable" and substituting therefor ". . . shall not be allocated to the contract unless allowable for pre-contract costs."

Selling costs.—This item of cost has been a highly controversial point over the long period during which your office has attempted the revision of Part 2, Section XV, of ASPR. The reasonableness of such expenses and their allocability to government contracts appears to be the theme of the current language—which we concede is an improvement over prior drafts—but allowability of selling expenses remains tied to the test of direct benefit to the government arising from such activities as technical consulting, demonstration and other services which are for such purposes as application or adaptation of the contractor's products to government use.

As in the case of advertising, such expenses are costs of doing business and are directly related to the continuing growth and vigor of the business enterprise, and as such contribute materially to the whole of the company's productive capacity. We think the flat disallowance of properly allocable portions of selling expense should be relaxed and particularly with reference to the production and sale of standard commercial products to the government. We think this end may be accomplished by deleting all of the remainder of this paragraph following the statement, ". . . to the extent they are reasonable and are allocable to government business."

Severance pay.—We note that the government recognizes its obligation to participate to the extent of its fair share in any specific payment of abnormal or mass severance pay. We assume this to

include a share in increased contributions to state unemployment funds when such increased contributions result from mass layoffs by reason of contract terminations. If this is not intended, this paragraph should be appropriately amended to take this kind of unusual expense into account.

Training and educational costs.—It seems to us a strain upon the test of reasonableness to allow—as the language of this section does —the costs of tuition, fees, etc., in connection with full-time scientific and engineering education at the post-graduate level and, at the same time, to deny payment of subsistence, salary, etc., to the student embarked upon such a course of study. If the promotion of scientific and engineering education is now an end of national policy, why should cost principles be written in this particular so as to frustrate the achievement of that end? It seems to us that training and educational costs—at least in the fields of science and engineering—should be fully reimbursable so long as they meet the test of reasonableness set up in ASPR 15-201.

We have already voiced our views on the disallowance of contributions and donations generally. We must concede that the disallowance of grants to educational or training institutions is consistent with the general disallowance but we are constrained to reassert our complete inability to understand this position, particularly in view of the imperative requirement for improvement in the standards of scientific and engineering education.

Quite aside from the impact on public policy, insofar as it encourages training of scientists and engineers, training and educational costs are actual costs and, as in the case of other items mentioned herein, the government should bear its fair share of such expense.

Transportation costs.—We suggest that all that portion of this paragraph following the sentence "these costs are allowable" be deleted. This recommendation is based upon the premise that management must retain its discretion to cost either directly or indirectly for both incoming and outgoing transportation.

Conclusion

This concludes our observations and suggestions on the proposed comprehensive set of contract cost principles. We should like again to express our appreciation for this opportunity of commenting on such an important change in basic procurement regulations—indeed,

as we have pointed out, in basic procurement policy. If we can be of any further assistance, or if you should desire to discuss these matters directly with representatives of the Institute, please do not hesitate to call upon us.

Respectfully,

CHARLES W. STEWART
President

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 Eighteenth Street, N. W. Washington 6, D. C.

December 16, 1957

Dear Mr. McGuire:

I should like to add this personal note to the enclosed formal response of the Machinery and Allied Products Institute to your request of October 14 for comments on the proposed comprehensive set of contract cost principles.

We are especially pleased that you are taking a personal interest in this project, and we hope that your schedule will permit you to follow closely all of the steps which may be involved in further consideration of the fundamental policy questions as well as detailed procedural matters at issue. May we express our hope also that Secretary of Defense Neil H. McElroy will join you in giving this project the highest level policy consideration.

It is difficult in dealing with such a complex and extremely important subject to have a written commentary reflect the full extent of our concern with respect to the comprehensive set of cost principles submitted to industry for comment. It would be appreciated, therefore, if at some time you could visit informally with Charles Derr, MAPI Secretary, who spearheads our work in this field, and with me so that we might exchange ideas on the subject.

Respectfully,
CHARLES W. STEWART
President

Mr. Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
Department of Defense
Washington 25, D. C.

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 Eighteenth Street, N. W. Washington 6, D. C.

December 17, 1957

Honorable Lyndon B. Johnson, USS
Chairman
Preparedness Investigating Subcommittee
Committee on Armed Services
U. S. Senate
Washington 25, D. C.

My dear Senator Johnson:

We have followed with great interest the inquiry conducted by the Preparedness Investigating Subcommittee into the status of the American defense position. My personal interest has been heightened by the opportunity of reading the full transcript of the first series of public hearings, and I have carefully followed the record of the more recent hearings through press dispatches.

It appears that your Subcommittee is attempting to determine in broadest outline our nation's relative position of preparednes vis-a-vis its potential enemies and to recommend such measures as may be necessary to secure our national defense. It is clear that your investigation has gone beyond the general scope of this vast problem and has inquired into certain of its constituent parts.

Two special problems developed to some extent by certain witnesses—as, for example, Dr. J. Sterling Livingston—and by your distinguished Counsel engage our particular interest. We refer, first of all, to the policies and methods of defense procurement.

I have no doubt the Subcommittee will agree that even the highest caliber of decision-making and research in the military field can be made wholly effective only if the most efficient, streamlined and economical procurement policies and procedures are employed. By its very nature the process of defense procurement is mundane and undramatic and for that reason we feel that it may not receive the full attention it deserves.

By way of example, may we refer the Subcommittee to a basic change in procurement policy and practice recently proposed by

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Senator Johnson has acknowledged this letter indicating that the Preparedness Subcommittee staff has been directed to consider this material in connection with the over-all investigation.

the Department of Defense. Procurement officials are now considering the application to all forms of defense contracts and subcontracts of a set of contract cost principles heretofore used solely in connection with the determination of expense allowability under cost-reimbursement type contracts. The implications of this proposal go beyond mere technical accounting questions. Its adoption would represent, in our opinion, a fundamental change in procurement policy and method and thus would directly and substantially affect the course of the whole national effort to which your inquiry is addressed.

We have no wish to argue the merits of the case in this letter. We do believe, however, that you and your associates on the Subcommittee will be interested in the very serious implications of this recent proposal by the Department of Defense, the importance of which is emphasized in the enclosed copy of our pertinent statement just filed with procurement officials.

The second of the questions considered in hearings before your Subcommittee—and to which we have given special attention in recent months—is that of the education and utilization of scientific and engineering manpower. The importance which the Machinery Institute and its affiliate, the Council for Technological Advancement, attach to this question is expressed fully in the enclosed Statement of Principles published by CTA in October. We believe that your Subcommittee has performed a tremendous public service in this area, among others, in stressing the need for immediate action in the improvement of scientific education, particularly at the local levels and in the primary and secondary curricula.

As our enclosed comment to the Department of Defense reveals, there is a direct connection between the two problems. That comment identifies an almost absurd inconsistency between established national policy which encourages prompt and drastic improvement in scientific education and The Pentagon's refusal to recognize as an ordinary cost of doing business contributions and donations by government contractors to colleges and universities as well as certain normal expenses incident to the advanced education of scientific and engineering personnel on the staff of firms engaged in defense work. These points are discussed in more detail at pages 19 and 22 in the enclosure to this letter.

The correction of problems to which this letter calls attention requires no legislation and none is suggested. The Department of Defense is vested with full authority to deal constructively with

these matters. Because, however, of their probable impact on the national defense effort, we respectfully suggest that they are matters appropriate for further review as a part of your current inquiry.

We have taken the liberty of sending a copy of this communication to Subcommittee Counsel for record purposes.

Respectfully,

CHARLES W. STEWART
President

cc: Mr. Edwin Weisl, Counsel to the Special Subcommittee

MAPI GOVERNMENT CONTRACTS PROGRAM

The government contracts program of the Machinery and Allied Products Institute is divided generally into four broad fields of activity: (1) analytical bulletins, (2) policy statements to government agencies, (3) consideration of specific government contract problems, including negotiation, procedures, regulations, etc., and (4) publication of major research studies in the government contracts field.

Recent examples of the Institute's analytical service in this field are Bulletins 3497, 3487, and 3470. In addition to the statement on contract cost principles appearing herein, the Institute has in recent months advanced a series of policy recommendations to the Department of Defense on certain proposed defense contract clauses and on a proposed change in contract termination regulations. Special research studies in the government contracts field are in process and will be announced shortly.

The work of the Institute in this area has been greatly assisted by the Joint Subcommittee on Government Contracts of the MAPI Accounting Council and the CTA Financial Council, the membership of which is shown on page 29 of this pamphlet.

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of the

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TAB B

INDUSTRY COORDINATION

OF

REVISED PART 2, SECTION XV

The comments of NSIA, MAPI, RETMA, NAM, AMA, C. of C., AIA, American Institute of Accountants, Council of Profit Sharing Industries, and Comptrollers Institute of America resulted in numerous revisions of the draft submitted to them for analysis.

At the outset, certain major issues with industry are historic and have not been resolved in this draft to the complete satisfaction of industry. While these issues have been taken up separately in this report, they are mentioned here because of their importance and long standing differences. They are: (1) 15-203.4 Selling and Distribution Costs, (2) 15-204.2(a) Advertising Costs, (3) 15-204.3(c) Contributions and Donations, (4) 15-204.3(d) Entertainment Costs, (5) 15-204.3(g) Interest and Other Financial Costs, and (6) 15-204.3(h) Losses and Other Contracts.

Industry made the following general observations believed worthy of mentioning. First, they object to the requirement, in many cases, that some costs to be allowable must be upon authorization by special contract provision or by written authorization of the contracting officer, rather than just the approval of the contracting officer.

Second, throughout the proposed draft there is interjected a requirement that the auditor evaluate the equities of the situation, in addition to his usual function of measuring the reasonableness of the amount and the proper allocability of the item. Section XV should be limited to indicate types and amounts of cost which are or are not allowable in cost-type contracts and it should not be made an audit manual for the various services.

The third observation is that detailed implementing instructions of the departments should be prepared prior to the publishing of this section.

The following paragraphs contain what are considered to be major unresolved issues with industry.

15-200 Scope of Part. (Tab A, page 1)

INDUSTRY POSITION

A statement should be included to the effect that Section XV is not applicable to fixed price contracts, including those with price redetermination provisions.

DEFENSE POSITION

The proposal is not acceptable since audit agencies have no alternative at present other than to use Section XV as a guide in auditing these contracts.

15-201.2 Factors Affecting Allowability of Costs. (Tab A, page 1)

INDUSTRY POSITION

Costs should not be measured by the new criterion "(iii) significant deviations from the established practices of the contractor which substantially increase the contract costs."

DEFENSE POSITION

This new criterion is only one of the factors affecting allowability of costs. This does not take anything away from the contractor. If the reason for the deviation is justified, costs may still be allowed.

15-203 Indirect Costs. (Tab A, page 2)

INDUSTRY POSITION

Subparagraph 15-203.1(c) is inconsistent with 15-203.1(b) and permits Government personnel to select the periods which must be used.

DEFENSE POSITION

No inconsistency is apparent between these subparagraphs. One deals with the method of allocation and the other with the base period for allocation.

15-203.4 Selling and Distribution Costs. (Tab A, page 4)

INDUSTRY POSITION

Selling and distribution expenses are generally a cost which should be acceptable as allocable to Government contracts by associating such expenditures with an indirect benefit to Government work. Industry contends that the Government stands to benefit by being able to place orders for standard commercial products or specially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have capacities to produce efficiently and quickly the requirements of the Government that otherwise could not be possible without delays and expenditures. Industry would like the allowable costs more clearly defined. However, it is noted that the American Institute of Accountants says: "This treatment of selling expenses seems entirely satisfactory to me, and is in agreement with good industrial and contract practice."

DEFENSE POSITION

Pure selling expense of the contractor as such is unallowable for the reason that it is not necessary and does not contribute anything to the performance of the contract. Generally, any type of marketing expense in the ordinary sense is not considered to be necessary in contract performance

and is not required in doing business with the Government. However, it is felt that a reasonable demonstration that his technical, consulting and related beneficial services which are for purposes of application and adaptation of the contractors products may justify allocation of Government contracts. Any further liberalization would be unjustified.

15-203.5 General and Administrative Costs. (Tab A, page 4)

INDUSTRY POSITION

It is not necessary to enumerate factors to be considered in determining whether a method of distributing general and administrative expenses will produce equitable results. The inclusion of such a listing will lead only to further confusion and may cause overemphasis on the use of the factors enumerated.

DEFENSE POSITION

It is recognized that this paragraph involves a controversial matter and one which requires the consideration of many different points. However, it is felt that inclusion in this paragraph of several illustrative factors to be given consideration will not only insure that the listed factors are considered but will tend to indicate that there are many facets to the problem.

15-204.2(a) Advertising Costs. (Tab A, page 5)

INDUSTRY POSITION

The present limitations on advertising are too restrictive, and overlook the fact that any advertising is a normal cost of doing business from which the Government has derived benefit and as such should bear a portion of the expenses.

DEFENSE POSITION

Advertising, generally, is not necessary in order for industry to conduct business with the Government. On the other hand, in the modified version, Government recognition has been accorded that portion of industry advertising which encourages dissemination of technical information within industry itself through certain media, the results of which benefit both industry and the Government, and the Government will share in its portion of same. One slight concession made is the deletion in the third line of subparagraph a. (1) after the word "placed" of the phrase, "for the purpose of offering financial support to," and substituting the word "in." The change was made because of the difficulty of determining a contractor's intent and the words were not helpful in determining cost allowances.

15-204.2(k) Maintenance and Repair Costs. (Tab A, page 10)

INDUSTRY POSITION

Industry objects to the restriction in subparagraph (2) of recognizing deferred maintenance expenses only by specific contract provision.

DEFENSE POSITION

The requirement of a specific contract provision for recognition of this expense is necessary in order that the Government may exercise some control over the amount of deferred maintenance expense which may be charged against cost-reimbursement contracts. The contract provision requirement in no way lessens the recognition of this expense. Since such expenses could be substantial and the possibility of a dispute would always be present as to the amount which should be accepted as a contract cost, it seems best that this be covered by a contract provision.

15-204.2(m) Materials Costs (Tab A, page 11)

INDUSTRY POSITION #1

Industry questions the requirement in subparagraph (2) of the Government that cash discount be taken as a credit against the cost of materials, their theory being that cash discount is actually financial income comparable to interest as a financial expense and, since interest is not considered an allowable cost, cash discount credits should be omitted from consideration.

DEFENSE POSITION #1

The subject of cash discount credit is in an area completely separate from that of financial expense or financial income. Classifying cash discount as financial income is fallacious since realized income cannot arise through the operation of buying. Net prices are substantially on a cash basis and therefore represent the most effective costs. It is the net price which a seller expects to receive, and a buyer expects to pay. The cost of materials therefore is represented by the total outlay of cash or its equivalent for the purchase of the materials; if the cash paid out includes a reduction for allowances or credits taken by the contractor, the net amount paid represents the true cost of the material.

INDUSTRY POSITION #2

Write-down of inventory value in subparagraph (5) should be allowed as a contract cost.

DEFENSE POSITION #2

Although this item is not a major objection by industry, the defense position is that there is little, if any, merit to industry's contention in cost-type contracts. Write-down of material costs would, of necessity, have

to apply to material costs unrelated to a Government cost-type contract and, therefore, should be absorbed by the business to which the write-down of value applies.

15-204.2(n) Overtime, Extra-Pay Shift, and Multi-Shift Premiums. (Tab A, page 12)

INDUSTRY POSITION

Industry wants restriction lifted with respect to cost of overtime and shift premium on indirect labor. The suggested change in the draft may remove some of the objection. As to such cost on direct labor industry wants no restriction except as provided by contract terms in accordance with the contractor's practices and procedures, this being a standard operating procedure for most companies and such provision is often made for such procedures in union contracts. This argument does not in any way appear to bind the Government.

DEFENSE POSITION

For the contractor to be required to identify separately shift premium and overtime on his books is a sound practice and one which requires but little or no overhead cost to segregate. This has been traditional with the Government to restrict and control overtime and extra pay shift cost. Not to do so would invite the contractor to work normal hours on commercial work and run up large amounts of extra pay and overtime cost. Extra pay cost and overtime premium on indirect labor is allowable on a pro rata basis to commercial and Government provided it is otherwise reasonable.

15-204.2(o) Patent Costs. (Tab A, page 12)

INDUSTRY POSITION #1

Costs of filing patent applications by a contractor should be allowed even though the Government may not obtain any rights under the patents because, by obtaining a patent, a contractor avoids the necessity of eventually being required to pay a royalty to some other person who may obtain a patent on the same invention.

DEFENSE POSITION #1

This comment was rejected on the basis that the contractor gets title to the patents and the primary benefits therefrom. This would amount to a windfall to the contractor if the Government paid.

INDUSTRY POSITION #2

Add to allowable costs "the defense of patent infringement litigation."

DEFENSE POSITION #2

Under the Act of June 25, 1910, as amended (28 USC 1498), only the Government can be sued for patent infringement on contractor's production for the Government. If a contractor is sued for patent infringement, it must be for its own commercial production. Therefore, there can be no costs to industry for defense of patent infringement litigation, except such as are passed on to industry by the Government through the Patent Indemnity clause. To allow such costs would conflict with the purpose of the Patent Indemnity clause.

15-204.2(r) Professional Service Costs - Legal, Accounting, Engineering, and Other. (Tab A, page 15)

INDUSTRY POSITION

The cost of successful anti-trust suits brought by the Government and the cost of successful prosecution of claims against the Government should be allowable on the premise that these are ordinary, necessary and proper expenses of doing business and therefore should be considered allowable.

DEFENSE POSITION

Costs incurred in these connections, whether the results of the actions are successful or not, are unallowable. Reimbursement of litigation costs where the Government is a party to the suit is obviously untenable. The Government cannot financially support the party with which it is engaged in legal dispute.

15-204.2(t) Rental Costs (Including Sale and Leaseback of Facilities) (Tab A, page 16)

INDUSTRY POSITION

The restriction in subparagraph (3) on amounts of allowable rent for facilities covered by sale and lease-back agreements is not equitable. As long as the rents are reasonable in the light of the type, condition and value of the facilities leased, options available and other provisions of the rental agreement the Government's interests are adequately protected. In addition, the Government would be penalizing companies who have sale and lease-back agreements as contrasted with companies holding conventional leases.

DEFENSE POSITION

Sale and lease-back agreements are primarily entered into to provide additional working capital, without borrowing funds, or issuing additional capital stock. Another reason could be to obtain tax benefits. To accept the risk, financing and profit factors included in the rental of sale and lease-back facilities would be contrary to our position regarding interest as a nonallowable cost. Furthermore, the accelerated amortization usually included in the rental may represent an unreasonable contract cost.

15-204.2(u) Research and Development Costs (Tab A, page 17)

Industry Position

The draft submitted to industry for comment in April of 1955 provided for a partial allowance of general research costs. Industry unanimously argued for total allowance.

Defense Position

The Materiel Secretaries' Council determined that such costs would not be allowable unless specifically provided for in the contract. This action is a reversal of the policy expressed in the draft coordinated with industry.

15-204.2(v) Royalties and Other Costs for Use of Patents (Tab A, page 18)

Industry Position

Industry takes objection to the limitation on the allowability of royalties where royalties paid or payable for the right to use patents necessary for the proper performance of a contract and where the Government does not already have a royalty-free license to use such patents, the royalties are allowable to the extent expressly provided for elsewhere in the contract or otherwise authorized by the Contracting Officer. Industry contends that it should be permitted to manufacture products under license agreements which they would otherwise have to purchase and that payment for same should not be subject to such limitations.

Defense Position

It is the Defense view that the payment of royalties to contractors under the circumstances described should be circumscribed by contract provisions or effected under the Contracting Officer's cognizance. Because fees for use of patents, where the Government does not have a royalty-free license to use same, may often be predicated on the highest rates the market will bear, and since payment limitations are difficult to establish where effective competition does not exist, the Government has established procedures leading to the reduction of royalties where royalty payments in connection with contract performance are deemed excessive. The inclusion of the limitations in the revision permits review of the circumstances surrounding the incurrence of royalty payment costs and assures control by the Contracting Officer. In addition to the cost feature, review by the Government can be effected to assure that the Government does not already have a royalty-free license to use the patent concerned. In summary, Contracting Officers can determine if the royalty costs are bona fide and reasonable.

15-204.2(w) Severance Pay (Tab A, page 18)

Industry Position

The revised provision in subparagraph (2)(ii) relating to contract costing of mass or abnormal severance pay is impractical and would be difficult and cumbersome to apply, and the cost of severance pay, generally, should be handled on a basis conforming with accepted accounting principles and practices and the established policy of a contractor, rather than policy which constitutes an implicit agreement on the contractor's part. Industry also feel that perhaps allowability should be provided for on either an actual or an accrual basis.

Defense Position

The treatment as proposed for mass severance pay is the most practical and realistic approach to a problem which concerns an unpredictable contingency. It is felt that a contingency reserve for mass severance pay is too conjectural to be considered a cost. The Government should not obligate itself for more than its pro rata share of severance wage payments actually made, in accordance with a policy reflecting implicit agreement by a contractor, on the basis of its ratio of participation in the contractor's total business during the period of employment of the individual involved.

15-204.2(y) Taxes (Tab A, page 19)

Industry Position

Industry generally contends that this paragraph should be revised to allow cost of taxes, interest, penalties and expenses of contractor's acts in resisting assessments or attempting to secure refunds, without the imposition of the restrictions presently included in this paragraph as in certain situations contractors cannot possibly or reasonably comply with these requirements.

Defense Position

The restrictions imposed by this paragraph are reasonable in that they merely require the contractor to obtain and follow instructions from the contracting officer in cases where there is a doubt as to the legality or correctness of a tax assessment.

15-204.2(z) Trade, Business, Technical and Professional Activity Costs (Tab A, page 20)

Industry Position

The expenses of holding exhibitions is a required cost of doing business as normal and essential as expenses incident to meetings and conferences, and as such should be allowable. Further, the revision is unduly restrictive in that it relates only to expenses incurred at meetings and

conferences when the primary purpose of the incurrence is the dissemination of technical information or information aimed at the stimulation of production, and does not include expenses of exhibitions incurred for dissemination of information to the trade, the public, prospective employees, etc., about the particular business.

Defense Position

This matter is quite similar to the problem of allowability of advertising. Doing business with the Government does not presume that dissemination of information about the business to the trade or public through exhibitions is necessary. The Government is agreeable, however, to accepting its pro rata share of expenses incurred for the dissemination of technical information or information aimed at stimulation of production through meetings or conferences. The exhibitions referred to by industry are those held for purposes other than these; therefore, the costs thereof are considered unallowable.

15-204.3(c) Contributions and Donations (Tab A, page 21)

Industry Position

The April 1955 draft circulated to industry provided for the allowance of contributions and donations except to religious organizations.

Defense Position

The Materiel Secretaries' Council determined that such costs should be unallowable. Industry has not been advised of this reversal of policy by the DOD.

15-204.3(d) Entertainment Costs (Tab A, page 21)

Industry Position

Industry objects to the words "social activities" as it may create conflict with the provisions of 15-204.2(f) and 15-204.2(z). It further contends that unless there is an overriding public policy to the contrary, entertainment expenses reasonably allocable to Government contracts should be recognized, to the extent that it can be demonstrated that such expenses are ordinary and necessary to the business of a contractor.

Defense Position

There is no conflict with this paragraph and paragraphs 15-204.2(f) and 15-204.2(z). Furthermore, this type of expense is solely for the benefit of the contractor, serves no purpose to Government work and has been traditionally disallowed. The contractor may be placed in a favored class should he be allowed to recoup entertainment expense through Government contracts and is considered to be against public policy.

15-204.3(g) Interest and Other Financial Costs (Tab A, page 22)

Industry Position

Industry contends that interest should be allowable.

Defense Position

Interest has always been considered as unallowable because it represents a distribution of profits to persons who have advanced capital on a loan basis. No new reason is advanced why this position should be changed. In this connection, it should be noted that DOD Directive requires interest to be charged on advance payments.

15-204.3(h) Losses on Other Contracts. (Tab A, page 22)

Industry Position

Industry, in effect, requests that the portion of cost-participation contracts not reimbursed by the Government under that contract be allowed as a cost on other contracts.

Defense Position

This proposal is rejected since a contractor in accepting a cost-participating R&D contract expects that later production contracts will be obtained resulting in profit to compensate for earlier costs of participation.

15-204.3(k) Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets. (Tab A, page 22)

Industry Position

Such profits and losses should be allowable to the extent that they represent adjustments to depreciation on assets acquired for Government business.

Defense Position

This contention is agreed to but it is felt that it would be impractical, if not impossible, to distinguish between that portion of a profit or loss which represents an adjustment of depreciation and that which was caused by fluctuations in the general price level.

15-204.3(l) Reconversion Costs (Tab A, page 22)

Industry Position

Industry comments ran the complete gamut from general agreement with the item as drafted to an extreme statement by Auto Manufacturers Association that "we can see no reason for disallowing any conversion expenses."

Defense Position

It is apparent that industry should seek a birth-to-burial treatment of reconversion expenses; however, the comments furnished no valid reasons for changing the principle. Specific provision in the contract of those reconversion expenses which are allowable appears the best method of assuring fair treatment of the Government's and contractors' interests. All items not specifically provided for in the initial contract or by modification are not allowable.

Comments on Proposed Revision
of
SECTION XV, ARMED SERVICES PROCUREMENT REGULATIONS
"Contract Cost Principles and Standards"

INTRODUCTION

While Parts 1 and 2 of the proposed Section XV contain certain explanatory material, it is believed that some additional remarks concerning the background, philosophy, and characteristics of the statement will be helpful to those asked to appraise and comment thereon prior to adoption.

The three parts attached cover statements of the applicability and purpose, general principles and standards for the determination of costs, and their application in supply and research contracts with commercial organizations. There will be three additional parts covering the application of the principles to facilities contracts, construction contracts, and research and development contracts with educational or other nonprofit institutions. However, these will be relatively brief sections concerned primarily with applications which differ from those stated in Part 3 due to the specialized nature of these types of contracts.

BACKGROUND

The history of cost principles utilized in making cost determinations under defense contracts reveals a continuing search for a uniform, improved, and consistent body of such principles -- satisfactory alike to the Government and the contractor. The World War II period and the years immediately following saw the birth of several sets, each of which was applicable to different departments or different phases of contract administration.

The first of these applicable to World War II contracts was Treasury Decision 5000. Adopted in 1940, this Decision was promulgated for the purpose of recapturing excess profits on certain contracts for vessels and aircraft, but in the absence of a more satisfactory statement of cost principles its use was extended to virtually all cost-type contracts entered into by the War Department (later the Departments of Army and Air Force) until 1949. The Navy Department utilized T.D. 5000 until 1942 when it issued an "Explanation of Principles for Determination of Costs Under Government Contracts" (the so-called "Green Book"). These Principles were employed by the Navy in making cost determinations under cost-type contracts until 1949. Section XV, "Contract Cost Principles," Armed Services Procurement Regulations, was adopted by the Department of Defense in 1949 and is applicable only to cost-type contracts.

Cost principles employed in contract terminations have likewise varied. Certain cost principles applicable in the event of termination were issued under the authority of the Contract Settlement Act of 1944, and these were subsequently continued in use upon the expiration of that Act. These were superseded by the adoption of Section VIII, "Termination of Contracts," ASPR, Part 4 of which contains a statement of principles applicable to the settlement of fixed-price contracts. These principles are also applicable to negotiated settlements under cost-type contracts.

Despite the apparent wealth of cost principles, the situation is still unsatisfactory. There is no set of principles applicable to the negotiation and performance of fixed-price contracts -- only to their termination. Section XV, ASPR, has been used "as a guide only" but even this use goes beyond assurances given Government contractors at its adoption and has been a constant source of conflict between contractors and contracting officers. Sections VIII and XV are not uniform in setting forth which costs are allowable or unallowable, so there exists the anomolous situation of certain costs being unallowable if the contract is completed, but allowable if terminated. Further, a pattern of "implementing" instructions by directive has developed to the extent that the mere volume of rules is forbidding, plus the fact that such directives are inconsistent between departments, and they not infrequently alter, through change or restriction, the policy adopted by the Department of Defense. All of these factors point to the need for and desirability of a single set of cost principles to be applicable uniformly to all types of contracts and all phases of the contracting process.

The process of recovery of excessive profits by renegotiation of contracts provides, by statute, for cost allowances on defense contracts more liberal than provided by Section XV, ASPR. The renegotiation regulations state specifically that the Renegotiation Board will not recognize cost disallowances pursuant to Section XV or other contractual provisions in contravention of the Renegotiation Act.

Moreover, the statement is frequently made in Government that the cost principles under the Internal Revenue Code have no necessary application to defense contract costs, and no attempt need be made to reconcile them. These general inconsistencies between different programs of the Government are undesirable.

The philosophy underlying the various sets of contract cost principles likewise indicated that a change is in order. Treasury Decision 5000 in defining allowable cost states: "The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs ... and (2) the proper portion of any indirect costs ... incident to and necessary for the performance of the contract or subcontract. (Emphasis supplied) The phrase "incident to and necessary for" was

interpreted by Government auditors, including those of the General Accounting Office, in such manner as to preclude reimbursement to the contractor of a share of normal business costs where it could not be demonstrated by the contractor that the incurrence of the cost was quite directly related to the performance of the contract. The "Green Book" referred to above contains the same restrictive language. In consequence numerous indirect costs are disallowed.

Section XV, ASPR, in defining total cost, uses the phrase "... incident to the performance of the contract, ..." in an effort to get away from the restrictive interpretation of T.D. 5000; while Section VIII, ASPR, uses "... reasonably necessary to the performance of the contract." However, the cost principles contained in each of these Sections include a list of unallowable costs which, in many situations, vitiates the advantages gained from the changed language.

PHILOSOPHY

In the drafting of this statement a bold approach was taken. All known significant problems were faced and solutions were proposed on the basis of equity and fairness of result -- both to the Government and contractors. Controversial areas were not purposely avoided, even though there was complete awareness that the proposed solutions would not entirely satisfy everyone. An honest attempt to achieve equity was the guiding principle.

To have avoided these controversial areas would have been the easy course. But following it would have meant continuation of the present situation under which the lack of adequate guides causes prolonged negotiations, questionable costs claimed, and excessive auditing, all of which slow down and make more costly procurement administration. It is hoped that a sincere and above-board discussion of this proposal, by representatives of both Government and industry, will result in a statement which will be understood and accepted by all.

Without general acceptance of a statement of cost principles, business will generally seek to protect itself in submitting contract cost data with utter disregard of the principles and with application of its own cost concepts. This breeds the necessity for excessive contract auditing and cost analysis. Chiseling on the part of the Government begets chiseling on the part of business. In other words, the application of the Golden Rule in this area is desirable.

CHARACTERISTICS

Implementation -- It is not intended that the proposed statement will be implemented by issuance of a large volume of interpretations,

cases, etc. For one reason, as mentioned above, many present day contracting officers are faced with a myriad of procurement instructions, guides, and regulations. Besides being practically an impossible task for the individual contracting officer to thoroughly acquaint himself with all of them, he is inclined to look for a directive which appears to fit most closely the situation involved, to which he will be able to point as justification for his action. This he tends to do rather than using his own best judgment. This lack of willingness of contracting officers to make their own decisions, in turn, calls for more detailed instructions. The situations encountered in the area of determination of allocability of costs are so varied that they defy satisfactory standard instructions.

Thus, Paragraph 15-106 imposes a restriction on the issuance of modifying or expanding instructions or interpretations on a unilateral basis. The demonstrated need for such will be served on a unified basis by the Secretary of Defense.

The principles provide for a wide degree of latitude in application. This will require contracting officers to exercise the highest degree of skill in their work. They must have a complete grasp, not only of the principles and the philosophy behind them, but must also thoroughly understand the conditions surrounding each proposed contract, and each contractor's business. Because of the absence of specific instructions or formulae, there can be no substitute for good judgment on the part of contracting officers. Their objective, as is the objective in all good contracting, should be to have the contract reflect a complete meeting of the minds of the contractor and the contracting officer.

In meeting the objective of providing a reasonably comprehensive and complete basis for reaching a contractual agreement or understanding between the parties on contract costs for pricing purposes, as well as providing restrictive safeguards and a basis for adaption to all conceivable situations, a very difficult problem was faced. Adequate details and explanation are necessary with general guides for application of the principles to the many conditions and circumstances which may be faced.

What the Statement Isn't -- The proposed statement should be read with the clear understanding that it constitutes only one section of the Armed Services Procurement Regulations -- that part confined primarily to establishing cost principles and standards for use where costs are a factor in determining what the Government will pay for contractual supplies or services. It is not intended that it provide all the necessary guidance, regulations, and procedures as to methods of negotiation, pricing, determination of profit margins, choice of the appropriate type of contract, or auditing. There is to be inferred no desire to encourage

the greater us of contract forms other than outright fixed-price contracts, or the greater use of cost data in negotiating prices on outright fixed-price contracts. In fact, the use of other factors, such as effective competition or standards established on the basis of prices of other efficient producers or production in our own plants, are to be preferred in negotiated firm prices. Criteria to serve these purposes are contained in other sections of ASPR. Other related sections are those concerned with taxes, patents, and Government furnished property.

The statement should not be looked upon as something which provides a formula which contracting officers can apply mechanically and have the price, or even an aggregate cost figure, appear automatically as a result. It constitutes a middle-of-the-road approach. It attempts to be sufficiently explicit to provide guidance for negotiators and auditors, but must necessarily be broad enough for application to the extremely varied conditions encountered in the contracting process. These varied conditions arise from wide differences in: the nature of contractors' businesses and organizations; the degree of criticalness of need for items being procured, supply of production facilities, and types of contracts used.

Recognizes Generally Accepted Accounting Principles -- Basically, the statement is founded on generally accepted accounting principles and standards (including cost accounting as well as general financial accounting). However, the reader may be able to cite examples in which departures have been made from this basis. These infrequent departures were dictated, in some instances, by public or business policy, and in others by long-standing precedent. The unallowability of entertainment, purely for entertainment's sake, and restrictions on executive compensation, donations, and advertising are examples of such departures.

Recognizes Normal Business Practice -- A significant characteristic which is apparent throughout the statement is that the principles will not ordinarily alter a contractor's normal business practices. In fact, every effort shall be made to follow his normal accounting practices. Safeguards have been provided, however, against any abuse of this approach, particularly where defense work constitutes the major part of a contractor's efforts, in that reasonableness of costs such as advertising and executive compensation will be judged, where appropriate, on the basis of the contractor's practice prior to the advent of defense business. Likewise, evidence of arm's length bargaining must be present in determining the allocability of such items as executive compensation, bonuses, and property rentals. Unreasonable deviations from good accounting practices are expected to be corrected by all responsible contractors.

Recognizes the Simultaneous and Consistent Determination of Profit Allowances in Price Determination -- The importance of avoiding duplicate allowances in profit margins and costs is stressed, and examples are given in Paragraph 15-207. However, no rigid line is drawn, nor can it be drawn, in the manner in which certain pricing factors shall be allowed in every case as between profits and costs.

Covers Cost Estimating as well as Historical Costs -- Application of the principles to forward pricing of fixed price contracts requires recognition of the special problems of cost estimating. The use of standard cost methods in this respect is endorsed, although it is recognized that cruder methods of estimating must be tolerated. Misuse of historical costs in forward pricing is warned against. An outline of the applicability (or uses) of both cost estimates and standard costs is provided.

Is This a Give-Away? -- Some readers may gain the impression, because the proposed statement allows costs under certain conditions which are excluded by the present Section XV, that the ceiling is off and cost of our procurement will skyrocket. This is not the case however.

First, a substantial portion of procurement in recent years has been under incentive or fixed-price-type contracts containing price redetermination provisions. It can be safely assumed that part of this increase has been due to the fact that the rather restrictive cost provisions of Section XV do not apply to those types of contracts, and in practice more liberal cost principles have been applied in pricing such contracts. In addition to obtaining reimbursement for some of these costs otherwise unallowable by this means, cost to the Government is often increased because the percentage of profit is usually unjustifiably higher on fixed-price contracts containing retroactive price-redetermination clauses than on cost-type contracts. Thus the advent and intelligent application of the guides provided in the proposed statement for appropriate use in fixed-price contracts may even decrease the cost of procurement by the Government.

Second, one of the most significant concepts of the proposed statement, designed to result in a fair and reasonable allocation of costs, is that of "direct costing." A clear statement of this long-utilized but rarely stated principle is one of the features of the proposed cost principles. If generally accepted cost accounting practices could be said to have but one underlying principle, that principle would be direct costing. As stated in paragraph 15-211 "Every major item of cost (actual or estimated) should be identified with the unit being costed, whether it be the product, a job order, or a contract, when such items of cost do not, in fact, have substantially proportionate applicability to all classes of work."

The military departments have long recognized this principle in procurement regulations and audit instructions. Section XV, ASPR, (as now published) distinguishes between direct and indirect costs in accordance with the conventions of generally accepted cost accounting practices but also recognizes that "there are numerous items of cost which are generally classified as indirect costs but which may, in particular cases, properly be chargeable directly to the contract, where the contractor demonstrates that such costs are specifically related to the contract." (Paragraph 15-202.3) It is obvious that all costs incurred are direct costs in relation to the entire business, and that indirect costs arise only because of the compartmentizing of business activities by function, location, operation, contract, etc. The greater the compartmentization, the greater the number and amount of indirect costs; fewer compartments result in fewer indirect costs. Hence, when costs are assigned only to classes of work (i.e., commercial and Government) most of the costs can be charged directly to the benefited class of work, leaving only a few costs incurred for common objectives to be apportioned.

While the principle of direct costing has generally been recognized for purposes of assigning costs to Government contracts, it has not been equally recognized with respect to the assignment of costs directly to other classes of work when such costs were incurred solely for such other classes. It has, however, been recognized indirectly. The list of unallowable costs in the present Section XV, ASPR, represents an attempt to get at the problem, but does not succeed because a mere listing of account titles cannot result in equitable treatment under varying circumstances. The military department audit agencies have endeavored to solve the problem through their concept of "double-screening of overhead," but this goes only part of the way.

Since it applies equally to all classes of work, the principle of direct costing accomplishes directly what other devices attempted to do indirectly. It is merely a recognition of the fundamental principle of cost accounting. Being fundamental, it provides for equitable treatment of all costs under all contracts of any type, including nondefense contracts. Further, it may be fairly said that the proposed cost principles provide for the allowance of substantially all normal business costs subject to their reasonableness in amount and allocability to the Government contract -- a goal which has long been sought.

SIGNIFICANT POINTS OF APPLICATION

Part 3 of the proposed cost principles, entitled "Application of Cost Principles in Supply and Research Contracts with Commercial Organizations," is devoted to a paragraph by paragraph presentation of specific cost elements. The presentation differs from the present Section XV in that in the proposal each item of cost is defined, and its treatment as

cost data is made flexible in light of the varying circumstances which may be encountered. Many of these circumstances are discussed by way of illustration. No rigid line is drawn between elements of cost which are allowable and those which are unallowable.

Obviously, if the proposal is to be any better than that which it has been designed to supersede, it must differ from its predecessor in the treatment of particular cost elements. The following paragraphs highlight and summarize a few of the more important changes. There are many clarifications of the treatment of other cost elements.

Materials -- Generally the same as heretofore; i.e., net cost derived from contractor's usual materials costing practices. One significant extension permits charging to Government contracts at provable replacement cost the quantities of materials consumed which were in inventory or under binding purchase contracts at date of contract. Once elected, this method must be used consistently thereafter. The basis of pricing intercompany and interdivisional sales is also clarified.

Labor -- Generally the same as heretofore with the addition of a substantial paragraph on fringe benefits.

Depreciation and Amortization -- Emphasis is placed on economic factors influencing depreciation. Bulletin F of the Bureau of Internal Revenue is not necessarily provided for as the standard for determination of depreciation. Cost is to be the basis for computation of depreciation, except that cost may be adjusted on a price index basis for changing price levels. Once elected, this method must be followed consistently thereafter. No rental or use charge on fully depreciated assets is permitted. Depreciation is allowed on such assets except when a substantial portion of the provision for depreciation was made during periods of Government contract performance. Flexibility in providing depreciation in relation to production volume is made permissible without strained rationalization.

Research and Development -- This is divided into product and general research. The cost of current product research may be allocated to Government contracts if the contract products benefited from research. General research costs incurred in accordance with contractor's established policies are allocable to all classes of work. Only the cost of current research, whether product or general, will be allowed. Amortization of costs capitalized in prior accounting periods (whether as patents or deferred research) is to be excluded, but the contractor will not be required to capitalize asset values arising

from current research. This treatment is considered to be equitable in that the Government will pay its share of current costs of general research regardless of benefit derived, but in exchange therefor will not bear any share of the cost of the contractor's past research even though its contracts may benefit therefrom. Obtaining patent rights flowing from such work is provided for insofar as defense business is concerned.

Patents -- Amortization of cost of purchased patents is allowable, but amortization of cost of developed patents is not allowable. This treatment is consistent with the treatment of research and development costs.

Selling and Distribution Expenses -- These expenses are generally allocable to defense contracts, but it is in this area that the principle of direct costing is particularly applicable. If sales and servicing of products to the Government are accomplished by a separate sales and servicing organization, the direct cost thereof should be allocated to the contracts but no other such costs for the benefit of other classes of work shall be allocated. However, where the Government is buying substantially standard commercial products and no separate sales organization is maintained, such costs may be allocated to the various classes of sales on whatever basis may be appropriate.

Advertising -- Costs usually allowable under the present Section XV continue to be allowable. In addition, the cost of product advertising is allowable with certain restrictions, but here also direct costing is important. Advertising of standard commercial products sold to the Government is allocable, if the quantity is not abnormally large, based on past experience. If abnormal, nondefense work shall first absorb the advertising cost on the basis of prior per unit advertising costs, the Government contract absorbing the remainder, if any, normally up to the amount which the contractor spent prior to the Government contract. This same principle applies when the Government is buying nonstandard items if the contractor's nondefense business is significantly curtailed because of a shift to defense production.

Selling Commissions -- Allowance of this element of cost is provided for when consistent with provisions relative to the covenant on contingent fees.

Entertainment Expenses -- These are generally unallowable as being contrary to public policy. Certain minor exceptions, which really are not entertainment, are specified in the proposed Section XV.

Executive Compensation -- Changed emphasis places reliance on the contractor's established practices and arm's length bargaining to result in an equitable amount in each case. If these factors are present, reasonableness of amounts of compensation will normally be assumed. Pension costs, bonuses, and costs of stock options are considered as supplementary compensation and, therefore, as allowable costs, subject to certain protective restrictions.

Contributions and Donations -- These costs are allowable if some benefit may be derived therefrom by the contractor or his employees or if the prestige of the contractor would be impaired if he refused to participate. In either case, the pattern of contributions prior to the award of Government contracts is important, and all such costs, to be allocable to Government contracts, must be deductible for purposes of Federal income tax payments.

Taxes and Insurance -- Based on the Supreme Court decision, Alabama vs. King and Boozer, the nature of allowable taxes is clarified but, related to Section XI, ASPR, State income taxes are made allowable on an equitable basis like any other State and local taxes, for which they are a substitute. Various types of insurance, for which costs are allowable, are specifically listed.

Interest on Borrowings -- Interest paid or accrued, regardless of the nature of the obligation which gives rise to the interest cost, is not allowable. Profit margins allowed in contract pricing result from the consideration of many factors, not the least of which is a return on total capital employed by the contractor whether borrowed or owner-contributed. To allow interest on borrowings as a cost would involve a duplication of allowance.

1. The document should be recast into "Principles" format.

Industry Contention

Industry stated that the title of the document, "Contract Cost Principles", is a misnomer. A "principle", it is stated, is a concept of fundamental truth, while the draft document includes additional rules, regulations, and manual-type matter. Industry suggests that the document be recast into "principle" format, and if audit instructions are needed, they should be provided as a separate document.

Evaluation

Our experience over many years has led us to the conclusion that what was needed to cover cost considerations in procurement is a document which (i) defines the cost areas, (ii) provides the necessary guidance to permit the contractors, the contracting activities and the auditors to KNOW the treatment which will be accorded for the area, (iii) is drafted in a manner suitable for incorporation by reference into cost-type contracts so as to stipulate a sufficient reimbursement of cost provisions, but sufficiently flexible to cover the problem of the cost consideration in the pricing of fixed-price type contracts.

On the basis of this experience, the entire DOD (including the audit and procurement elements of the military departments) is unanimous in the view that in basic format and content we need something very close to the present draft. The staff does not believe this to be a serious industry objection. We believe that the argument is made simply to beg for the moment the problem of the unallowables, but that any document (such as an audit manual) which has the identical unallowables would be subjected to the same objections. In the event that industry wishes to press this point it is recommended that we rename it. Among the names could be: "Contract Principles and Rules", "Contract Costs", 'Costs in Negotiated Procurement", and 'Cost Standards in Defense Contracting".

Recommendation

Maintain the nature of the document and negotiate with industry on an appropriate title for the concept.

2. Objective

a. If adjustments are made the general objective is sound.

Industry Contention

Industry (except MAPI) states generally that the objective of one set of cost principles is sound for use, however, only in "cost-related areas." While there is a diversity of view as to what the cost related areas are, there is general agreement that it is improper to use the set for the purpose of the submission of cost estimates by contractors to support pricing. (See paragraph 3.a. entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.") There is some feeling also that the entire firm-fixed price area is not a cost-related area.

Specifically, NSIA says the "uniformity of treatment of contractors, without regard to the specific type of contract involved is, undoubtedly, a desirable goal... However,"... "AMA calls it a commendable project". EIA says that "This Association has consistently taken the view that in theory no exception can be taken to the development of one set of cost principles for cost-type and fixed price contracts alike, provided..." NAM says "We recognize the desirability of having a single set of cost principles to be applied to all Government contracts when costs are a factor, provided..." AIA infers the same thing when it says that it "has no objection to the establishment of a set of cost principles which will be guide only with respect to the negotiation of fixed price types contracts and which..." [Notwithstanding, the AIA provides an actual proposal which provides different treatment of costs for both the negotiation of prices and termination settlement.] The American Institute of CPAs states concurrence "in the idea of a single broad set of cost

Principles provided that in their application, recognition is given to the circumstances created by each type of contract as a part of the conditions and factors which have a bearing on reasonableness, relevancy, allowability," etc. MAPI, on the other hand, takes the point of view that, "Few, if any, advantages are discernable and that the suggestions bristles with possible disadvantages."

Evaluation

Only MAPI thinks that the objective, even with acceptance of certain policy changes, is unsatisfactory. There is general admission that the use is proper (i) in cost reimbursement-type, (ii) incentive type and price redetermination type contracts, so long as the "sound" policies in Part 8, Section III, Price Negotiation Policies and Techniques and Section VIII, Termination of Contracts are emphasized.

Recommendation

The objective of the comprehensive set is sound. Continue the development. See the issue entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates"(paragraph 3.a.) for discussion of and recommendation with respect to the use of the Set by contractors in the submission of cost data by contractors to support pricing.

b. Allowance of all costs which are "normal costs of conducting business is necessary.

Industry Contention

> The basic objective of the comprehensive set must be fairness and equity to Government and to industry. Fairness to industry requires recognition and allowability of ALL COSTS OF DOING BUSINESS to the extent that such costs are allocable and reasonable.

Specifically, NSIA says that the "cost principles must be based on the Government's willingness to recognize and accept all normal and legitimate costs of doing business. The determination of such costs should not be subject to shadings, gradations, or special circumstances, nor should allowability be conditioned on the ability of a contractor to previously negotiate special cost allowances into individual contracts. Again the NSIA speaks against the "disallowance in whole or in part of many elements of costs which are generally considered to be normal costs of doing business, costs which cannot be avoided merely because the Government chooses to call them unallowable and which in non-Government business are normally recovered in the market place in the price of the article sold." AMA says that, as a matter of sound philosophy, the Government must be willing "to pay a fair and proportionate share of all the normal costs of conducting business." MAPI states that "To achieve a profit the business first must realize enough from the sale of its products or services to pay all its costs of doing business. To the extent that it fails to recover all its legitimate costs incurred in performing work for a single customer it is subsidizing that customer. ...[This] is not sound economics and it is not sound public policy in the Government interest." The Chamber of Commerce says that the "comprehensive set of cost principles should allow all legitimate costs of doing business provided they are reasonable and allocable to the contract involved." EIA says it this way: "The basis and foundation of such a set of cost principles would be a recognition by the Government that all normal and legitimate costs of doing business are properly chargeable

to Government business depending on their reasonableness and allocability to the work in question." NAM states that the comprehensive-set objective is sound provided the principles "recognize the concept of reasonableness, generally accepted accounting practices and allocability, and encompass all normal costs of doing business." The Comptrollers Institute of America says that the proposal is defective since it fails "to recognize or accept certain normal and legitimate costs of doing business and fails to give proper emphasis to the basic principles of reasonableness, allocability and generally accepted accounting principles and standards."

Evaluation

Of all the points raised by industry, this is probably the most difficult to resolve to the satisfaction of both parties. We agree that application of the tests of allocability and reasonableness as the sole criteria for determining allowability is appealing. However, such application for purposes of this statement is not adequate for two reasons. First, the two terms "allocable" and "reasonable," despite the fact that we have defined them, are indefinite, judgment terms. The thousands of users need further guidance and a fuller description of their application to certain elements of cost if we are to achieve any satisfactory degree of uniformity of treatment. Second, there are certain costs which, (1) as a matter of public policy, or (2) because allowance would represent duplicate recovery.

(1) "Public Policy". Entertainment expenses have become an accepted cost in commercial practice. They are, in part at least, a selling expense. The code of ethics of public servants clearly prohibits acceptance of such favors. Are we then to condone the practice

by inference by acceptance of such costs? We believe the answer is clearly "no" and must be specifically stated.

(2) "To avoid duplicate recovery". In several places we have included provisions which are designed to reach equitable results, but avoid duplicate recovery. For example, research and development costs incurred in accounting periods prior to the award of the contract are not allowable, but at the same time, we accept the cost of current research and development activities. This is done in order to prevent duplicate payment (i) when originally accomplished and (ii) in the pricing of later production. We believe that the results represents substantial equity to contractors who may capitalize such costs as well as those who charge them to operations as they are incurred.

Recommendation

Based upon conversations with certain industry representatives and the general tenor of the written comments, it is believed that some relaxation of our treatment of a few costs would remove not only this objection to the present draft but several others along with it, and still represent equitable treatment. It is clear that their principal objections go to; (i) compensation based upon or measured by profits, (ii) advertising, and (iii) contributions and donations.

c. Industry's "gains" won in ASBCA and the Courts should be allowed.

Industry Contention

Industry contends that, in any event, the "gains" won in the ASBCA and the Courts, ought to be made allowable.

Specifically, MAPI, in criticizing the draft says that "in one stroke, the effect of such Armed Services Board of Contract Appeals' decision as Swartzbaugh, Wichita Engineering, Gar Wood and others will have been nullified." It is stated further that "any revised set of contract cost principles should give full recognition to doctrines propounded in the decisions of the Armed Services Board of Contract Appeals. That is to say, the spirit of such cases as the Swartzbaugh case,the Wichita Engineering case should be preserved." The NSIA infers the same thing when, in criticizing the disallowance of "losses on other contracts" states: "As written, the paragraph is inconsistent with the Court of Claims decision in the Bell Aircraft Corporation v. U.S. ...where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts."

Evaluation

We believe that these "gains"ought to be reappraised on an objective basis in the manner in which all cost elements should. To the extent that this consideration indicates disallowance, they should be so treated. ASBCA and Court cases are determinations of existing facts only based upon the then existing cost rules. The question of whether these rules and, hence, these decisions are proper from a policy standpoint is now up for recommendation.

Recommendation

Reject the contention and reevaluate the items as appropriate.

Application //

v. Marshall.

Formula Pricing.

205.
5
200
15
160

Cost not a cost when it is disallowed.

disregard traditional accounting systems.

does not necessarily need to mirror costs.

Profit is not

Important sec 3 part 8.

determination of contract – fixed price contract.

mutual determination in case of Termination for convenience & cost fixed price contractor subject to Contractors decisions.

15(101) I B

(v. Stewart of MAPA. (Good Presentation two points)

Commercial producers have established relationships with customers – in other words it is a price list business which principles would destroy.

Principles do not contribute to risk + Profits

Good in cost contract area

Worse in fixed price.

Time not clear enough.

Inconsistant with pricing regulations.

Must be different in applicability cost-

Marshall * Revision of 21 Aug 58

Section 15.101.2.

3. Application

a. Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.

Industry Contention

> Industry must not be asked to accept the cost principles as a basis for their development and submission of cost data in support of pricing, repricing, progress payments, etc.

Specifically, AMA says, "...the contractor's price breakdown submitted in support of firm price bids or proposals cannot properly be forced into the framework of any set of cost principles." NAM and NSIA state, "Under no circumstances can we agree to omit from submissions of cost data or estimates any costs that are incurred as legitimate costs of doing business and properly allocable to a contract, even though the Government may be disinclined to share in such costs."

Evaluation

We recognize that our proposed provision [15-101(a)(ii)(A)] cannot be strictly enforced upon contractors, particularly in connection with precontract negotiations. However, the statement of fact that contractors are expected to follow these principles as a guide will, we believe, be effective in most cases. However, whether industry accepts or not, we need an objective standard by which to evaluate price proposals and if industry includes unallowable cost elements we need to be able to identify such costs through expanded audit evaluation of proposals.

Apparently the requirement would be much less objectionable if certain items were not flatly disallowed in every case.

Supported by this provision in ASPR, we believe that contracting officers and auditors will be able to obtain the cooperation of contractors in so making their submissions. If so, auditing can be reduced to a minimum.

Recommendation

Maintain this concept in the course of the negotiation with industry.

b. Application of principles in resolution of cost issues will harm negotiation.

Industry Contention

> Industry's objection to the applicability provision which provides that the comprehensive set will serve as a "guide in the resolution of the acceptability of specific items of costs in forward pricing when such costs have become an issue" is usually coupled with the contention relating to the ALLOWABILITY OF ALL COSTS. While the NSIA does the same thing, they do so in a way which will permit the isolation of this provision as a separate issue.

Specifically, NSIA construes the words as implying that "controversial issues cannot be negotiated and that they will be unilaterally settled by the Government." Accordingly, NSIA suggests this application be deleted.

Evaluation

The general industry position is that the cost factors ought not to be the subject of negotiation, that price, not costs, in fixed-price contracting ought to be negotiated. Since the Government agrees to the conclusion (see 3.b. above), provision is made that the principles shall be used as a "GUIDE" in the establishment of the fixed price. Not to do so leaves the ASBCA and the Courts with the problem of the measurement of costs in determining settlement of price without a yardstick. We consider the guidance proper.

Recommendation

Since we believe that it is sound to utilize the same yardstick in measuring costs in the settlement of issues as used in the negotiation and termination action, adherence to the position is recommended.

4. "Reasonableness" and "allocability" are adequate standards for the determination of costs.

a. Reasonableness as a standard.

Industry Contention

> All comments offered indicated that "reasonableness" is a critical consideration upon which a proper set of cost principles should be constructed. They seem to say that use of the mere word is all that is necessary to secure a proper performance. They object particularly to some of our blanket determinations of unallowability which have been determined on the basis that it is unreasonable for any of the particular expense to be charged to the Government. They content that the term cannot include "second guessing" of contractor's management.

Specifically, AIA says that reasonableness is important, but they suggest the deletion of the proposed definition without offering a substitute. EIA, in suggesting the deletion of the "competitive restraints" test says that this test "will require both the Contracting Officer and audit personnel to make economic determinations outside the scope of their experience." NSIA says that "it is totally contrary to good contracting policy"... to superimpose upon [the contractor's judgment] ... "criteria involving retroactive review of individual business judgments with respect to the incurrence of costs." AMA says that "organizations must function through the judgments and discretion of its executives in the accomplishing of the purpose for which the contract has been let", and suggests that it is not proper to second-guess this management judgment. MAPI concurs substantially with the definition of reasonableness provided with minor modifications. NAM

says that the requirement for special contract coverage "limits management's preogative to make sound business decisions by requiring prior approval to incur legitimate business expenses.

Evaluation

It is essential that the definition of reasonableness be agreed upon. Once it is agreed upon, it will be incumbent upon the Government representatives to apply it in the performance under the contract. In the event that such monitoring causes disallowances which will be interpreted by contractors to be an "usurpation" of management prerogative, resolution can be effectuated through the "disputes" procedure. If reasonableness is to mean anything at all, it must presuppose that it is possible for something to be unreasonable, and if an action is unreasonable, the cost thereof should not be allowed. If such a determination of unreasonableness of cost can be made in advance of the incurring of such cost, the contractor should be benefitted.

Recommendation

The concept is sound and should be maintained.

b. Allocability as a standard.

Industry Contention

> The concept of "allocability", like "reasonableness", needs no definition or expansion. Any method of allocation, if in accordance with generally accepted accounting principles and practices, may be used and must suffice for DOD contract costing purposes.

Specifically, MAPI says, "Comprehensive cost principles should recognize that 'generally accepted accounting procedures' include a variety of acceptable methods of expense allocation" (but accepts our definition with only the addition of an "or" in its detailed criticism). In AIA's rewrite, the definition is omitted and mentioned is made only to the

effect that, "In ascertaining what constitutes allocable costs, any generally accepted accounting method of determining costs that is equitable under the circumstances may be used..."

Evaluation

For purposes of this document, it is believed that definition and some discussion of the concept of allocation is necessary. Allocation, for certain business purposes such as published statements or taxes, does not require the degree of refinement that is appropriate for our costing purposes. Our proposal merely points out the various methods of allocation which should be considered in distributing expenses for contract cost purposes depending upon the circumstances. EIA seemed to recognize this view when they commented; "It (a set of cost principles) would have as its two main objectives, first, the enumeration of acceptable methods of allocating earnings and expenses to segments of the contractor's business and, where required, to specific contracts; and second, the establishment of acceptable accounting methods for identifying and reporting items of income and expenditures, and those items of a Contractor's income statement which do not represent cost of operations."

Throughout we have provided for the greatest latitude by such provisions as: "The contractor's established practices, if in accord with such generally accepted accounting principles, shall be acceptable" and "This principle for selection is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results are achieved through less precise methods."

It appears that this criticism is actually directed, not at our coverage of allocability, but rather to the fact that the principles have determined

that certain elements such as contributions, profit sharing, and advertising, are not allocable to Government contracts.

Recommendation

That this approach be continued.

c. Soundness of the requirement for negotiation in the determination of cost treatment, particularly in relation to reasonableness and allocability is questioned.

Industry Contention

Uniformity in cost treatment is considered a sound objective. However, this uniformity which has been a basic aim of all previous drafts of the cost principles, has been lost by the requirement that certain listed costs be the subject of negotiation to make them allowable.

Specifically, NSIA states that "Uniformity of [cost] treatment... is a desirable goal." But it states that the negotiation requirement "(a) favors any company in a strong negotiating position, (b) opens the door to special treatment, and (c) limits management's discretion... merely because cost coverage had not previously been negotiated." Again it is stated that the new test of acceptability, i.e., "companies with a preponderance of Government business are not subject to competitive restraints"...would promote a lack of uniformity in treatment..." The C. of C. notes an inference "that the predetermination of basis for the allowability of costs must be agreed to in advance" and recommends deletion of the requirement. NAM feels that the negotiating language "limits management's prerogative to make sound business decisions by requiring prior approval to incur legitimate business expenses...and ...special provisions are required which have the effect of defeating the objective of uniformity by favoring contractors in a strong negotiating position. Inasmuch as uniformity and equity in the allowance

of costs is one of the objectives of a set of cost principles, we feel that the Government should remove the requirement." EIA, although critical of the actual provisions, seems to take a different view when it says "Provision should...be made for the treatment of some items of cost by contractual coverage where special or peculiar circumstances justify it."

Evaluation

Some of the comments apparently arose through a mistaken impression that failure to negotiate these items of cost in advance would make them unallowable. This is erroneous. Absolute uniformity of cost treatment and cost result cannot be achieved. As a matter of fact, industry's own proposals relating to the tests of reasonableness and generally accepted accounting principles, if applied, can only result in gross lack of uniformity of treatment and cost result. The negotiation technique complained about was included in the draft to cause specific consideration of the traditionally difficult costs which are potentially unallowable becuase of the high probability of unreasonableness or nonallocability. We believe, moreover, that the very best finding of reasonableness of cost is one which is specifically considered and negotiated between the parties in advance. Because we believe that the success or failure of the whole project is tied around these difficult costs, we believe that it is essential that the concept be maintained until it is determined that a mutually acceptable DOD - Industry position can be agreed upon.

Recommendation

Maintain the concept at this time.

d. Contractors Accounting Systems should be controlling if in accordance with "Generally Accepted Accounting Principles".

Industry Contention

> The selection of an accounting system is a management prerogative. If the system selected and applied is in accordance with generally accepted accounting principles and practices and is consistently applied, it must suffice for governmental costing purposes. It is therefore improper that particular accounting standards be included in the comprehensive set.

Specifically, NSIA says, "It would require drastic revisions in existing and accepted accounting systems of contractors." AIA says that we "...should recognize the basic principle that any financial system must assign the total cost of doing business to the work performed upon whatever basis fits a company's particular requirements for the realistic reporting of operating results to stockholders, the Securities and Exchange Commission, and others." AMA states that we should recognize "the existence and prima facie propriety of the selected contractor's established accounting system." (Underscoring added.)

Evaluation

Generally accepted accounting principles are broad standards for the evaluation of the financial position of an enterprise and for the measurement of income and expense over a given period of time. Thus, a system may be maintained in accordance with such principles, fulfilling the requirements of management, the stockholders, taxing authorities, and others, and yet not necessarily yield costs related to a product or contract to the extent required for cost reimbursement or to support pricing judgments. Thus, we have accepted the concept in its correct sense by adding "applicable in the circumstances" meaning to DOD contract costing and pricing. The related point of consistency, we view

the same way. Consistency is essential only so long as conditions remain substantially the same. When conditions change, a system change may be required also. The draft recognizes this fact.

As an example of the inadequacy of "generally accepted accounting principles and practices" for Government contract costing purposes, we might cite the treatment of depreciation on fully depreciated assets. Ordinarily such depreciation could not be charged as a cost under generally accepted accounting principles. However, to achieve equity in reimbursing the contractor for use of his assets in this category in any procurement program, we permit a "use charge" under certain circumstances, which is the equivalent of depreciation.

Within this very flexible framework of generally accepted accounting principles and practices, in order to achieve some degree of consistency and equity of treatment of different contractors and to eliminate as many questions as possible, we have set forth accounting standards or guides in certain instances. These do not require that the contractor change his accounting system any more than a tax statute requires him to change his own method of accounting. But such guides are necessary if we are to achieve any reasonable degree of uniformity of policy or practice in the dealings of our thousands of procurement and audit personnel with the many Defense contractors.

It is interesting to note that response of the American Institute of CPA's did not contain objections to this aspect of the proposal.

Recommendation

That this general approach be continued.

Reasonableness + Allocability.

1. is cost reasonable in amt
2. allocated properly
3. Consistent with accounting practices.

Disallow 30 items of cost no test of reasonableness does so in section on application.

F. Billows.

C. Kilgore

(P) Hogg - Ky.

re Mechanics for subcontracting

note recommendation of clause to be inserted.

Not susceptible to individual contract basis...

original draft was word of advice
Revised insists that this be done.
15-2014-1b be deleted entirely

(J) Jones.

XY. See Latham Remarks.
and recommendations.

See Murdock Remarks on Subcontracts.

P. Moulton · Possibility of Ideal Plumplets ·

G Racusin

Issues in Basic Concepts
(in Brief)

Industry Contentions	Evaluation and Recommendations
1. The nature of the proposal is more of "cost policies" than "Cost Principles". It is contended that the document should be recast into the format of "Principles".	Both Government and industry require the type of document which the draft represents. If consistency between name and the nature of document is necessary, change the name.
2. Three problems are presented relating to the "Objectives of the Comprehensive Set:	
a. The basic soundness of the objective of uniformity of cost treatment in the several uses and under the several pertinent types of contracts is questioned.	Industry generally thinks that with some modifications the concept is sound. MAPI dissents, but in this matter should not prevail.
b. The allowance of ALL COSTS which are "normal costs of conducting business" is necessary.	All costs are not per se reasonable or allocable against Gov't business. In addition public policy and duplicate recovery situations require disallowance in some respects.
c. All "gains" won in the ASBCA and the Courts should be allowed without reappraisal.	The "gains" ought to be reappraised from a policy viewpoint as the other elements of cost.
3. Four problems were presented relating to the Application of the Comprehensive Set:	
a. It is not proper to require contractors to use the principles in support of the presentation of pricing estimates.	Although it is likely that prospective contractors cannot be forced to so utilize the principles, their use will decrease audit burden, and will expedite negotiation.
b. The proposal seriously affects the sound pricing and termination philosophy and practices included in Part 8, Section III and Section VIII, ASPR.	There was no intent to modify the sound pricing policies. If the basic direction does not so provide, suitable mutually acceptable words ought to be found.
c. If pricing by audit is to be avoided, the authority of contracting officers in the use of cost data in the pricing of fixed-price type contracts should be made clear.	ASPR, Part 8, Section III which the Industry finds satisfactory now includes this provision.

TAB A

d. The application of the comprehensive set in the resolution of cost issues is improper in that it may imply that controversial issues may not be negotiated but will be unilaterally settled by the Government.

A yardstick for the measurement of costs in the settlement of issues is necessary. The standard set is recommended for this purpose.

4. It is contended that "reasonableness" and "allocability" are adequate standards for the determination of cost. "Allocability" is determined by the contractor's normal accounting system if in accordance with "generally accepted accounting principles." As a consequence it is questionable that the requirement for negotiation of certain of the cost elements is sound. These matters are discussed in the following order:

a. Reasonableness as a standard.

"Reasonableness" requires both definition and application in the cost elements.

b. Allocability as a standard.

"Allocability", also, requires definition and application in the cost elements.

c. Soundness of the requirement for negotiation in the determination of the cost treatment, particularly reasonableness and allocability is questioned.

We believe that the negotiation requirement of some costs under some circumstances is sound. Benefit should flow to the contractor by reason of such agreements.

d. Contractors' accounting systems should be controlling if in accord with "Generally accepted accounting principles."

"Generally accepted accounting principles" do not necessarily yield costs related to a product or contract to the extent required for cost reimbursement or to support pricing judgments. Therefore, accounting standards must be established which will provide this information.

Issues in Items of Cost
(in Brief)

Industry Contention	Evaluation and Recommendation
1. Advertising Costs: (i) product advertising creates mass markets, which, in turn, contribute to industry's ability to perform defense work cheaper; (ii) institutional type advertising affects employee and community relations and stimulates interest in employment; and (iii) the requirements of carrying out the contract sometimes require advertising for scarce materials, subcontracting and the like. It is contended that all should be allowed.	Both product and institutional type advertising are designed to influence the general public and should be so allocated. We should allow the costs of carrying out the contract. Recommendation: modify the principle to allow advertising for scarce material, second hand materials, subcontracting, and the like.
2. Bad Debts: Although the Government always pays its bills there are bad debts flowing from Government business which justify allowability of some bad debts.	If there are bad debt situations growing out of Government business, they are not significant. Recommendation: Continue to disallow all bad debts.
3. Compensation for personal services. All techniques for compensation of individuals for services rendered ought to be allowable if the total compensation is reasonable for services rendered. Specifically, the cost of stock options and compensation which may be dependent on or are measured by profits, are costs and should be made allowable.	We agree that the technique for paying reasonable compensation should not affect its allowability. We recommend that cost of stock options and compensation dependent upon or measured by profits be made allowable.
4. Contributions and Donations. Contributions are a part of the industrial way of life and failure to contribute to local, state and national charitable causes impairs the effectiveness of the contractor.	We concur and recommend allowability of reasonable contributions and donations.
5. Interest and Other Financial Costs. Borrowings are also contended to be a part of the industrial way of life and the cost thereof ought to be allowable.	This problem has been thoroughly studied and the conclusion reached that interest should not be allowed as a cost but that the degree of capital requirements for carrying out the

	Government's purposes should continue to be taken into consideration in the negotiation of the fee or price. Recommendation: include this concept in the principles.
6. Overtime, etc. Industry is critical of the draft which reflected the policy existing at the time the draft was written. We have since modified the policy.	Since we have found it desirable to modify the policy basis upon which the draft was written, we recommend that the principles be recast to conform to the new policy.
7. Plant Reconversion Costs. Reconversion from defense work to civilian work may be so costly as to make it inequitable to require such reconversion to be paid for by the new production. It is suggested that allowability should be stated in such a way as to not preclude payment therefor by the Government.	Make-ready expense ought to be allocated against the ensuing production. Recommendation: that additional reconversion costs be not allowed.
8. Rental Costs. Industry objects to the limitations of costs to "normal costs of ownership" of (i) interplant rentals, and (ii) facilities under sale and lease-back arrangements, contending that the general rule ought to be "open market" rental worth of the property.	We must remove the incentive for a contractor to increase the cost of the Government by his own action. The limitation of costs to the "normal cost of ownership accomplishes this purpose. Recommendation: Allow only the "normal cost of ownership" in the two situations described.
9. Research and Development. Allowance of applied research upon a product line basis, and disallowance of such product line research in research contracts, is criticized. The AIA criticizes, as they did in their presentation of 22 January, the requirement for negotiation of the research expense.	Applied research has for its purpose the development of improvement of particular hardware. As such, it is appropriate that the cost thereof be borne by the product line involved and since the cost should be absorbed through sales of the product line, it should not be allocated against other research projects specifically awarded to the contractor. Recommend: no change.
10. Training and Educational Costs. Industry objects to (i) the limitation of 2 hours a week for classes during working hours, (ii) allowance of only tuition, etc., (but not salary and subsistence) at post graduate levels, and (iii) unallowability of grants.	The entire program was developed by the procurement, manpower and research interests of OASD and the military departments as a reasonable program under today's conditions. Recommend: no change in the principle.

TAB A to
Draft of Part [illegible] Subj DI
10 Sept

Issues in Basic Concepts

1. The document should be recast into "Principles" format.

Industry Contention

Industry stated that the title of the document, "Contract Cost Principles", is a misnomer. A "principle", it is stated, is a concept of fundamental truth, while the draft document includes additional rules, regulations, and manual-type matter. Industry suggests that the document be recast into "principle" format, and if audit instructions are needed, they should be provided as a separate document.

Evaluation

Our experience over many years has led us to the conclusion that what was needed to cover cost considerations in procurement is a document which (i) defines the cost areas, (ii) provides the necessary guidance to permit the contractors, the contracting activities and the auditors to KNOW the treatment which will be accorded for the area, (iii) is drafted in a manner suitable for incorporation by reference into cost-type contracts so as to stipulate a sufficient reimbursement of cost provisions, but sufficiently flexible to cover the problem of the cost consideration in the pricing of fixed-price type contracts.

On the basis of this experience, the entire DOD (including the audit and procurement elements of the military departments) is unanimous in the view that in basic format and content we need something very close to the present draft. The staff does not believe this to be a serious industry objection. We believe that the argument is made simply to beg for the moment the problem of the unallowables, but that any document (such as an audit manual) which has the identical unallowables would be subjected to the same objections. In the event that industry wishes to press this point it is recommended that we rename it. Among the names could be: "Contract Principles and Rules", "Contract Costs", 'Costs in Negotiated Procurement", and 'Cost Standards in Defense Contracting".

TAB B

Recommendation

Maintain the nature of the document and negotiate with industry on an appropriate title for the concept.

2. Objective

a. If adjustments are made the general objective is sound.

Industry Contention

> Industry (except MAPI) states generally that the objective of one set of cost principles is sound for use, however, only in "cost-related areas." While there is a diversity of view as to what the cost related areas are, there is general agreement that it is improper to use the set for the purpose of the submission of cost estimates by contractors to support pricing. (See paragraph 3.a. entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.") There is some feeling also that the entire firm-fixed price area is not a cost-related area.

Specifically, NSIA says the "uniformity of treatment of contractors, without regard to the specific type of contract involved is, undoubtedly, a desirable goal... However,"... "AMA calls it a commendable project". EIA says that "This Association has consistently taken the view that in theory no exception can be taken to the development of one set of cost principles for cost-type and fixed price contracts alike, provided..." NAM says "We recognize the desirability of having a single set of cost principles to be applied to all Government contracts when costs are a factor, provided..." AIA infers the same thing when it says that it "has no objection to the establishment of a set of cost principles which will be guide only with respect to the negotiation of fixed price types contracts and which..." [Notwithstanding, the AIA provides an actual proposal which provides different treatment of costs for both the negotiation of prices and termination settlement.] The American Institute of CPAs states concurrence "in the idea of a single broad set of cost

Principles provided that in their application, recognition is given to the circumstances created by each type of contract as a part of the conditions and factors which have a bearing on reasonableness, relevancy, allowability," etc. MAPI, on the other hand, takes the point of view that, "Few, if any, advantages are discernable and that the suggestions bristles with possible disadvantages."

Evaluation

Only MAPI thinks that the objective, even with acceptance of certain policy changes, is unsatisfactory. There is general admission that the use is proper (i) in cost reimbursement-type, (ii) incentive type and price redetermination type contracts, so long as the "sound" policies in Part 8, Section III, Price Negotiation Policies and Techniques and Section VIII, Termination of Contracts are emphasized.

Recommendation

The objective of the comprehensive set is sound. Continue the development. See the issue entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates"(paragraph 3.a.) for discussion of and recommendation with respect to the use of the Set by contractors in the submission of cost data by contractors to support pricing.

b. Allowance of all costs which are "normal costs of conducting business is necessary.

Industry Contention

The basic objective of the comprehensive set must be fairness and equity to Government and to industry. Fairness to industry requires recognition and allowability of ALL COSTS OF DOING BUSINESS to the extent that such costs are allocable and reasonable.

Specifically, NSIA says that the "cost principles must be based on the Government's willingness to recognize and accept all normal and legitimate costs of doing business. The determination of such costs should not be subject to shadings, gradations, or special circumstances, nor should allowability be conditioned on the ability of a contractor to previously negotiate special cost allowances into individual contracts. Again the NSIA speaks against the "disallowance in whole or in part of many elements of costs which are generally considered to be normal costs of doing business, costs which cannot be avoided merely because the Government chooses to call them unallowable and which in non-Government business are normally recovered in the market place in the price of the article sold." AMA says that, as a matter of sound philosophy, the Government must be willing "to pay a fair and proportionate share of all the normal costs of conducting business." MAPI states that "To achieve a profit the business first must realize enough from the sale of its products or services to pay all its costs of doing business. To the extent that it fails to recover all its legitimate costs incurred in performing work for a single customer it is subsidizing that customer. .../This/ is not sound economics and it is not sound public policy in the Government interest." The Chamber of Commerce says that the "comprehensive set of cost principles should allow all legitimate costs of doing business provided they are reasonable and allocable to the contract involved." EIA says it this way: "The basis and foundation of such a set of cost principles would be a recognition by the Government that all normal and legitimate costs of doing business are properly chargeable

to Government business depending on their reasonableness and allocability to the work in question." NAM states that the comprehensive-set objective is sound provided the principles "recognize the concept of reasonableness, generally accepted accounting practices and allocability, and encompass all normal costs of doing business." The Comptrollers Institute of America says that the proposal is defective since it fails "to recognize or accept certain normal and legitimate costs of doing business and fails to give proper emphasis to the basic principles of reasonableness, allocability and generally accepted accounting principles and standards."

Evaluation

Of all the points raised by industry, this is probably the most difficult to resolve to the satisfaction of both parties. We agree that application of the tests of allocability and reasonableness as the sole criteria for determining allowability is appealing. However, such application for purposes of this statement is not adequate for two reasons. First, the two terms "allocable" and "reasonable," despite the fact that we have defined them, are indefinite, judgment terms. The thousands of users need further guidance and a fuller description of their application to certain elements of cost if we are to achieve any satisfactory degree of uniformity of treatment. Second, there are certain costs which, (1) as a matter of public policy, or (2) because allowance would represent duplicate recovery.

(1) "Public Policy". Entertainment expenses have become an accepted cost in commercial practice. They are, in part at least, a selling expense. The code of ethics of public servants clearly prohibits acceptance of such favors. Are we then to condone the practice

by inference by acceptance of such costs? We believe the answer is clearly "no" and must be specifically stated.

(2) "To avoid duplicate recovery". We have proposed certain compromises which, while perhaps not precise from an accounting viewpoint, reach equitable results. Consider, for example, research and development costs incurred in accounting periods prior to the award of a contract. They are declared unallowable since we accept the cost of current similar activities. To accept the cost of current research, and then later pay again for the same benefit, would result in duplication. In addition, this approach achieves substantial equity of treatment of all contractors, whether they follow the practice of capitalizing such costs or charging them to operations as they are incurred. Our handling of plant reconversion costs represents another example of this approach.

Recommendation

Based upon conversations with certain industry representatives and the general tenor of the written comments, it is believed that some relaxation of our treatment of a few costs would remove not only this objection to the present draft but several others along with it, and still represent equitable treatment. It is clear that their principal objections go to; (i) compensation based upon or measured by profits, (ii) advertising, and (iii) contributions and donations.

c. Industry's "gains" won in ASBCA and the Courts should be allowed.

Industry Contention

Industry contends that, in any event, the "gains" won in the ASBCA and the Courts, ought to be made allowable.

Specifically, MAPI, in criticizing the draft says that "in one stroke, the effect of such Armed Services Board of Contract Appeals' decision as Swartzbaugh, Wichita Engineering, Gar Wood and others will have been nullified." It is stated further that "any revised set of contract cost principles should give full recognition to doctrines propounded in the decisions of the Armed Services Board of Contract Appeals. That is to say, the spirit of such cases as the Swartzbaugh case, the Wichita Engineering case should be preserved." The NSIA infers the same thing when, in criticizing the disallowance of "losses on other contracts" states: "As written, the paragraph is inconsistent with the Court of Claims decision in the Bell Aircraft Corporation v. U.S. ...where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts."

Evaluation

We believe that these "gains" ought to be reappraised on an objective basis in the manner in which all cost elements should. To the extent that this consideration indicates disallowance, they should be so treated. ASBCA and Court cases are determinations of existing facts only based upon the then existing cost rules. The question of whether these rules and, hence, these decisions are proper from a policy standpoint is now up for recommendation.

Recommendation

Reject the contention and reevaluate the items as appropriate.

3. Application

a. Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.

Industry Contention

> Industry must not be asked to accept the cost principles as a basis for their development and submission of cost data in support of pricing, repricing, progress payments, etc.

Specifically, AMA says, "...the contractor's price breakdown submitted in support of firm price bids or proposals cannot properly be forced into the framework of any set of cost principles." NAM and NSIA state, "Under no circumstances can we agree to omit from submissions of cost data or estimates any costs that are incurred as legitimate costs of doing business and properly allocable to a contract, even though the Government may be disinclined to share in such costs."

Evaluation

We recognize that our proposed provision [15-101(a)(ii)(A)] cannot be strictly enforced upon contractors, particularly in connection with precontract negotiations. However, the statement of fact that contractors are expected to follow these principles as a guide will, we believe, be effective in most cases. However, whether industry accepts or not, we need an objective standard by which to evaluate price proposals and if industry includes unallowable cost elements we need to be able to identify such costs through expanded audit evaluation of proposals.

Apparently the requirement would be much less objectionable if certain items were not flatly disallowed in every case.

Supported by this provision in ASPR, we believe that contracting officers and auditors will be able to obtain the cooperation of contractors in so making their submissions. If so, auditing can be reduced to a minimum.

Recommendation

Maintain this concept in the course of the negotiation with industry.

b. Proposed application in pricing seriously harms present sound pricing policies.

Industry Contention

> The draft, by its terms or by implication, largely negates the sound negotiation policies and techniques contained in ASPR Part 8, Section III, Price Negotiation Policies and Techniques, and Section VIII, Termination of Contracts: (i) by necessitating a preoccupation with elements of costs and the element of profit and thereby losing the fundamental objective -- Price, and (ii) resulting in interference with the present sound policy emphasis toward firm fixed price contracting.

Specifically, NSIA says that the format "changes the basic philosophy with respect to the pricing of negotiated contracts" and results in "mathematical pricing [which] is incompatible with the intent of fixed price contracts and would result in pricing on the illegal basis of cost plus a percentage of cost." EIA says that the proposal "conflicts with Part 8, Section III of ASPR which specifies in detail how the contract price must be arrived at through negotiation...and as a practical matter, the detailed cost treatment of Part 2 will have the same application for fixed price redeterminable contracts as for cost-type contracts." AIA says that the "application...in the form proposed to fixed-price type contracts is viewed with grave concern. We do not believe that prices under fixed-price type contracts should be established in a manner which would substitute the arbitrary listing of allowable costs plus a profit allowance for the sound practice of negotiating a total price... It is our opinion that such a requirement would not only destroy the fixed-price concept of contracting but would also impose arbitrary and burdensome administrative controls upon industry which would seriously impair management responsibility, authority, flexibility, and incentive."

The Chamber of Commerce says that the "contractor has no freedom to bargain for a total price that will assure him a return of the actual costs..." MAPI quotes with apparent appreciation several passages from Part 8, Section III which it characterizes as an "excellent statement of broad policy" but states a "special concern with the possible effects of this proposal's adoption on firm, fixed-price contracting." Adoption would "inevitably...extend the area of negotiation and certainly to complicate its conduct.: The "proposal...cannot fail, in our judgment, to distribute these (cost-type) disadvantages much more widely by converting many so-called fixed-price agreements into cost-type contracts, in fact if not in law." "Its specifications of cost allowability will be substituted for that 'sound' judgment which this (pricing) policy invokes, and the distinction between 'cost-type' and'fixed-price' contracts will -- in a large measure -- have been obliterated."

Evaluation

There was no intention of changing the "sound" procurement policy relative to negotiation of prices as contained in ASPR Part 8, Section III and of termination contained in ASPR Section VIII, relative to the necessity of audit to support pricing, the use of cost data as submitted by contractors and as developed by the Audit Agencies in pricing, nor is there actually any change. The intention was simply that there ought to be provided standards to be applied in the event that a cost or price inquiry or audit is indicated and conducted. We do not believe that industry actually believes what is contended here, since the same agruments can be made with respect to ANY KNOWLEDGE or concern with the prospective costs of performance under any standards. Thus, they must be saying that any knowledge, concern, or relationship of price to expected cost of performance is not proper. We believe that the concern

expressed here actually is with the unallowables and NOT with negotiation and termination policy. We cannot imagine the award of a contract without an inquiry into the reasonableness of the pricing unless the pricing level is established by adequate competition. Similarly, assurance of reasonable pricing in situations in which other pricing aids are deemed inadequate must be related to costs, and the measurement of costs requires the use of a yardstick. Under the pricing and termination Sections, concern with these factors is directed.

Recommendation

Maintain the concept but negotiate mutually acceptable word changes to clarify the intention.

c. Use of audit data by Contracting Officers in pricing of fixed-price type contracts should be made clear.

Industry Contention

> In pricing, the audit aid must be advisory to the contracting officer and price analysis should be the responsibility of the contracting officer. To have either of these responsibilities performed by the auditor necessarily results in formula pricing and pricing by audit.

Specifically, AMA says that the "draft does not clearly spell out the function of the contracting officer in making business decisions, but encourages an audit approach to contract writing and administration. While the audit function is vital, it should only be advisory and business evaluation and decision should be vested in the contracting officer." AMA also incorporated a previous submission in which it said, "Certainly all of the tools of price redetermination should be available to and utilized by, the Contracting Officer, but such aids should be advisory and not conclusive. One of the objectives of the contemplated principles should be to restore negotiation to the revision of prices under price-redetermination type contracts."

Evaluation

Industry's suggestion is now included in Part 8, Section III, with which Industry has expressed satisfaction.

Recommendation

No action.

d. Application of principles in resolution of cost issues will harm negotiation.

Industry Contention

> Industry's objection to the applicability provision which provides that the comprehensive set will serve as a "guide in the resolution of the acceptability of specific items of costs in forward pricing when such costs have become an issue" is usually coupled with the contention relating to the ALLOWABILITY OF ALL COSTS. While the NSIA does the same thing, they do so in a way which will permit the isolation of this provision as a separate issue.

Specifically, NSIA construes the words as implying that "controversial issues cannot be negotiated and that they will be unilaterally settled by the Government." Accordingly, NSIA suggests this application be deleted.

Evaluation

The general industry position is that the cost factors ought not to be the subject of negotiation, that price, not costs, in fixed-price contracting ought to be negotiated. Since the Government agrees to the conclusion (see 3.b. above), provision is made that the principles shall be used as a "GUIDE" in the establishment of the fixed price. Not to do so leaves the ASBCA and the Courts with the problem of the measurement of costs in determining settlement of price without a yardstick. We consider the guidance proper.

Recommendation

Since we believe that it is sound to utilize the same yardstick in measuring costs in the settlement of issues as used in the negotiation and termination action, adherence to the position is recommended.

4. "Reasonableness" and "allocability" are adequate standards for the determination of costs.

a. Reasonableness as a standard.

Industry Contention

> All comments offered indicated that "reasonableness" is a critical consideration upon which a proper set of cost principles should be constructed. They seem to say that use of the mere word is all that is necessary to secure a proper performance. They object particularly to some of our blanket determinations of unallowability which have been determined on the basis that it is unreasonable for any of the particular expense to be charged to the Government. They content that the term cannot include "second guessing" of contractor's management.

Specifically, AIA says that reasonableness is important, but they suggest the deletion of the proposed definition without offering a substitute. EIA, in suggesting the deletion of the "competitive restraints" test says that this test "will require both the Contracting Officer and audit personnel to make economic determinations outside the scope of their experience." NSIA says that "it is totally contrary to good contracting policy"... to superimpose upon [the contractor's judgment] ... "criteria involving retroactive review of individual business judgments with respect to the incurrence of costs." AMA says that "organizations must function through the judgments and discretion of its executives in the accomplishing of the purpose for which the contract has been let", and suggests that it is not proper to second-guess this management judgment. MAPI concurs substantially with the definition of reasonableness provided with minor modifications. NAM

says that the requirement for special contract coverage "limits management's preogative to make sound business decisions by requiring prior approval to incur legitimate business expenses.

Evaluation

It is essential that the definition of reasonableness be agreed upon. Once it is agreed upon, it will be incumbent upon the Government representatives to apply it in the performance under the contract. In the event that such monitoring causes disallowances which will be interpreted by contractors to be an "usurpation" of management prerogative, resolution can be effectuated through the "disputes" procedure. If reasonableness is to mean anything at all, it must presuppose that it is possible for something to be unreasonable, and if an action is unreasonable, the cost thereof should not be allowed. If such a determination of unreasonableness of cost can be made in advance of the incurring of such cost, the contractor should be benefitted.

Recommendation

The concept is sound and should be maintained.

b. Allocability as a standard.

Industry Contention

> The concept of "allocability", like "reasonableness", needs no definition or expansion. Any method of allocation, if in accordance with generally accepted accounting principles and practices, may be used and must suffice for DOD contract costing purposes.

Specifically, MAPI says, "Comprehensive cost principles should recognize that 'generally accepted accounting procedures' include a variety of acceptable methods of expense allocation" (but accepts our definition with only the addition of an "or" in its detailed criticism). In AIA's rewrite, the definition is omitted and mentioned is made only to the

effect that, "In ascertaining what constitutes allocable costs, any generally accepted accounting method of determining costs that is equitable under the circumstances may be used..."

Evaluation

For purposes of this document, it is believed that definition and some discussion of the concept of allocation is necessary. Allocation, for certain business purposes such as published statements or taxes, does not require the degree of refinement that is appropriate for our costing purposes. Our proposal merely points out the various methods of allocation which should be considered in distributing expenses for contract cost purposes depending upon the circumstances. EIA seemed to recognize this view when they commented; "It (a set of cost principles) would have as its two main objectives, first, the enumeration of acceptable methods of allocating earnings and expenses to segments of the contractor's business and, where required, to specific contracts; and second, the establishment of acceptable accounting methods for identifying and reporting items of income and expenditures, and those items of a Contractor's income statement which do not represent cost of operations."

Throughout we have provided for the greatest latitude by such provisions as: "The contractor's established practices, if in accord with such generally accepted accounting principles, shall be acceptable" and "This principle for selection is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results are achieved through less precise methods."

It appears that this criticism is actually directed, not at our coverage of allocability, but rather to the fact that the principles have determined

that certain elements such as contributions, profit sharing, and advertising, are not allocable to Government contracts.

Recommendation

That this approach be continued.

c. Soundness of the requirement for negotiation in the determination of cost treatment, particularly in relation to reasonableness and allocability is questioned.

Industry Contention

Uniformity in cost treatment is considered a sound objective. However, this uniformity which has been a basic aim of all previous drafts of the cost principles, has been lost by the requirement that certain listed costs be the subject of negotiation to make them allowable.

Specifically, NSIA states that "Uniformity of [cost] treatment... is a desirable goal." But it states that the negotiation requirement "(a) favors any company in a strong negotiating position, (b) opens the door to special treatment, and (c) limits management's discretion... merely because cost coverage had not previously been negotiated." Again it is stated that the new test of acceptability, i.e., "companies with a preponderance of Government business are not subject to competitive restraints"...would promote a lack of uniformity in treatment..." The C. of C. notes an inference "that the predetermination of basis for the allowability of costs must be agreed to in advance" and recommends deletion of the requirement. NAM feels that the negotiating language "limits management's prerogative to make sound business decisions by requiring prior approval to incur legitimate business expenses...and ...special provisions are required which have the effect of defeating the objective of uniformity by favoring contractors in a strong negotiating position. Inasmuch as uniformity and equity in the allowance

of costs is one of the objectives of a set of cost principles, we feel that the Government should remove the requirement." EIA, although critical of the actual provisions, seems to take a different view when it says "Provision should...be made for the treatment of some items of cost by contractual coverage where special or peculiar circumstances justify it."

Evaluation

Some of the comments apparently arose through a mistaken impression that failure to negotiate these items of cost in advance would make them unallowable. This is erroneous. Absolute uniformity of cost treatment and cost result cannot be achieved. As a matter of fact, industry's own proposals relating to the tests of reasonableness and generally accepted accounting principles, if applied, can only result in gross lack of uniformity of treatment and cost result. The negotiation technique complained about was included in the draft to cause specific consideration of the traditionally difficult costs which are potentially unallowable becuase of the high probability of unreasonableness or nonallocability. We believe, moreover, that the very best finding of reasonableness of cost is one which is specifically considered and negotiated between the parties in advance. Because we believe that the success or failure of the whole project is tied around these difficult costs, we believe that it is essential that the concept be maintained until it is determined that a mutually acceptable DOD - Industry position can be agreed upon.

Recommendation

Maintain the concept at this time.

d. Contractors Accounting Systems should be controlling if in accordance with "Generally Accepted Accounting Principles".

Industry Contention

> The selection of an accounting system is a management prerogative. If the system selected and applied is in accordance with generally accepted accounting principles and practices and is consistently applied, it must suffice for governmental costing purposes. It is therefore improper that particular accounting standards be included in the comprehensive set.

Specifically, NSIA says, "It would require drastic revisions in existing and accepted accounting systems of contractors." AIA says that we "...should recognize the basic principle that any financial system must assign the total cost of doing business to the work performed upon whatever basis fits a company's particular requirements for the realistic reporting of operating results to stockholders, the Securities and Exchange Commission, and others." AMA states that we should recognize "the existence and prima facie propriety of the selected contractor's established accounting system." (Underscoring added.)

Evaluation

Generally accepted accounting principles are broad standards for the evaluation of the financial position of an enterprise and for the measurement of income and expense over a given period of time. Thus, a system may be maintained in accordance with such principles, fulfilling the requirements of management, the stockholders, taxing authorities, and others, and yet not necessarily yield costs related to a product or contract to the extent required for cost reimbursement or to support pricing judgments. Thus, we have accepted the concept in its correct sense by adding "applicable in the circumstances" meaning to DOD contract costing and pricing. The related point of consistency, we view

the same way. Consistency is essential only so long as conditions remain substantially the same. When conditions change, a system change may be required also. The draft recognizes this fact.

As an example of the inadequacy of "generally accepted accounting principles and practices" for Government contract costing purposes, we might cite the treatment of depreciation on fully depreciated assets. Ordinarily such depreciation could not be charged as a cost under generally accepted accounting principles. However, to achieve equity in reimbursing the contractor for use of his assets in this category in any procurement program, we permit a "use charge" under certain circumstances, which is the equivalent of depreciation.

Within this very flexible framework of generally accepted accounting principles and practices, in order to achieve some degree of consistency and equity of treatment of different contractors and to eliminate as many questions as possible, we have set forth accounting standards or guides in certain instances. These do not require that the contractor change his accounting system any more than a tax statute requires him to change his own method of accounting. But such guides are necessary if we are to achieve any reasonable degree of uniformity of policy or practice in the dealings of our thousands of procurement and audit personnel with the many Defense contractors.

It is interesting to note that response of the American Institute of CPA's did not contain objections to this aspect of the proposal.

Recommendation

That this general approach be continued.

Issues in Basic Concepts
(in Brief)

Industry Contentions	Evaluation and Recommendations
1. The nature of the proposal is more of "cost policies" than "Cost Principles". It is contended that the document should be recast into the format of "Principles".	Both Government and industry require the type of document which the draft represents. If consistency between name and the nature of document is necessary, change the name.
2. Three problems are presented relating to the "Objectives of the Comprehensive Set:	
a. The basic soundness of the objective of uniformity of cost treatment in the several uses and under the several pertinent types of contracts is questioned.	Industry generally thinks that with some modifications the concept is sound. MAPI dissents, but in this matter should not prevail.
b. The allowance of ALL COSTS which are "normal costs of conducting business" is necessary.	All costs are not per se reasonable or allocable against Gov't business. In addition public policy and duplicate recovery situations require disallowance in some respects.
c. All "gains" won in the ASBCA and the Courts should be allowed without reappraisal.	The "gains" ought to be reappraised from a policy viewpoint as the other elements of cost.
3. Four problems were presented relating to the Application of the Comprehensive Set:	
a. It is not proper to require contractors to use the principles in support of the presentation of pricing estimates.	Although it is likely that prospective contractors cannot be forced to so utilize the principles, their use will decrease audit burden, and will expedite negotiation.
b. The proposal seriously affects the sound pricing and termination philosophy and practices included in Part 8, Section III and Section VIII, ASPR.	There was no intent to modify the sound pricing policies. If the basic direction does not so provide, suitable mutually acceptable words ought to be found.
c. If pricing by audit is to be avoided, the authority of contracting officers in the use of cost data in the pricing of fixed-price type contracts should be made clear.	ASPR, Part 8, Section III which the Industry finds satisfactory now includes this provision.

TAB A

d. The application of the comprehensive set in the resolution of cost issues is improper in that it may imply that controversial issues may not be negotiated but will be unilaterally settled by the Government.	A yardstick for the measurement of costs in the settlement of issues is necessary. The standard set is recommended for this purpose.
4. It is contended that "reasonableness" and "allocability" are adequate standards for the determination of cost. "Allocability" is determined by the contractor's normal accounting system if in accordance with "generally accepted accounting principles." As a consequence it is questionable that the requirement for negotiation of certain of the cost elements is sound. These matters are discussed in the following order:	
a. Reasonableness as a standard.	"Reasonableness" requires both definition and application in the cost elements.
b. Allocability as a standard.	"Allocability", also, requires definition and application in the cost elements.
c. Soundness of the requirement for negotiation in the determination of the cost treatment, particularly reasonableness and allocability is questioned.	We believe that the negotiation requirement of some costs under some circumstances is sound. Benefit should flow to the contractor by reason of such agreements.
d. Contractors' accounting systems should be controlling if in accord with "Generally accepted accounting principles."	"Generally accepted accounting principles" do not necessarily yield costs related to a product or contract to the extent required for cost reimbursement or to support pricing judgments. Therefore, accounting standards must be established which will provide this information.

Issues in Items of Cost
(in Brief)

	Industry Contention	Evaluation and Recommendation
1.	Advertising Costs: (i) product advertising creates mass markets, which, in turn, contribute to industry's ability to perform defense work cheaper; (ii) institutional type advertising affects employee and community relations and stimulates interest in employment; and (iii) the requirements of carrying out the contract sometimes require advertising for scarce materials, subcontracting and the like. It is contended that all should be allowed.	Both product and institutional type advertising are designed to influence the general public and should be so allocated. We should allow the costs of carrying out the contract. Recommendation: modify the principle to allow advertising for scarce material, second hand materials, subcontracting, and the like.
2.	Bad Debts: Although the Government always pays its bills there are bad debts flowing from Government business which justify allowability of some bad debts.	If there are bad debt situations growing out of Government business, they are not significant. Recommendation: Continue to disallow all bad debts.
3.	Compensation for personal services. All techniques for compensation of individuals for services rendered ought to be allowable if the total compensation is reasonable for services rendered. Specifically, the cost of stock options and compensation which may be dependent on or are measured by profits, are costs and should be made allowable.	We agree that the technique for paying reasonable compensation should not affect its allowability. We recommend that cost of stock options and compensation dependent upon or measured by profits be made allowable.
4.	Contributions and Donations. Contributions are a part of the industrial way of life and failure to contribute to local, state and national charitable causes impairs the effectiveness of the contractor.	We concur and recommend allowability of reasonable contributions and donations.
5.	Interest and Other Financial Costs. Borrowings are also contended to be a part of the industrial way of life and the cost thereof ought to be allowable.	This problem has been thoroughly studied and the conclusion reached that interest should not be allowed as a cost but that the degree of capital requirements for carrying out the

		Government's purposes should continue to be taken into consideration in the negotiation of the fee or price. Recommendation: include this concept in the principles.
6.	Overtime, etc. Industry is critical of the draft which reflected the policy existing at the time the draft was written. We have since modified the policy.	Since we have found it desirable to modify the policy basis upon which the draft was written, we recommend that the principles be recast to conform to the new policy.
7.	Plant Reconversion Costs. Reconversion from defense work to civilian work may be so costly as to make it inequitable to require such reconversion to be paid for by the new production. It is suggested that allowability should be stated in such a way as to not preclude payment therefor by the Government.	Make-ready expense ought to be allocated against the ensuing production. Recommendation: that additional reconversion costs be not allowed.
8.	Rental Costs. Industry objects to the limitations of costs to "normal costs of ownership" of (i) interplant rentals, and (ii) facilities under sale and lease-back arrangements, contending that the general rule ought to be "open market" rental worth of the property.	We must remove the incentive for a contractor to increase the cost of the Government by his own action. The limitation of costs to the "normal cost of ownership accomplishes this purpose. Recommendation: Allow only the "normal cost of ownership" in the two situations described.
9.	Research and Development. Allowance of applied research upon a product line basis, and disallowance of such product line research in research contracts, is criticized. The AIA criticizes, as they did in their presentation of 22 January, the requirement for negotiation of the research expense.	Applied research has for its purpose the development of improvement of particular hardware. As such, it is appropriate that the cost thereof be borne by the product line involved and since the cost should be absorbed through sales of the product line, it should not be allocated against other research projects specifically awarded to the contractor. Recommend: no change.
10.	Training and Educational Costs. Industry objects to (i) the limitation of 2 hours a week for classes during working hours, (ii) allowance of only tuition, etc., (but not salary and subsistence) at post graduate levels, and (iii) unallowability of grants.	The entire program was developed by the procurement, manpower and research interests of OASD and the military departments as a reasonable program under today's conditions. Recommend: no change in the principle.

Issues in Basic Concepts

1. The document should be recast into "Principles" format.

Industry Contention

Industry stated that the title of the document, "Contract Cost Principles", is a misnomer. A "principle", it is stated, is a concept of fundamental truth, while the draft document includes additional rules, regulations, and manual-type matter. Industry suggests that the document be recast into "principle" format, and if audit instructions are needed, they should be provided as a separate document.

Evaluation

Our experience over many years has led us to the conclusion that what was needed to cover cost considerations in procurement is a document which (i) defines the cost areas, (ii) provides the necessary guidance to permit the contractors, the contracting activities and the auditors to KNOW the treatment which will be accorded for the area, (iii) is drafted in a manner suitable for incorporation by reference into cost-type contracts so as to stipulate a sufficient reimbursement of cost provisions, but sufficiently flexible to cover the problem of the cost consideration in the pricing of fixed-price type contracts.

On the basis of this experience, the entire DOD (including the audit and procurement elements of the military departments) is unanimous in the view that in basic format and content we need something very close to the present draft. The staff does not believe this to be a serious industry objection. We believe that the argument is made simply to beg for the moment the problem of the unallowables, but that any document (such as an audit manual) which has the identical unallowables would be subjected to the same objections. In the event that industry wishes to press this point it is recommended that we rename it. Among the names could be: "Contract Cost Principles and Rules", "Contract Costs", "Costs in Negotiated Procurement", and "Cost Standards in Defense Contracting".

TAB B

Recommendation

Maintain the nature of the document and negotiate with industry on an appropriate title for the concept.

2. Objective

a. If adjustments are made the general objective is sound.

Industry Contention

> Industry (except MAPI) states generally that the objective of one set of cost principles is sound for use, however, only in "cost-related areas." While there is a diversity of view as to what the cost related areas are, there is general agreement that it is improper to use the set for the purpose of the submission of cost estimates by contractors to support pricing. (See paragraph 3.a. entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.") There is some feeling also that the entire firm-fixed price area is not a cost-related area.

Specifically, NSIA says the "uniformity of treatment of contractors, without regard to the specific type of contract involved is, undoubtedly, a desirable goal... However,"... "AMA calls it a commendable project". EIA says that "This Association has consistently taken the view that in theory no exception can be taken to the development of one set of cost principles for cost-type and fixed price contracts alike, provided..." NAM says "We recognize the desirability of having a single set of cost principles to be applied to all Government contracts when costs are a factor, provided..." AIA infers the same thing when it says that it "has no objection to the establishment of a set of cost principles which will be guide only with respect to the negotiation of fixed price types contracts and which..." [Notwithstanding, the AIA provides an actual proposal which provides different treatment of costs for both the negotiation of prices and termination settlement.] The American Institute of CPAs states concurrence "in the idea of a single broad set of cost

Principles provided that in their application, recognition is given to the circumstances created by each type of contract as a part of the conditions and factors which have a bearing on reasonableness, relevancy, allowability," etc. MAPI, on the other hand, takes the point of view that, "Few, if any, advantages are discernable and that the suggestions bristles with possible disadvantages."

Evaluation

Only MAPI thinks that the objective, even with acceptance of certain policy changes, is unsatisfactory. There is general admission that the use is proper (i) in cost reimbursement-type, (ii) incentive type and price redetermination type contracts, so long as the "sound" policies in Part 8, Section III, Price Negotiation Policies and Techniques and Section VIII, Termination of Contracts are emphasized.

Recommendation

The objective of the comprehensive set is sound. Continue the development. See the issue entitled "Application - Contractors should not be bound by the principles in submitting cost data in support of pricing estimates"(paragraph 3.a.) for discussion of and recommendation with respect to the use of the Set by contractors in the submission of cost data by contractors to support pricing.

b. Allowance of all costs which are "normal costs of conducting business is necessary.

Industry Contention

> The basic objective of the comprehensive set must be fairness and equity to Government and to industry. Fairness to industry requires recognition and allowability of ALL COSTS OF DOING BUSINESS to the extent that such costs are allocable and reasonable.

Specifically, NSIA says that the "cost principles must be based on the Government's willingness to recognize and accept all normal and legitimate costs of doing business. The determination of such costs should not be subject to shadings, gradations, or special circumstances, nor should allowability be conditioned on the ability of a contractor to previously negotiate special cost allowances into individual contracts." Again the NSIA speaks against the "disallowance in whole or in part of many elements of costs which are generally considered to be normal costs of doing business, costs which cannot be avoided merely because the Government chooses to call them unallowable and which in non-Government business are normally recovered in the market place in the price of the article sold." AMA says that, as a matter of sound philosophy, the Government must be willing "to pay a fair and proportionate share of all the normal costs of conducting business." MAPI states that "To achieve a profit the business first must realize enough from the sale of its products or services to pay all its costs of doing business. To the extent that it fails to recover all its legitimate costs incurred in performing work for a single customer it is subsidizing that customer. ...[This] is not sound economics and it is not sound public policy in the Government interest." The Chamber of Commerce says that the "comprehensive set of cost principles should allow all legitimate costs of doing business provided they are reasonable and allocable to the contract involved." EIA says it this way: "The basis and foundation of such a set of cost principles would be a recognition by the Government that all normal and legitimate costs of doing business are properly chargeable

to Government business depending on their reasonableness and allocability to the work in question." NAM states that the comprehensive-set objective is sound provided the principles "recognize the concept of reasonableness, generally accepted accounting practices and allocability, and encompass all normal costs of doing business." The Comptrollers Institute of America says that the proposal is defective since it fails "to recognize or accept certain normal and legitimate costs of doing business and fails to give proper emphasis to the basic principles of reasonableness, allocability and generally accepted accounting principles and standards."

Evaluation

Of all the points raised by industry, this is probably the most difficult to resolve to the satisfaction of both parties. We agree that application of the tests of allocability and reasonableness as the sole criteria for determining allowability is appealing. However, such application for purposes of this statement is not adequate for two reasons. First, the two terms "allocable" and "reasonable," despite the fact that we have defined them, are indefinite, judgment terms. The thousands of users need further guidance and a fuller description of their application to certain elements of cost if we are to achieve any satisfactory degree of uniformity of treatment. Second, there are certain costs which must be unallowable (1) as a matter of public policy, or (2) because allowance would represent duplicate recovery.

(1) "Public Policy". Entertainment expenses have become an accepted cost in commercial practice. They are, in part at least, a selling expense. The code of ethics of public servants clearly prohibits acceptance of such favors. Are we then to condone the practice

by inference by acceptance of such costs? We believe the answer is clearly "no" and must be specifically stated.

(2) "To avoid duplicate recovery". We have proposed certain compromises which, while perhaps not precise from an accounting viewpoint, reach equitable results. Consider, for example, research and development costs incurred in accounting periods prior to the award of a contract. They are declared unallowable since we accept the cost of current similar activities. To accept the cost of current research, and then later pay again for the same benefit, would result in duplication. In addition, this approach achieves substantial equity of treatment of all contractors, whether they follow the practice of capitalizing such costs or charging them to operations as they are incurred. Our handling of plant reconversion costs represents another example of this approach.

Recommendation

Based upon conversations with certain industry representatives and the general tenor of the written comments, it is believed that some relaxation of our treatment of a few costs would remove not only this objection to the present draft but several others along with it, and still represent equitable treatment. It is clear that their principal objections go to; (i) compensation based upon or measured by profits, (ii) advertising, and (iii) contributions and donations.

c. Industry's "gains" won in ASBCA and the Courts should be allowed.

Industry Contention

Industry contends that, in any event, the "gains" won in the ASBCA and the Courts, ought to be made allowable.

Specifically, MAPI, in criticizing the draft says that "in one stroke, the effect of such Armed Services Board of Contract Appeals' decision as Swartzbaugh, Wichita Engineering, Gar Wood and others will have been nullified." It is stated further that "any revised set of contract cost principles should give full recognition to doctrines propounded in the decisions of the Armed Services Board of Contract Appeals. That is to say, the spirit of such cases as the Swartzbaugh case, the Wichita Engineering case should be preserved." The NSIA infers the same thing when, in criticizing the disallowance of "losses on other contracts" states: "As written, the paragraph is inconsistent with the Court of Claims decision in the Bell Aircraft Corporation v. U.S. ...where a Government contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts."

See Also [illegible] "unallowable"

Evaluation

We believe that these "gains" ought to be reappraised on an objective basis in the manner in which all cost elements should. To the extent that this consideration indicates disallowance, they should be so treated. ASBCA and Court cases are determinations of existing facts only based upon the then existing cost rules. The question of whether these rules and, hence, these decisions are proper from a policy standpoint is now up for recommendation.

Recommendation

Reject the contention and reevaluate the items as appropriate.

3. Application

a. Contractors should not be bound by the principles in submitting cost data in support of pricing estimates.

Industry Contention

> Industry must not be asked to accept the cost principles as a basis for their development and submission of cost data in support of pricing, repricing, progress payments, etc.

Specifically, AMA says, "...the contractor's price breakdown submitted in support of firm price bids or proposals cannot properly be forced into the framework of any set of cost principles." NAM and NSIA state, "Under no circumstances can we agree to omit from submissions of cost data or estimates any costs that are incurred as legitimate costs of doing business and properly allocable to a contract, even though the Government may be disinclined to share in such costs."

Evaluation

We recognize that our proposed provision [15-101(a)(ii)(A)] cannot be strictly enforced upon contractors, particularly in connection with precontract negotiations. However, the statement of fact that contractors are expected to follow these principles as a guide will, we believe, be effective in most cases. However, whether industry accepts or not, we need an objective standard by which to evaluate price proposals and if industry includes unallowable cost elements we need to be able to identify such costs through expanded audit evaluation of proposals.

Apparently the requirement would be much less objectionable if certain items were not flatly disallowed in every case.

Supported by this provision in ASPR, we believe that contracting officers and auditors will be able to obtain the cooperation of contractors in so making their submissions. If so, auditing can be reduced to a minimum.

Recommendation

Maintain this concept in the course of the negotiation with industry.

b. Proposed application in pricing seriously harms present sound pricing policies.

Industry Contention

> The draft, by its terms or by implication, largely negates the sound negotiation policies and techniques contained in ASPR Part 8, Section III, Price Negotiation Policies and Techniques, and Section VIII, Termination of Contracts: (i) by necessitating a preoccupation with elements of costs and the element of profit and thereby losing the fundamental objective -- Price, and (ii) resulting in interference with the present sound policy emphasis toward firm fixed price contracting.

Specifically, NSIA says that the format "changes the basic philosophy with respect to the pricing of negotiated contracts" and results in "mathematical pricing [which] is incompatible with the intent of fixed price contracts and would result in pricing on the illegal basis of cost plus a percentage of cost." EIA says that the proposal "conflicts with Part 8, Section III of ASPR which specifies in detail how the contract price must be arrived at through negotiation...and as a practical matter, the detailed cost treatment of Part 2 will have the same application for fixed price redeterminable contracts as for cost-type contracts." AIA says that the "application...in the form proposed to fixed-price type contracts is viewed with grave concern. We do not believe that prices under fixed-price type contracts should be established in a manner which would substitute the arbitrary listing of allowable costs plus a profit allowance for the sound practice of negotiating a total price... It is our opinion that such a requirement would not only destroy the fixed-price concept of contracting but would also impose arbitrary and burdensome administrative controls upon industry which would seriously impair management responsibility, authority, flexibility, and incentive."

The Chamber of Commerce says that the "contractor has no freedom to bargain for a total price that will assure him a return of the actual costs..." MAPI quotes with apparent appreciation several passages from Part 8, Section III which it characterizes as an "excellent statement of broad policy" but states a "special concern with the possible effects of this proposal's adoption on firm, fixed-price contracting." Adoption would "inevitably...extend the area of negotiation and certainly to complicate its conduct.: The "proposal...cannot fail, in our judgment, to distribute these (cost-type) disadvantages much more widely by converting many so-called fixed-price agreements into cost-type contracts, in fact if not in law." "Its specifications of cost allowability will be substituted for that 'sound' judgment which this (pricing) policy invokes, and the distinction between 'cost-type' and'fixed-price' contracts will -- in a large measure -- have been obliterated."

Evaluation

There was no intention of changing the "sound" procurement policy relative to negotiation of prices as contained in ASPR Part 8, Section III and of termination contained in ASPR Section VIII, relative to the necessity of audit to support pricing, the use of cost data as submitted by contractors and as developed by the Audit Agencies in pricing, nor is there actually any change. The intention was simply that there ought to be provided standards to be applied in the event that a cost or price inquiry or audit is indicated and conducted. We do not believe that industry actually believes what is contended here, since the same agruments can be made with respect to ANY KNOWLEDGE or concern with the prospective costs of performance under any standards. Thus, they must be saying that any knowledge, concern, or relationship of price to expected cost of performance is not proper. We believe that the concern

expressed here actually is with the unallowables and NOT with negotiation and termination policy. We cannot imagine the award of a contract without an inquiry into the reasonableness of the pricing unless the pricing level is established by adequate competition. Similarly, assurance of reasonable pricing in situations in which other pricing aids are deemed inadequate must be related to costs, and the measurement of costs requires the use of a yardstick. Under the pricing and termination Sections, concern with these factors is directed.

Recommendation

Maintain the concept but negotiate mutually acceptable word changes to clarify the intention.

c. Use of audit data by Contracting Officers in pricing of fixed-price type contracts should be made clear.

Industry Contention

> In pricing, the audit aid must be advisory to the contracting officer and price analysis should be the responsibility of the contracting officer. To have either of these responsibilities performed by the auditor necessarily results in formula pricing and pricing by audit.

Specifically, AMA says that the "draft does not clearly spell out the function of the contracting officer in making business decisions, but encourages an audit approach to contract writing and administration. While the audit function is vital, it should only be advisory and business evaluation and decision should be vested in the contracting officer." AMA also incorporated a previous submission in which it said, "Certainly all of the tools of price redetermination should be available to and utilized by, the Contracting Officer, but such aids should be advisory and not conclusive. One of the objectives of the contemplated principles should be to restore negotiation to the revision of prices under price-redetermination type contracts."

Evaluation

Industry's suggestion is now included in Part 8, Section III, with which Industry has expressed satisfaction.

Recommendation

No action.

d. Application of principles in resolution of cost issues will harm negotiation.

Industry Contention

> Industry's objection to the applicability provision which provides that the comprehensive set will serve as a "guide in the resolution of the acceptability of specific items of costs in forward pricing when such costs have become an issue" is usually coupled with the contention relating to the ALLOWABILITY OF ALL COSTS. While the NSIA does the same thing, they do so in a way which will permit the isolation of this provision as a separate issue.

Specifically, NSIA construes the words as implying that "controversial issues cannot be negotiated and that they will be unilaterally settled by the Government." Accordingly, NSIA suggests this application be deleted.

Evaluation

The general industry position is that the cost factors ought not to be the subject of negotiation, that price, not costs, in fixed-price contracting ought to be negotiated. Since the Government agrees to the conclusion (see 3.b. above), provision is made that the principles shall be used as a "GUIDE" in the establishment of the fixed price. Not to do so leaves the ASBCA and the Courts with the problem of the measurement of costs in determining settlement of price without a yardstick. We consider the guidance proper.

Recommendation

Since we believe that it is sound to utilize the same yardstick in measuring costs in the settlement of issues as used in the negotiation and termination action, adherence to the position is recommended.

4. "Reasonableness" and "allocability" are adequate standards for the determination of costs.

a. Reasonableness as a standard.

Industry Contention

> All comments offered indicated that "reasonableness" is a critical consideration upon which a proper set of cost principles should be constructed. They seem to say that use of the mere word is all that is necessary to secure a proper performance. They object particularly to some of our blanket determinations of unallowability which have been determined on the basis that it is unreasonable for any of the particular expense to be charged to the Government. They content that the term cannot include "second guessing" of contractor's management.

Specifically, AIA says that reasonableness is important, but they suggest the deletion of the proposed definition without offering a substitute. EIA, in suggesting the deletion of the "competitive restraints" test says that this test "will require both the Contracting Officer and audit personnel to make economic determinations outside the scope of their experience." NSIA says that "it is totally contrary to good contracting policy"... to superimpose upon [the contractor's judgment] ... "criteria involving retroactive review of individual business judgments with respect to the incurrence of costs." AMA says that "organizations must function through the judgments and discretion of its executives in the accomplishing of the purpose for which the contract has been let", and suggests that it is not proper to second-guess this management judgment. MAPI concurs substantially with the definition of reasonableness provided with minor modifications. NAM

says that the requirement for special contract coverage "limits management's preogative to make sound business decisions by requiring prior approval to incur legitimate business expenses.

Evaluation

It is essential that the definition of reasonableness be agreed upon. Once it is agreed upon, it will be incumbent upon the Government representatives to apply it in the performance under the contract. In the event that such monitoring causes disallowances which will be interpreted by contractors to be an "usurpation" of management prerogative, resolution can be effectuated through the "disputes" procedure. If reasonableness is to mean anything at all, it must presuppose that it is possible for something to be unreasonable, and if an action is unreasonable, the cost thereof should not be allowed. If such a determination of unreasonableness of cost can be made in advance of the incurring of such cost, the contractor should be benefitted.

Recommendation

The concept is sound and should be maintained.

b. Allocability as a standard.

Industry Contention

> The concept of "allocability", like "reasonableness", needs no definition or expansion. Any method of allocation, if in accordance with generally accepted accounting principles and practices, may be used and must suffice for DOD contract costing purposes.

Specifically, MAPI says, "Comprehensive cost principles should recognize that 'generally accepted accounting procedures' include a variety of acceptable methods of expense allocation" (but accepts our definition with only the addition of an "or" in its detailed criticism). In AIA's rewrite, the definition is omitted and mentioned is made only to the

effect that, "In ascertaining what constitutes allocable costs, any generally accepted accounting method of determining costs that is equitable under the circumstances may be used..."

Evaluation

For purposes of this document, it is believed that definition and some discussion of the concept of allocation is necessary. Allocation, for certain business purposes such as published statements or taxes, does not require the degree of refinement that is appropriate for our costing purposes. Our proposal merely points out the various methods of allocation which should be considered in distributing expenses for contract cost purposes depending upon the circumstances. EIA seemed to recognize this view when they commented; "It (a set of cost principles) would have as its two main objectives, first, the enumeration of acceptable methods of allocating earnings and expenses to segments of the contractor's business and, where required, to specific contracts; and second, the establishment of acceptable accounting methods for identifying and reporting items of income and expenditures, and those items of a Contractor's income statement which do not represent cost of operations."

Throughout we have provided for the greatest latitude by such provisions as: "The contractor's established practices, if in accord with such generally accepted accounting principles, shall be acceptable" and "This principle for selection is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results are achieved through less precise methods."

It appears that this criticism is actually directed, not at our coverage of allocability, but rather to the fact that the principles have determined

that certain elements such as contributions, profit sharing, and advertising, are not allocable to Government contracts.

Recommendation

That this approach be continued.

c. Soundness of the requirement for negotiation in the determination of cost treatment, particularly in relation to reasonableness and allocability is questioned.

Industry Contention

Uniformity in cost treatment is considered a sound objective. However, this uniformity which has been a basic aim of all previous drafts of the cost principles, has been lost by the requirement that certain listed costs be the subject of negotiation to make them allowable.

Specifically, NSIA states that "Uniformity of [cost] treatment... is a desirable goal." But it states that the negotiation requirement "(a) favors any company in a strong negotiating position, (b) opens the door to special treatment, and (c) limits management's discretion... merely because cost coverage had not previously been negotiated." Again it is stated that the new test of acceptability, i.e., "companies with a preponderance of Government business are not subject to competitive restraints"...would promote a lack of uniformity in treatment..." The C. of C. notes an inference "that the predetermination of basis for the allowability of costs must be agreed to in advance" and recommends deletion of the requirement. NAM feels that the negotiating language "limits management's prerogative to make sound business decisions by requiring prior approval to incur legitimate business expenses...and ...special provisions are required which have the effect of defeating the objective of uniformity by favoring contractors in a strong negotiating position. Inasmuch as uniformity and equity in the allowance

of costs is one of the objectives of a set of cost principles, we feel that the Government should remove the requirement." EIA, although critical of the actual provisions, seems to take a different view when it says "Provision should...be made for the treatment of some items of cost by contractual coverage where special or peculiar circumstances justify it."

Evaluation

Some of the comments apparently arose through a mistaken impression that failure to negotiate these items of cost in advance would make them unallowable. This is erroneous. Absolute uniformity of cost treatment and cost result cannot be achieved. As a matter of fact, industry's own proposals relating to the tests of reasonableness and generally accepted accounting principles, if applied, can only result in gross lack of uniformity of treatment and cost result. The negotiation technique complained about was included in the draft to cause specific consideration of the traditionally difficult costs which are potentially unallowable becuase of the high probability of unreasonableness or nonallocability. We believe, moreover, that the very best finding of reasonableness of cost is one which is specifically considered and negotiated between the parties in advance. Because we believe that the success or failure of the whole project is tied around these difficult costs, we believe that it is essential that the concept be maintained until it is determined that a mutually acceptable DOD - Industry position can be agreed upon.

Recommendation

Maintain the concept at this time.

d. Contractors Accounting Systems should be controlling if in accordance with "Generally Accepted Accounting Principles".

Industry Contention

> The selection of an accounting system is a management prerogative. If the system selected and applied is in accordance with generally accepted accounting principles and practices and is consistently applied, it must suffice for governmental costing purposes. It is therefore improper that particular accounting standards be included in the comprehensive set.

Specifically, NSIA says, "It would require drastic revisions in existing and accepted accounting systems of contractors." AIA says that we "...should recognize the basic principle that any financial system must assign the total cost of doing business to the work performed upon whatever basis fits a company's particular requirements for the realistic reporting of operating results to stockholders, the Securities and Exchange Commission, and others." AMA states that we should recognize "the existence and prima facie propriety of the selected contractor's established accounting system." (Underscoring added.)

Evaluation

Generally accepted accounting principles are broad standards for the evaluation of the financial position of an enterprise and for the measurement of income and expense over a given period of time. Thus, a system may be maintained in accordance with such principles, fulfilling the requirements of management, the stockholders, taxing authorities, and others, and yet not necessarily yield costs related to a product or contract to the extent required for cost reimbursement or to support pricing judgments. Thus, we have accepted the concept in its correct sense by adding "applicable in the circumstances" meaning to DOD contract costing and pricing. The related point of consistency, we view

the same way. Consistency is essential only so long as conditions remain substantially the same. When conditions change, a system change may be required also. The draft recognizes this fact.

As an example of the inadequacy of "generally accepted accounting principles and practices" for Government contract costing purposes, we might cite the treatment of depreciation on fully depreciated assets. Ordinarily such depreciation could not be charged as a cost under generally accepted accounting principles. However, to achieve equity in reimbursing the contractor for use of his assets in this category in any procurement program, we permit a "use charge" under certain circumstances, which is the equivalent of depreciation.

Within this very flexible framework of generally accepted accounting principles and practices, in order to achieve some degree of consistency and equity of treatment of different contractors and to eliminate as many questions as possible, we have set forth accounting standards or guides in certain instances. These do not require that the contractor change his accounting system any more than a tax statute requires him to change his own method of accounting. But such guides are necessary if we are to achieve any reasonable degree of uniformity of policy or practice in the dealings of our thousands of procurement and audit personnel with the many Defense contractors.

It is interesting to note that response of the American Institute of CPA's did not contain objections to this aspect of the proposal.

Recommendation

That this general approach be continued.

Issues in Items of Cost
(in Brief)

	Industry Contention	Evaluation and Recommendation
1.	Advertising Costs: (i) product advertising creates mass markets, which, in turn, contribute to industry's ability to perform defense work cheaper; (ii) institutional type advertising affects employee and community relations and stimulates interest in employment; and (iii) the requirements of carrying out the contract sometimes require advertising for scarce materials, subcontracting and the like. It is contended that all should be allowed.	Both product and institutional type advertising are designed to influence the general public and should be so allocated. While we should allow the costs of carrying out the contract, we have found no reasonable way of separating this very small item from the above and therefore it is recommended that this expense be absorbed in the fee allowance.
2.	Bad Debts: Although the Government always pays its bills there are bad debts flowing from Government business which justify allowability of some bad debts.	If there are bad debt situations growing out of Government business, they are not significant. Recommendation: Continue to disallow all bad debts.
3.	Plant Reconversion Costs. Reconversion from defense work to civilian work may be so costly as to make it inequitable to require such reconversion to be paid for by the new production. It is suggested that allowability should be stated in such a way as to not preclude payment therefor by the Government.	Make-ready expense ought to be allocated against the ensuing production. Recommendation: That additional reconversion costs be not allowed.
4.	Rental Costs. Industry objects to the limitations of costs to "normal costs of ownership" of (i) interplant rentals, and (ii) facilities under sale and lease-back arrangements, contending that the general rule ought to be "open market" rental worth of the property.	We must remove the incentive for a contractor to increase the cost of the Government by his own action. The limitation of costs to the "normal cost of ownership" accomplishes this purpose. Recommendation: Allow only the "normal cost of ownership" in the two situations described.

5.	Research and Development. Allowance of applied research upon a product line basis, and disallowance of such product line research in research contracts, is criticized. The AIA criticizes, as they did in their presentation of 22 January, the requirement for negotiation of the research expense.	Applied research has for its purpose the development of improvement of particular hardware. As such, it is appropriate that the cost thereof be borne by the product line involved and since the cost should be absorbed through sales of the product line, it should not be allocated against other research projects specifically awarded to the contractor. Recommend: No change.
6.	Training and Educational Costs. Industry objects to (i) the limitation of 2 hours a week for classes during working hours, (ii) allowance of only tuition, etc., (but not salary and subsistence) at post graduate levels and (iii) unallowability of grants.	The entire program was developed by the procurement, manpower and research interests of OASD and the military departments as a reasonable program under today's conditions. Recommend: No change in the principle.

Issue

1. Applicability of the Cost Principles to other than cost reimbursement type contracts.

Industry Position

The extension of cost principles to fixed price type contracts will inevitably result in formula pricing. Industry particularly objects to the requirement for submission of price proposals in accordance with the cost principles. Objection is made to use of principles in connection with terminated fixed price type contracts and to their applicability to subcontractors and vendors.

Government Position

We have recognized that industry objections to our previous draft are, to some extent, well taken. By emphasizing the pricing principles set forth in ASPR Section III, Part 8, and by treating the applicability of the cost principles to fixed price type contracts in a separate section, we feel that there is less danger of formula pricing. The requirement for submission of price proposals in accordance with the principles has been eliminated. We do not agree that the principles should have no applicability to fixed price type contracts. We do not agree with Industry that the cost principles be inapplicable to terminated contracts. The principles would be used to provide general guidance in both the prime and subcontract areas when costs are a factor in pricing.

Current Proposal

1. A new part is proposed in Section XV to specifically deal with fixed price type contracts.
2. Pricing, as distinguished from costing, is emphasized.
3. The fundamental difference between retrospective and forward pricing has been maintained.
4. The principles "shall be used to provide general guidance in the evaluation of cost data required to establish a fair and reasonable price" when costs are to be considered in the negotiation of fixed price type contracts.

Issue

2. Recognition of all normal and legitimate costs.

Industry Position

Industry believes that the Government should start from the proposition that it is willing to accept any cost which has been incurred or accrued, in good faith, by a responsible contractor exercising its best management skills in the conduct of its business.

Government Position

As a generality, we agree that we should accept our share of the normal expenses of doing business. Nevertheless, the difference between commercial business and government business is such that certain types of expense should not be allocated to us, no matter what the accounting system of the contractor normally provides. Examples of such expenses are entertainment expense and reserves for commercial bad debts.

Current Proposal

While we have suggested a more liberal treatment of certain individual cost items, we have not adopted the Industry position that all normal and necessary costs of doing business are appropriate for allocation against government contracts.

Issue

3. The issue is whether the cost principles should contain rules or guidelines for determining the "reasonableness" or "allocability" of various cost elements or whether we should accept as the criterion "generally accepted accounting practices."

Industry Position

Industry feels strongly and nearly uniformly that "reasonableness" and "allocability" of costs should be governed by good accounting practice as reflected in going accounting systems and that the government should not adopt special tests or criteria which require significant variations in industry's accounting systems. Hence, they feel that the cost principles should not attempt to prescribe how to evaluate the "reasonableness" or the "allocability" of any element of cost and, above all, that we should not say that a cost is not allocable to us.

Government Position

"Generally accepted accounting principles" are broad standards for the evaluation of the financial position of an enterprise and for the measurement of income and expense over a given period of time. Thus a system may be maintained in accordance with such principles and fulfill the requirements of management, the stockholders, the taxing authorities, and others, and yet not yield cost data satisfactory for cost reimbursement or to support pricing judgments without some adjustments. Accordingly what may be "good accounting practice," for the purpose of determining the company's overall income and expense, may be inappropriate when determining the price to be charged a particular customer or class of customers.

Current Proposal

We have made no additional changes in the cost principles to accommodate this Industry argument.

further →

Issue

4. Advanced understandings with respect to certain specific cost elements, ~~as a generality.~~

Industry Position

IN GENERAL, Industry agrees to the concept of reaching an advanced agreement on the controversial cost questions. However, Industry is fearful that advanced agreements will be required in each instance and that the absence of an advanced agreement will result in cost disallowances. Industry recommends deletion of this section of the regulation. If retained, it should affirm that failure to negotiate in advance does not lead to disallowance, that initially negotiated amounts or clauses may be reopened on showing of necessity or changed circumstances, and it should provide a form in which contractors might negotiate these factors on an overall basis.

Government Position

We think that the desirability of reaching advanced understandings FEATURE on certain controversial items is an important ~~factor~~ of the regulation and should be retained. We have made certain changes in this section of a clarifying nature which are designed to accommodate the industry objections in some degree.

Current Proposal

We propose that the cost principle be changed to clearly indicate that "the absence of such an advanced agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable." Additionally, we have segregated the items for which advanced understandings are "normally essential" from those where elements are "normally appropriate."

Issue

5. Advertising Costs.

Industry Position

While recognizing that some forms of advertising are seldom, if ever, properly allocable to government contracts, Industry protests the absolute exclusion of certain types of advertising costs and wants the right to present its case in negotiations to show whether and to what extent its advertising is of benefit to the Government, is reasonable in character and in amount, and is fairly allocable to government contracts.

Issue 5. Cont.

Government Position

We feel that it is feasible to exclude certain types of advertising as being inappropriate for allocation against government contracts. This is particularly true with respect to product and institutional advertising. We have made certain relatively minor changes in this principle to accommodate Industry's suggestions.

Current Proposal

We propose that this principle be liberalized somewhat to include the cost of exhibits sponsored by the Government as well as advertising for scarce materials or disposing of scrap or surplus materials.

Issue

6. Compensation for personal services.

Industry Position

Prior to the 15 October meeting, we had changed this principle so as to allow the inclusion of profit sharing plans as a part of total compensation. Industry agrees with this change.

Government Position

While no substantive issue with industry remains on this principle, it is felt that certain additional language is desirable to recognize that, in the determination of reasonableness of total compensation, contracting officers, as a practical matter, can only cope with the unreasonable or out of line situation. Since this is true, it is felt that we should inject some flavor of this approach into the cost principle to assist contracting officers in an extremely difficult area of contract administration.

Current Proposal

The following is proposed as an addition to the August 21 draft of the compensation principle: "In the administration of this principle, it is recognized that not every compensation case need be subjected in detail to the above tests. Such tests need be applied only to those cases in which a general review reveals amounts or types of compensation which appear unreasonable or otherwise out of line."

Issue

7. Research and Development.

Industry Position:

Industry spokesmen argued strenously and persuasively against our

Issue 7. Cont.

previous draft of this principle. Basically, Industry contended that applied research should be grouped with basic research, and not with development.

Government Position

~~As a generality,~~ We have changed our basic position on this principle and our redraft incorporates the industry suggestion that applied research be grouped with basic research. We have added the concept, however, that in some cases it is desirable that the Government bear less than an allocable share of the total cost of a contractor's research program.

Current Proposal

The revised research and development cost principle has been officially approved by all parties at interest, with one exception. As redrafted, we expect this principle to be acceptable to Industry.

Issue

8. Contributions and Donations.

Industry Position

Industry objects strenuously to our proposed disallowance of contributions and donations. Industry claims that expenditures for contributions and donations are normal and legitimate costs which they must incur. Industry feels that the possible problem of excessive gifts can be solved by the establishment of certain tests of reasonableness which are acceptable to both industry and government.

Government Position

We do not feel that all contributions and donations should be allowable. However, we proposed an extensive change in this principle to allow the costs of reasonable contributions to establish non-profit charitable organizations. The Air Force representative does not concur in this change from the 21 Aug draft. The following addition to the 21 Aug draft is proposed:

"Reasonable contributions and donations to established nonprofit charitable organizations are allowable provided they are expected of the contractor by the community and it can reasonably be expected that the prestige of the contractor in the community would suffer through the lack of such contributions.

"The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each

Issue 8 cont.

allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost."

Issue

9. Interest.

Industry Position.

Industry argued strongly that interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts. Industry contends that the fluctuating nature of government business precludes availability of equity capital in many instances.

Government Position

We do not feel that Industry has made a case for allowance of interest as a cost. We feel that such allowance would provide a preference for one method of obtaining capital requirements over other methods, and therefore would provide an incentive for borrowing for the performance of our contracts.

Current Proposal

While we propose that interest remain an unallowable cost, we are recommending a revision in our profit policy appearing in ASPR 3-808.4 by adding a new subparagraph (d) which would read:

"d. Extent of the Contractor's Investment. The extent of the contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee of profit."

Issue

10. Training and Education.

Industry Position.

Industry did not make a strong case against our proposed cost principle at the 15 Oct meeting. Subsequent written comments failed to mention this item.

Government Position

In view of the lack of further industry comment on this item, we feel that our proposal, as contained in the 21 August draft, is correct.

Current Proposal

No change from the 21 Aug draft.

Issue

11. Plant Reconversion Cost.

Industry Position

Industry contends that there are circumstances wherein equity requires the payment of plant reconversion cost on a mutually acceptable basis. Industry contends that our prior draft precluded any such negotiation on a case by case basis.

Government Position

While retaining the substance of our previous draft of this principle, we recognize the industry argument that the payment of reconversion cost on a case by case basis should not be precluded by the cost principles.

Current Proposal

We propose that the following provision be added to the principles:
"However, in special circumstances where equity so dictates, additional costs may be allowed to the extent mutually agreed upon."

12. Overtime.

Industry Position

Industry's recommendations here are limited to requesting a clarification between overtime premium pay and fixed premium pay, both in ASPR Section XII and the proposed Cost Principles.

Government Position

We do not feel that any further clarification is required on this subject.

Current Proposal

No change from our 21 August draft.

ISSUES IN ITEMS OF COST

Virtually every item of cost has been the subject of some criticism or comment by some of the respondees. Many of these appear solvable by editing some of the points into the document. As might be expected, all of the Associations did not make the same comment nor criticise the same element. In order to reduce the problem to the costs which were subjected to the most consistent and broad criticism, the following are discussed:

1. Advertising Costs (a)
2. Bad Debts (b)
3. Compensation for Personal Services (f)
4. Contributions and Donations (h)
5. Interest and other Financial Costs (q)
6. Overtime, Extra Pay Shift and Multi-Shift Premiums (y)
7. Plant Rehabilitation Costs (cc)
8. Rental Costs
9. Research and Development (ii)
10. Training and Educational Costs (qq)

1. Advertising Costs (a)

Contention

NAM, NSIA, MAPI, AMA, AIA, C. of C., EIA, and CPA were critical of the coverage of the draft of this item. The recommendations centered upon the allowability of product and institutional advertising, subject only to allocability and reasonableness. With respect to product advertising one association suggested that in the establishment of mass markets, the Government has received price benefits which justify the proposed action. All contended that INSTITUTIONAL TYPE ADVERTISING should be allowed since such advertising "informs the public on matters of general interest, stimulates interest and the pursuit of careers in science and engineering, or affects employee relations." The American Institute of CPA's notes that it is "reasonable to allow the cost of advertising for scarce materials, or for second-hand machinery when new machinery is hard to obtain."

Evaluation

Industry generally seems to admit that product advertising ought not to be allocated against Government contracts. Institutional advertising may result in some benefit to the Government under certain circumstances, but that benefit is somewhat elusive and thus reasonableness of cost is extremely difficult to determine.

On the other hand, advertising for needed specific materials, subcontractors, engineering proposals, and the like, for the purpose of carrying out the contract, establish the kind of a relationship which justifies allowance.

Recommendation

1. Disallow product and institutional advertising.

2. Adjust advertising for "scarce material or for second-hand materials" and for other advertising directly related to the accomplishment of the contract mission.

2. Bad Debts.

Contention

NSIA, MAPI, AMA, AIA, C. of C., and EIA proposed modifications of the bad debts principle. Generally it is stated that the unallowability of bad debts is too sweeping since, it is asserted

that there are many kinds of credit losses as "a result of handling Government business."

Evaluation

There is some merit to the argument that there is a possibility of losses in connection with subcontract operations which might be considered to be in the nature of bad debts. However this is insignificant. Since the major source of bad debts relates to customers, and since the Government, as a customer, pays its debts, such expense is not allocable to the Government.

Recommendation

Continue to disallow all bad debts.

3. Compensation for Personal Services (f)

Contention

It is contended that the proposed coverage which disallows compensation plans based upon or measured by profits of the immediate distribution type (so-called profit-sharing plans) and stock option techniques of compensation, imposes "arbitrary limitations upon allowable personnel compensation based on the form in which compensation is paid" rather than upon the reasonableness of the total compensation using all forms.

Evaluation

The above is a general complaint. In September, 1957, when it was considered urgent that a draft proposal be released to industry for their consideration so that the project could move forward several compromises were reached and one issue was determined by SECDEF. Profit sharing unallowability was determined by SECDEF. Similar treatment of the costs of stock options was one of the compromises. The issue was accompanied by a memorandum which states, in part:

"..it is proposed that this set of cost principles be furnished immediately to the industrial associations for comment and after full consideration of such comments and appropriate modifications

of the principles, that they be incorporated in the Armed Services Procurement Regulation."

In determining the issue for the purpose of securing comment, SECDEF determined the matter by disallowing profit sharing.

Industry contends that both profit sharing and stock options are appropriate forms of compensation and argues:

a. That immediate distribution compensation plans based upon or measured by profits--

1. are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.

2. are "costs" by generally accepted accounting principles and practices, as distinguished from a distribution of profits.

3. are allowable for tax purposes and in renegotiation.

4. are accorded different treatment from bonuses (which are allowable under the draft). This distinction is unsound since they "are treated alike by the employer for other purposes."

5. were recognized as "essential to the ultimate maintenance of the Capitalistic System" in 1939 by a Senate Subcommittee which investigated profit sharing (bi-partisan - Senators Vandenberg and Herring).

b. That Stock Options--

1. are a proper means of compensating employees for services rendered.

2. are recognized as costs by "generally accepted accounting principles and practices."

3. are allowable for tax purposes.

Recommendation

Allow immediate distribution type compensation plans which may be

dependent upon or measured by profits and the cost of compensation paid by stock options both subject to the negotiation requirement of ASPR 15-204.1(b).

4. Contributions and Donations (h) See also Training and Educational Costs, #10

Contention

NAM, NSIA, MAPI, AMA, AIA, C. of C., EIA and CPA were critical of the disallowance of all contributions and donations. It is stated that every concern is called upon to contribute to local, state and national charitable and non-profit organizations and to fail to do so would seriously impair the prestige of the contractor and result in adverse public opinion and employee discontent. It is stated also that such contributions aid in the development of technical education and scientific research and are essential for the public welfare. It is stated that such contributions are allowable for Income Tax purposes and have been allowed by the ASBCA in their findings.

Evaluation

We believe that this element of expense is an insignificant element and that a case can be made for the soundness of the policy of allowing reasonable contributions under the basic premises of our project.

Recommendation

We recommend allowance of this element.

5. Interest and Other Financial Costs (q)

Contention

NAM, NSIA, AMA, MAPI, C. of C., EIA criticize the unallowability of this item. On the other hand, the AIA seeks the allowability of interest only when it is assessed as a result of protecting rights of the Government and at the Government's direction. CPA "agrees with the disallowance of interest costs if it is made clear that the profit allowed is to be large enough to cover interest on the turnover of borrowed capital in addition to a return on equity capital, thus assuring equitable treatment of contractors employing different methods of financing." "Those claiming allowability of interest assert that it is a normal and legitimate cost of doing business allowable by the courts, for tax purposes, under renegotiation, under ASPR Section VIII, that the GAO would not object; and finally, that the recent DOD restrictions upon financing of inventories and work in process necessitates, and that the DOD Directives require, "that capital investment by the Contractor will be taken into consideration in determining fixed-fee or allowable profit."

Evaluation

The allowability of interest as a cost has been considered many times over the years, and again as late as last fall. The general conclusion reached was that although it was proper that interest not be allowed AS A COST, it was appropriate that the fee, profit or price be established in light of the capital investment by the Contractor.

Recommendation

We recommend that this concept be appropriately introduced into the principles. This could be done with the concept used in DOD Directive 7800.6, as follows:

> "However, the extent of the contractor's capital investment in the performance of the contract will be taken into consideration in the negotiation of the fee or price, as the case may be."

6. Overtime, Extra Pay Shift and Multi-Shift Premiums (y)

Contention

> NSIA, AMA, AIA, MAPI, C. of C., EIA and CPA criticize this principle stating that the draft perpetuates the existing difficulties which are presently being corrected. It is stated that what is required is a sound, operable overtime and extra pay shift policy with a principle embodying the revised policy.

Evaluation

We have found industry's complaint justified to the extent that the basic policy has been adjusted. The adjustments have been coordinated with the NSIA Defense Advisory Council and have been considered fair and operable.

Recommendation

Embody the revised policy into an appropriate principle to the following effect:

While continuing the basic policy against unnecessary overtime:

1. reduce administrative burdens on both Government and industry

2. retain control by the Government of overtime premium and shift premiums at Government expense of an extended nature

3. permit contractors to exercise management judgment with respect to overtime or extra pay shifts which are of a sporadic or emergency nature, or which reduces overall cost

4. apply the tests of "reasonableness" and "allocability" to overtime and shift premiums.

7. Plant Reconversion Costs (cc)

Contention

NAM, NSIA, ALA, C. of C., EIA and MAPI are critical of the allowability of only the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. It is contended that the nature of the Contractor's business and the use of the plant and the extent of his involvement in defense procurement programs should be the determining factor in the determination of whether these costs are allowable. The argument is made that while the non-allowability may be correct with respect to minor plant adjustments to undertake defense work, major or abnormal changes ought to be allowed "on the basis of negotiation", particularly where there is knowledge that after performance of the Defense work the contractor will resume his previous operation.

Evaluation

The proposed action was taken in the belief that make-ready expense ought to be allocated against the ensuing production. Thus, the Government ought to allow the costs of preparing for the production under its contract and the civilian production ought to take care of the make-ready for the new production--thus such expenses should not be allocated against the Government contract. Notwithstanding, we found it necessary to both remove Government property from the contractors premises and to rehabilitate the premises "caused by such removal".

Recommendation

Maintain the principle.

8. Rental Costs (hh)

Contention

NSIA, AIA, MAPI, C. of C., EIA, and CPA are critical of two provisions of the principle (i) the limitation on inter-plant rentals that such should not "exceed the normal costs of ownership" and (ii) and that in general sale and lease back situations, subject to negotiated exceptions, the costs should not exceed that "which would have been incurred had the contractor retained legal title to the facilities." It is asserted that in both situations the tests ought to be reasonableness of the rental, including such other tests as "in line with those charged for similar properties;" and "comparable to normal rental to be paid for like facilities in the open market." It is asserted that the sale-and-lease back technique is an "established method of raising capital."

Evaluation

Both provisions are designed to maintain rentals at reasonable levels and remove an initiative of a contractor by his own action to Increase Governmental costs. The technique utilized is simply to limit the costs to that which would have occurred had the transfer not been made. At the same time, the policy recognizes that these are often arms-length transactions of the type which justify cost adjustments and the draft makes provisions for specific negotiations therefor. One Association recognizes the problem. They say; "To judge the leaseback rental in terms of the lessor's costs had he retained title is to measure the rental by the very index which the leaseback arrangement was designed to repudiate." Government's recognition of the validity of this argument was the very reason for adoption of the policy. If the sale and leaseback techniques is an "established method of raising capital", there is all the more reason why we should not allow excess cost attributable to this technique inasmuch as we do not allow the costs of raising capital generally.

Recommendation

Maintain the principle.

9. Research and Development Costs (ii).

Contention

NAM, NSIA, AMA, AIA, MAPI, C. of C., and EIA have criticized this principle, although concluding, generally, that the present draft represents the soundest draft which has been yet developed. The criticisms relate to (i) the difficulty in breaking down all research into basic and applied for the purpose of allowing the applied on the basis of allocability to the product line; (ii) the non-allocability of research overhead to the accomplishment of a research contract mission; and (iii) the AIA particularly contends that the requirement for negotiation to support reasonableness of the research expense represents an unwholesome control of research.

Evaluation

It is recognized that it is sometimes difficult to break down all research into basic and applied. However it is sound that applied research be allocated to the product to which the research attention is being supplied. This being true methods must be found for segregating questionable projects appropriately.

When research is the service being purchased it seems manifestly inappropriate that other applied research expense be allocated against such a mission since, as indicated above, applied research should be allocated upon a product line basis and the costs should be absorbed through sales of the product line.

Only the AIA makes a strong case against the desirability of negotiation of the reasonableness and allocability of research expense. This problem was recently analyzed fully as a part of the AIA presentation of 22 January 1958, and that analysis is applicable hereto. The conclusion reached was that this requirement must be retained since; (i) in the aircraft industry there are no competitive restraints to discipline the contractors and (ii) there is an urgent need for utilizing fully the results of the research and for relating all projects to others.

Recommendation

Maintain the principle.

10. Training and Educational Costs (qq) See also Contributions and Donations, #4.

Contention

NAM, AMA, AIA, MAPI, C. of C., and EIA are critical of the extent of allowability included in this principle. Although the proposed allowances are considerably more liberal than the status quo, the industry contends that it is the current national policy to stimulate scientific and technical study and thus it is incumbent upon the DOD to encourage its contractors to minimize their efforts in this regard, including cost support of the effort.

Evaluation

The present proposal:

(i) allows in-training and out-training at vocational and non-college levels.

(ii) allows part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary straight time compensation for attendance of classes during working hours for 156 hours a ~~week for one year~~ year (~~1 course~~).

(iii) allows post-graduate tuition, fees, materials for fulltime scientific and engineering education (BUT NO SALARY OR SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) grants to educational institutions are considered donations and are unallowable by the draft.

The above policy was developed cooperatively by the procurement, manpower and research interests of ASD and the military departments. During the development every aspect of the problem was reconsidered and the above was adopted as being a reasonable treatment under today's circumstances.

In connection with (ii) industry objects to the limitation of 156 ~~2 hours a week~~ per year for the study during working hours. Basically, this sort of activity ought to be accomplished outside of working hours but instances

were found in which this was not possible. ~~Two hours per work week~~ 156 hours per year appeared to be a reasonable solution.

In connection with (iii) industry objects to the non-allowability of salary and subsistence. Allocability of this expense against Government contracts is a tight question. As a matter of policy, therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive.

Finally, industry objects to the non-allowance of grants in (iv). These were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

Recommendation

Maintain the principle except with respect to educational grants which should be allowed as a contribution or donation.

ISSUES IN ITEMS OF COST

Virtually every item of cost has been the subject of some criticism or comment by some of the respondees. Many of these appear solvable by editing some of the points into the document. As might be expected, all of the Associations did not make the same comment nor criticise the same element. In order to reduce the problem to the costs which were subjected to the most consistent and broad criticism, the following are discussed:

1. Advertising Costs (a)
2. Bad Debts (b)
3. Compensation for Personal Services (f)
4. Contributions and Donations (h)
5. Interest and other Financial Costs (q)
6. Overtime, Extra Pay Shift and Multi-Shift Premiums (y)
7. Plant Rehabilitation Costs (cc)
8. Rental Costs
9. Research and Development (ii)
10. Training and Educational Costs (qq)

1. Advertising Costs (a)

Contention

NAM, NSIA, MAPI, AMA, AIA, C. of C., EIA, and CPA were critical of the coverage of the draft of this item. The recommendations centered upon the allowability of product and institutional advertising, subject only to allocability and reasonableness. With respect to product advertising one association suggested that in the establishment of mass markets, the Government has received price benefits which justify the proposed action. All contended that INSTITUTIONAL TYPE ADVERTISING should be allowed since such advertising "informs the public on matters of general interest, stimulates interest and the pursuit of careers in science and engineering, or affects employee relations." The American Institute of CPA's notes that it is "reasonable to allow the cost of advertising for scarce materials, or for second-hand machinery when new machinery is hard to obtain."

Evaluation

Industry generally seems to admit that product advertising ought not to be allocated against Government contracts. Institutional advertising may result in some benefit to the Government under certain circumstances, but that benefit is somewhat elusive and thus reasonableness of cost is extremely difficult to determine.

On the other hand, advertising for needed specific materials, subcontractors, engineering proposals, and the like, for the purpose of carrying out the contract, establish the kind of a relationship which justifies allowance.

Recommendation

1. Disallow product and institutional advertising.

2. Adjust advertising for "scarce material or for second-hand materials" and for other advertising directly related to the accomplishment of the contract mission.

2. Bad Debts.

Contention

NSIA, MAPI, AMA, AIA, C. of C., and EIA proposed modifications of the bad debts principle. Generally it is stated that the unallowability of bad debts is too sweeping since, it is asserted

that there are many kinds of credit losses as "a result of handling Government business."

Evaluation

There is some merit to the argument that there is a possibility of losses in connection with subcontract operations which might be considered to be in the nature of bad debts. However this is insignificant. Since the major source of bad debts relates to customers, and since the Government, as a customer, pays its debts, such expense is not allocable to the Government.

Recommendation

Continue to disallow all bad debts.

3. Compensation for Personal Services (f)

Contention

It is contended that the proposed coverage which disallows compensation plans based upon or measured by profits of the immediate distribution type (so-called profit-sharing plans) and stock option techniques of compensation, imposes "arbitrary limitations upon allowable personnel compensation based on the form in which compensation is paid" rather than upon the reasonableness of the total compensation using all forms.

Evaluation

The above is a general complaint. In September, 1957, when it was considered urgent that a draft proposal be released to industry for their consideration so that the project could move forward several compromises were reached and one issue was determined by SECDEF. Profit sharing unallowability was determined by SECDEF. Similar treatment of the costs of stock options was one of the compromises. The issue was accompanied by a memorandum which states, in part:

"..it is proposed that this set of cost principles be furnished immediately to the industrial associations for comment and after full consideration of such comments and appropriate modifications

of the principles, that they be incorporated in the Armed Services Procurement Regulation."

In determining the issue for the purpose of securing comment, SECDEF determined the matter by disallowing profit sharing.

Industry contends that both profit sharing and stock options are appropriate forms of compensation and argues:

a. That immediate distribution compensation plans based upon or measured by profits--

1. are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.

2. are "costs" by generally accepted accounting principles and practices, as distinguished from a distribution of profits.

3. are allowable for tax purposes and in renegotiation.

4. are accorded different treatment from bonuses (which are allowable under the draft). This distinction is unsound since they "are treated alike by the employer for other purposes."

5. were recognized as "essential to the ultimate maintenance of the Capitalistic System" in 1939 by a Senate Subcommittee which investigated profit sharing (bi-partisan - Senators Vandenberg and Herring).

b. That Stock Options--

1. are a proper means of compensating employees for services rendered.

2. are recognized as costs by "generally accepted accounting principles and practices."

3. are allowable for tax purposes.

Recommendation

Allow immediate distribution type compensation plans which may be

dependent upon or measured by profits and the cost of compensation paid by stock options both subject to the negotiation requirement of ASPR 15-204.1(b).

4. Contributions and Donations (h) See also Training and Educational Costs, #10

Contention

NAM, NSIA, MAPI, AMA, AIA, C. of C., EIA and CPA were critical of the disallowance of all contributions and donations. It is stated that every concern is called upon to contribute to local, state and national charitable and non-profit organizations and to fail to do so would seriously impair the prestige of the contractor and result in adverse public opinion and employee discontent. It is stated also that such contributions aid in the development of technical education and scientific research and are essential for the public welfare. It is stated that such contributions are allowable for Income Tax purposes and have been allowed by the ASBCA in their findings.

Evaluation

We believe that this element of expense is an insignificant element and that a case can be made for the soundness of the policy of allowing reasonable contributions under the basic premises of our project.

Recommendation

We recommend allowance of this element.

5. Interest and Other Financial Costs (q)

Contention

NAM, NSIA, AMA, MAPI, C. of C., EIA criticize the unallowability of this item. On the other hand, the AIA seeks the allowability of interest only when it is assessed as a result of protecting rights of the Government and at the Government's direction. CPA "agrees with the disallowance of interest costs if it is made clear that the profit allowed is to be large enough to cover interest on the turnover of borrowed capital in addition to a return on equity capital, thus assuring equitable treatment of contractors employing different methods of financing. "Those claiming allowability of interest assert that it is a normal and legitimate cost of doing business allowable by the courts, for tax purposes, under renegotiation, under ASPR Section VIII, that the GAO would not object; and finally, that the recent DOD restrictions upon financing of inventories and work in process necessitates, and that the DOD Directives require, "that capital investment by the Contractor will be taken into consideration in determining fixed-fee or allowable profit."

Evaluation

The allowability of interest as a cost has been considered many times over the years, and again as late as last fall. The general conclusion reached was that although it was proper that interest not be allowed AS A COST, it was appropriate that the fee, profit or price be established in light of the capital investment by the Contractor.

Recommendation

We recommend that this concept be appropriately introduced into the principles. This could be done with the concept used in DOD Directive 7800.6, as follows:

> "However, the extent of the contractor's capital investment in the performance of the contract will be taken into consideration in the negotiation of the fee or price, as the case may be."

6. Overtime, Extra Pay Shift and Multi-Shift Premiums (y)

Contention

> NSIA, AMA, AIA, MAPI, C. of C., EIA and CPA criticize this principle stating that the draft perpetuates the existing difficulties which are presently being corrected. It is stated that what is required is a sound, operable overtime and extra pay shift policy with a principle embodying the revised policy.

Evaluation

We have found industry's complaint justified to the extent that the basic policy has been adjusted. The adjustments have been coordinated with the NSIA Defense Advisory Council and have been considered fair and operable.

Recommendation

Embody the revised policy into an appropriate principle to the following effect:

While continuing the basic policy against unnecessary overtime:

1. reduce administrative burdens on both Government and industry

2. retain control by the Government of overtime premium and shift premiums at Government expense of an extended nature

3. permit contractors to exercise management judgment with respect to overtime or extra pay shifts which are of a sporadic or emergency nature, or which reduces overall cost

4. apply the tests of "reasonableness" and "allocability" to overtime and shift premiums.

7. Plant Reconversion Costs (cc)

Contention

NAM, NSIA, AIA, C. of C., EIA and MAPI are critical of the allowability of only the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. It is contended that the nature of the Contractor's business and the use of the plant and the extent of his involvement in defense procurement programs should be the determining factor in the determination of whether these costs are allowable. The argument is made that while the non-allowability may be correct with respect to minor plant adjustments to undertake defense work, major or abnormal changes ought to be allowed "on the basis of negotiation", particularly where there is knowledge that after performance of the Defense work the contractor will resume his previous operation.

Evaluation

The proposed action was taken in the belief that make-ready expense ought to be allocated against the ensuing production. Thus, the Government ought to allow the costs of preparing for the production under its contract and the civilian production ought to take care of the make-ready for the new production--thus such expenses should not be allocated against the Government contract. Notwithstanding, we found it necessary to both remove Government property from the contractors premises and to rehabilitate the premises "caused by such removal".

Recommendation

Maintain the principle.

8. Rental Costs (hh)

Contention

NSIA, AIA, MAPI, C. of C., EIA, and CPA are critical of two provisions of the principle (i) the limitation on inter-plant rentals that such should not "exceed the normal costs of ownership" and (ii) and that in general sale and lease back situations, subject to negotiated exceptions, the costs should not exceed that "which would have been incurred had the contractor retained legal title to the facilities." It is asserted that in both situations the tests ought to be reasonableness of the rental, including such other tests as "in line with those charged for similar properties;" and "comparable to normal rental to be paid for like facilities in the open market." It is asserted that the sale-and-lease back technique is an "established method of raising capital."

Evaluation

Both provisions are designed to maintain rentals at reasonable levels and remove an initiative of a contractor by his own action to Increase Governmental costs. The technique utilized is simply to limit the costs to that which would have occurred had the transfer not been made. At the same time, the policy recognizes that these are often arms-length transactions of the type which justify cost adjustments and the draft makes provisions for specific negotiations therefor. One Association recognizes the problem. They say; "To judge the leaseback rental in terms of the lessor's costs had he retained title is to measure the rental by the very index which the leaseback arrangement was designed to repudiate." Government's recognition of the validity of this argument was the very reason for adoption of the policy. If the sale and leaseback techniques is an "established method of raising capital", there is all the more reason why we should not allow excess cost attributable to this technique inasmuch as we do not allow the costs of raising capital generally.

Recommendation

Maintain the principle.

9. Research and Development Costs (ii).

Contention

NAM, NSIA, AMA, AIA, MAPI, C. of C., and EIA have criticized this principle, although concluding, generally, that the present draft represents the soundest draft which has been yet developed. The criticisms relate to (i) the difficulty in breaking down all research into basic and applied for the purpose of allowing the applied on the basis of allocability to the product line; (ii) the non-allocability of research overhead to the accomplishment of a research contract mission; and (iii) the AIA particularly contends that the requirement for negotiation to support reasonableness of the research expense represents an unwholesome control of research.

Evaluation

It is recognized that it is sometimes difficult to break down all research into basic and applied. However it is sound that applied research be allocated to the product to which the research attention is being supplied. This being true methods must be found for segregating questionable projects appropriately.

When research is the service being purchased it seems manifestly inappropriate that other applied research expense be allocated against such a mission since, as indicated above, applied research should be allocated upon a product line basis and the costs should be absorbed through sales of the product line.

Only the AIA makes a strong case against the desirability of negotiation of the reasonableness and allocability of research expense. This problem was recently analyzed fully as a part of the AIA presentation of 22 January 1958, and that analysis is applicable hereto. The conclusion reached was that this requirement must be retained since; (i) in the aircraft industry there are no competitive restraints to discipline the contractors and (ii) there is an urgent need for utilizing fully the results of the research and for relating all projects to others.

Recommendation

Maintain the principle.

10. Training and Educational Costs (qq) See also Contributions and Donations, #4.

Contention

NAM, AMA, AIA, MAPI, C. of C., and EIA are critical of the extent of allowability included in this principle. Although the proposed allowances are considerably more liberal than the status quo, the industry contends that it is the current national policy to stimulate scientific and technical study and thus it is incumbent upon the DOD to encourage its contractors to minimize their efforts in this regard, including cost support of the effort.

Evaluation

The present proposal:

(i) allows in-training and out-training at vocational and non-college levels.

(ii) allows part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).

(iii) allows post-graduate tuition, fees, materials for fulltime scientific and engineering education (BUT NO SALARY OR SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) grants to educational institutions are considered donations and are unallowable by the draft.

The above policy was developed cooperatively by the procurement, manpower and research interests of ASD and the military departments. During the development every aspect of the problem was reconsidered and the above was adopted as being a reasonable treatment under today's circumstances.

In connection with (ii) industry objects to the limitation of 2 hours a week for the study during working hours. Basically, this sort of activity ought to be accomplished outside of working hours but instances

were found in which this was not possible. Two hours per work week appeared to be a reasonable solution.

In connection with (iii) industry objects to the non-allowability of salary and subsistence. Allocability of this expense against Government contracts is a tight question. As a matter of policy therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive.

Finally, industry objects to the non-allowance of grants in (iv). These were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

Recommendation

Maintain the principle except with respect to educational grants which should be allowed as a contribution or donation.

ISSUES IN ITEMS OF COST

Virtually every item of cost has been the subject of some criticism or comment by some of the respondees. Many of these appear solvable by editing some of the points into the document. As might be expected, all of the Associations did not make the same comment nor criticize the same element. In order to reduce the problem to the costs which were subjected to the most consistent and broad criticism, the following are discussed:

1. Advertising Costs (a)
2. Bad Debts (b)
3. Plant Rehabilitation Costs (cc)
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5. Research and Development (ii)
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1. Advertising Costs (a)

Contention

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Evaluation

Industry generally seems to admit that product advertising ought not to be allocated against Government contracts. Institutional advertising may result in some benefit to the Government under certain circumstances, but that benefit is somewhat elusive and thus reasonableness of cost is extremely difficult to determine.

On the other hand, while advertising for needed specific materials, subcontractors, engineering proposals, and the like, for the purpose of carrying out the contract, establish the kind of a relationship which justifies allowance, it is so minor in nature and so difficult to isolate as to indicate the desirability that this aspect be absorbed in the fee allowance.

Recommendation

Disallow product and institutional advertising.

2. Bad Debts.

Contention

NSIA, MAPI, AMA, AIA, C. of C., and EIA proposed modifications of the bad debts principle. Generally, it is stated that the unallowability of bad debts is too sweeping since, it is asserted that there are many kinds of credit losses as "a result of handling Government business."

Evaluation

There is some merit to the argument that there is a possibility of losses in connection with subcontract operations which might be considered to be in the nature of bad debts. However this is insignificant. Since the major source of bad debts relates to customers, and since the Government, as a customer, pays its debts, such expense is not allocable to the Government.

Recommendation

Continue to disallow all bad debts.

3. Plant Reconversion Costs (cc)

Contention

NAM, NSIA, AIA, C. of C., EIA and MAPI are critical of the allowability of only the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. It is contended that the nature of the Contractor's business and the use of the plant and the extent of his involvement in defense procurement programs should be the determining factor in the

determination of whether these costs are allowable. The argument is made that while the non-allowability may be correct with respect to minor plant adjustments to undertake defense work, major or abnormal changes ought to be allowed "on the basis of negotiation", particularly where there is knowledge that after performance of the Defense work the contractor will resume his previous operation.

Evaluation

The proposed action was taken in the belief that make-ready expense ought to be allocated against the ensuing production. Thus, the Government ought to allow the costs of preparing for the production under its contract and the civilian production ought to take care of the make-ready for the new production--thus such expenses should not be allocated against the Government contract. Notwithstanding, we found it necessary to both remove Government property from the contractors premises and to rehabilitate the premises "caused by such removal".

Recommendation

Maintain the principle.

4. Rental Costs (hh)

Contention

NSIA, AIA, MAPI, C. of C., EIA, and CPA are critical of two provisions of the principle (i) the limitation on inter-plant rentals that such should not "exceed the normal costs of ownership" and (ii) that in general sale and lease back situations, subject to negotiated exceptions, the costs should not exceed that "which would have been incurred had the contractor retained legal title to the facilities." It is asserted that in both situations the tests ought to be reasonableness of the rental, including such other tests as "in line with those charged for similar properties;" and "comparable to normal rental to be paid for like facilities in the open market." It is asserted that the sale-and-lease back technique is an "established method of raising capital."

Evaluation

Both provisions are designed to maintain rentals at reasonable levels and remove an initiative of a contractor by his own action to increase

Governmental costs. The technique utilized is simply to limit the costs to that which would have occurred had the transfer not been made. At the same time, the policy recognizes that these are often arms-length transactions of the type which justify cost adjustments and the draft makes provisions for specific negotiations therefor. One Association recognizes the problem. They say; "To judge the leaseback rental in terms of the lessor's costs had he retained title is to measure the rental by the very index which the lease-back arrangement was designed to repudiate." Government's recognition of the validity of this argument was the very reason for adoption of the policy. If the sale and leaseback technique is an "established method of raising capital", there is all the more reason why we should not allow excess cost attributable to this technique inasmuch as we do not allow the costs of raising capital generally.

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Evaluation

It is recognized that it is sometimes difficult to break down all research into basic and applied. However it is sound that applied re-

search be allocated to the product to which the research attention is being supplied. This being true methods must be found for segregating questionable projects appropriately.

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Recommendation

Maintain the principle.

6. Training and Educational Costs (qq).

Contention

NAM, AMA, AIA, MAPI, C. of C., and EIA are critical of the extent of allowability included in this principle. Although the proposed allowances are considerably more liberal than the status quo, the industry contends that it is the current national policy to stimulate scientific and technical study and thus it is incumbent upon the DOD to encourage its contractors to minimize their efforts in this regard, including cost support of the effort.

Evaluation

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Recommendation

Maintain the principle except with respect to educational grants which should be allowed as a contribution or donation.

Draft
10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section contains general cost principles and standards in connection with (i) the determination of historical costs, (ii) the preparation and presentation of cost estimates by contractors and subcontractors, and (iii) the review, audit and evaluation of cost data; in the negotiation and administration of Government contracts and subcontracts thereunder.

Part 1 - Applicability

15-100 Scope of Part. This Part prescribes the circumstances under which the cost principles and standards set forth in the several succeeding Parts of this Section shall be used in contracting and subcontracting and the nature of that use.

15-101 Applicability of Part 2. (a) General. In all contracts described in ASPR 15-200, ASPR, Section XV, Part 2, shall:

(i) be incorporated by reference so as to provide the contractual basis for ascertaining —

(A) reimbursable costs under cost-reimbursement type contracts and the cost-reimbursement portion of time and materials contracts, and

(B) costs which will be allowed by the contracting officer in unilaterally determining the amount due the contractor under a fixed-price type contract terminated for the convenience of the Government or a terminated cost-reimbursement type contract;

(ii) serve as the basis for --

(A) the development and submission of cost data and price analyses by contractors and prospective contractors in support of pricing, repricing, negotiated overhead rates, requests for progress payments, and termination settlement proposals;

(B) the evaluation of cost information by contracting officers in the negotiation and administration of contracts, whenever such information becomes a factor in pricing, repricing, establishing overhead rates, disposing of requests for progress payments, or settlement of termination claims by agreement;

(C) the resolution of questions of acceptability of specific items of cost in retrospective pricing;

(D) audit reports prepared by audit agencies in their advisory capacity of providing accounting information; and

(iii) serve as a guide for the resolution of questions of acceptability of specific items of costs in forward pricing when such costs have become an issue.

(b) Use in Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contract, redetermination of price after completion of the work, negotiation of final overhead rates, or negotiation of a settlement agreement

under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. Accordingly, ASPR, Section XV, Part 2, shall serve as the basis for the development and evaluation of cost data, and in any event for the resolution of questions of acceptability of costs in retrospective pricing. However, the finally agreed price or settlement represents something more than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

(c) Use in Forward Pricing. To the extent that costs are a factor in forward pricing, ASPR, Section XV, Part 2, shall apply to the development and evaluation of cost data. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while Part 2 will be used to develop and evaluate cost data, it will not control negotiation of prices for work to be performed in the future (e.g., negotiation of a firm fixed-price

contract an intermediate price revision covering, in whole or important part, work which is yet to be performed, or a target price under an incentive contract.) Nevertheless, when the question of acceptability of a specific item of cost becomes an issue, Part 2 will serve as a guide for the resolution of the issue.

(d) "Allowable" and "Unallowable" in Connection with Fixed-Price Type Contracts. As used in ASPR, Section XV, Part 2, the words "allowable," "unallowable," and the like, shall, in connection with any fixed-price type contract, mean "acceptable," "unacceptable," and the like.

Part 2 - Principles and Standards Applicable to Supply, Service, and Research and Development Contracts with Commercial Organizations

15-200 Scope of Part. This Part contains, for use in accordance with the provisions of ASPR 15-101, general principles and standards for the evaluation and determination of costs in connection with supply, service, and research and development contracts, other than (i) such contracts with educational or other nonprofit institutions, (ii) construction contracts and contracts for architect-engineering services related to construction, and (iii) facilities contracts and clauses in supply or service contracts providing for the furnishing of facilities.

15-201 Basic Considerations.

15-201.1 Composition of Total Cost. The total cost of a contract is the sum of the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits. In ascertaining what constitutes costs, any generally accepted method of determining or estimating costs that is equitable under the circumstances may be used, including standard costs properly adjusted for applicable variances.

15-201.2 Factors Affecting Allowability of Costs. Factors to be considered in determining the allowability of individual items of cost include (i) reasonableness, (ii) allocability, (iii) application of those generally accepted accounting principles and practices appropriate to the particular circumstances, (iv) significant deviations from the established practices of the contractor which would substantially increase the contract costs, and (v) any limitations or exclusions set forth in this Part 2, or otherwise included in the contract as to types or amounts of cost items.

15-201.3 Definition of Reasonableness. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with companies or separate divisions thereof which are not subject to competitive restraints because the preponderance of their business is with the Government or because of any other reason. What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, consideration shall be given to:

(i) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business and the performance of the contract;

(ii) the restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and state laws and regulations, and contract terms and specifications; and

(iii) the action that a prudent business man would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the Government and the public at large.

15-201.4 Definition of Allocability. A cost is allocable if it is assignable or chargeable to a particular cost objective, such as a contract, product, product line, process, or class of customer or activity, in accordance with the relative benefits received or other equitable relationship. Thus, a cost is allocable to a Government contract if it:

(i) is incurred specifically for the contract;

(ii) benefits both the contract and other work or both Government work and other work and can be distributed to them in reasonable proportion to the benefits received; or

(iii) is necessary to the over-all operation of the business, although a direct relationship to any particular cost objective cannot be shown.

15-201.5 Credits. The applicable portion of any actual or anticipated income, rebate, allowance, and other credit relating to any allowable cost, received by or accruing to the contractor, shall be credited to the Government either as a cost reduction or by cash refund, as appropriate.

15-202 Direct Costs.

(a) A direct cost is any cost incurred or to be incurred solely for the benefit of a single cost objective. Classification of an item as a direct cost is not determined by its incorporation in the end product as material or labor. Costs incurred or to be incurred solely for the benefit of the contract are direct

costs of the contract and are to be charged directly thereto. Costs incurred solely for the benefit of other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly.

(b) This definition shall be applied to all items of cost of significant amount regardless of the established accounting practices of the contractor unless the contractor demonstrates that the application of his current practice achieves substantially the same results. Direct cost items of minor amount may be distributed as indirect costs as provided in ASPR 15-203.

15-203 Indirect Costs

(a) An indirect cost is any cost incurred or to be incurred for the benefit of more than one cost objective. Minor direct cost items may be considered to be indirect costs for reasons of practicality. After direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs are those remaining to be allocated to the several classes of work.

(b) Indirect costs shall be accumulated by logical cost groupings with due consideration of the reasons for incurring the costs which are in turn distributed to the cost objectives. Each grouping should be determined so as to permit distribution of the grouping on the basis of the benefits accruing to the several cost objectives. Commonly, manufacturing overhead, selling expenses, and general and administrative expenses are separately grouped. Similarly, the particular case may require subdivisions of these groupings; e.g., building occupancy costs might be separable from those of personnel administration within the manufacturing overhead group. The number and composition of the groupings should be governed by practical considerations and should be such as not to unduly complicate the allocation where substantially the same results are achieved through less precise methods.

(c) Each cost grouping shall be distributed to the appropriate cost objectives. This necessitates the selection of a distribution base common to all cost objectives to which the grouping is to be allocated. The base should be selected so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives. This principle for selection is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results are achieved through less precise methods.

(d) The method of allocation of indirect costs must be based on the particular circumstances involved. The method shall be in accord with those generally accepted accounting principles which are applicable in the circumstances. The contractor's established practices, if in accord with such generally accepted accounting principles, shall be acceptable. However, the methods used by the contractor may require reexamination when:

(i) any substantial difference occurs between the cost patterns of work under the contract and other work of the contractor; or

(ii) any significant change occurs in the nature of the business, the extent of subcontracting, fixed asset improvement programs, the inventories, the volume of sales and production, manufacturing processes, the contractor's products, or other relevant circumstances.

(e) A base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period or periods shall be so selected as to represent the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but normally no longer than one year.

When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-204 Application of Principles and Standards.

15-204.1 General.

(a) Costs (including those discussed in ASPR 15-204.2) shall not be allowed except to the extent that they are reasonable (see ASPR 15-201.3), allocable (see ASPR 15-201.4), and determined to be allowable in view of the other factors set forth in ASPR 15-201.2 .

(b) The extent of allowability of the selected items of cost covered in ASPR 15-204.2 has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in the case of contractors whose business is predominantly or substantially with the Government. In order to avoid controversy and possible subsequent disallowance based on unreasonableness or non-allocability, the extent of allowability of such costs should be specifically discussed and agreed to in advance of the contractor's incurring of such costs under cost-reimbursement type contracts, fixed-price incentive contracts, and fixed-price contracts subject to price redetermination. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. Such items of cost include:

(i) use charges for fully depreciated assets (ASPR 15-204.2(i)(6));

(ii) food and dormitory service furnished without cost to employees or involving significant losses (ASPR 15-204.2(n));

(iii) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii));

(iv) pre-contract costs (ASPR 15-204.2(dd));

(v) research and development costs (ASPR 15-204.2(ii)(6));

(vi) royalties (ASPR 15-204.2 (jj));

(vii) selling and distribution costs (ASPR 15-204.2(kk)(2)); and

(viii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)).

(c) Selected items of cost are considered in ASPR 15-204.2. However, ASPR 15-204.2 does not cover every element of cost and every situation that might arise in a particular case. Failure to treat any item of cost in ASPR 15-204.2 is not intended to imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related selected items.

15-204.2 Selected Costs.

(a) Advertising Costs.

(1) Advertising costs include the cost of advertising media and corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, trade papers, outdoor advertising, dealer cards and window displays, conventions, exhibits, free goods and samples, and sales literature. The following advertising costs are allowable:

(i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in journals which are valuable for the dissemination of technical information within the contractor's industry; and

(ii) help wanted advertising, as set forth in (gg) below, when considered in conjunction with all other recruiting costs.

(2) All other advertising costs are unallowable.

(b) Bad Debts. Bad debts, including losses (whether actual or estimated) arising from uncollectible customers' accounts and other claims, related collection costs, and related legal costs, are unallowable.

(c) Bidding Costs. Bidding costs are the costs of preparing bids or proposals on potential Government and non-Government contracts or projects, including the development of engineering data and cost data necessary to support the contractor's bids or proposals. Bidding costs of the current accounting period of both successful and unsuccessful bids and proposals normally shall be treated as indirect costs and allocated currently to all business of the contractor, in which event no bidding costs of past accounting periods shall be allocable in the current period to the Government contract; however, the contractor's established practice may be to treat bidding costs by some other recognized method. Regardless of the method used, the results obtained may be accepted only if found to be reasonable and equitable.

(d) Bonding Costs.

(1) Bonding costs arise when the Government requires assurance against financial loss to itself or others by reason of the act or default of the contractor. They arise also in instances where the contractor requires similar assurance. Included are such

bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

(2) Costs of bonding required pursuant to the terms of the contract are allowable.

(3) Costs of bonding required by the contractor in the general conduct of his business are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

(e) Civil Defense Costs:

(1) Civil defense costs are those incurred in planning for, and the protection of life and property against, the possible effects of enemy attack. Reasonable costs of civil defense measures (including costs in excess of normal plant protection costs, first-aid training and supplies, fire fighting training and equipment, posting of additional exit notices and directions, and other approved civil defense measures) undertaken on the contractor's premises pursuant to suggestions or requirements of civil defense authorities are allowable when allocated to all work of the contractor.

(2) Costs of capital assets under (1) above are allowable through depreciation in accordance with (i) below.

(3) For contributions to local civil defense funds and projects, see (h) below.

(f) Compensation for Personal Services.

(1) General. a. Compensation for personal services includes all remuneration paid or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages,

directors' and executive committee members' fees, bonuses, incentive awards, employee stock options, fringe benefits, and contributions to pension, annuity, stock-bonus and profit-sharing plans. Except as otherwise specifically provided in this paragraph (f), such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered.

b. Compensation is reasonable to the extent that the total amount paid or accrued, is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. Compensation will be particularly scrutinized to determine whether the compensation is reasonable in amount and is for actual personal services, rather than a distribution of profits, when paid (i) to owners of closely-held corporations, (ii) to partners and sole proprietors, (iii) to members of the immediate families of persons within (i) and (ii), above, or (iv) to persons who are committed to acquire a substantial financial interest in the contractor's enterprise. In addition, compensation expenses must be particularly scrutinized in light of the presence or absence of the restraints occurring in the conduct of competitive business.

c. Compensation for services rendered paid to partners and sole proprietors in lieu of salary will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.

d. In addition to the general requirements set forth in a through c above, certain forms of compensation are subject to further requirements as specified in (2) through (11) below.

(2) Salaries and Wages. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and are allowable subject to the qualifications of (y) below.

(3) Cash Bonuses and Awards. Cash bonuses, suggestion awards, and safety awards, based on production, cost reduction, or efficient management or performance, are allowable to the extent paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment.

(4) Bonuses and Incentive Compensation Paid in Stock. Costs of bonuses and incentive compensation paid in the stock of the contractor or of an affiliate are allowable to the extent set forth in (3) above (including the incorporation of the principles of paragraph (7) below for deferred bonuses and incentive compensation), subject to the following additional requirements:

(i) valuation placed on the stock shall be the fair market value, determined upon the most objective basis available; and

(ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (7)c. below. (But see ASPR 15-204.1 (b).).

(5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate are unallowable.

(6) Profit Sharing Plans. For purposes of these principles, profit

sharing plans are divided into two types, namely, immediate payment plans and deferred distribution plans. Immediate payment plans include those which provide for payment (of the profits being distributed) to the individual officers and employees shortly after determination of the amount due to each rather than after a lapse of a stated period of years or upon the retirement, death or disability of the individual officers and employees. Deferred distribution plans include those which provide for payment (of the profits being distributed) into a separate bank account or fund usually under the control of a trustee, for disbursement to the individual officers and employees after a stated period of years or upon their retirement, death or disability. Profit sharing plan costs under plans of the immediate distribution type are unallowable. Profit sharing plan costs under plans providing for deferred distributions will be allowable, subject to the provisions of paragraph (7) below, only in those cases and to the extent the distributions of benefits are to be made upon or after retirement, disability or death of the covered officers and employees.

(7) Deferred Compensation. a. As used herein, deferred compensation includes all remuneration, in whatever form, for services currently rendered, for which the employee is not paid until after the lapse of a stated period of years or the occurrence of other events as provided in the plans, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension, annuity, stock bonus, and profit sharing plans, (ii) contributions to disability, withdrawal, insurance, survivorship, and similar benefit plans, and (iii) other deferred compensation, whether paid in cash or in stock.

b. Deferred compensation, including profit sharing plan costs allowable under (6) above, is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all

other compensation paid to the employee, reasonable in amount; (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payments; and (iv) for a plan which is subject to the Bureau of Internal Revenue, it falls within the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. (But see ASPR 15-204.1(b).)

c. In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible future abnormal forfeitures shall be effected according to the following rules:

(i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and

(ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the

contractor either as to an equitable adjustment or a method of determining such adjustment.

d. In determining whether deferred compensation is for services rendered during the contract period or is for future services, consideration shall be given to conditions imposed upon eventual payment, such as, requirements of continued employment, consultation after retirement, and covenants not to compete. Similar consideration should be given to the cost of past service credits of pension and annuity plans.

(8) Fringe Benefits. See (o).

(9) Overtime, Extra-Pay Shift and Multi-Shift Premiums. See (y).

(10) Training and Education Expenses. See (qq).

(11) Insurance and Indemnification. See (p).

(g) Contingencies.

(1) A contingency is a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at a present time.

(2) In historical costing, i.e., costing as related to past events or experience, contingencies are not allowable.

(3) In connection with estimates of future costs, contingencies fall into two categories:

(i) those which may arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy; e.g., anticipated costs of rejects and defective work; in such situations where they exist, contingencies of this category are to be included in the estimates of future cost so as to provide the best estimate of performance costs, and

(ii) those which may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation, and other general business risks. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately, including the basis upon which the contingency is computed in order to facilitate the negotiation of appropriate contractual coverage (see, for example, (p), (t), and (mm) below).

(h) Contributions and Donations. Contributions and donations are unallowable.

(i) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed:

(i) upon the property cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); or

(ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes, had such organizations been subject to the payment of income tax; and in either case

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, and subject to the limitations of the Internal Revenue Code of 1954, including --

(A) the straight line method;

(B) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in (A) above;

(C) the sum of the years-digits method; and

(D) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the use of the property and including the current year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in (B) above.

(3) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(4) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation" or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board. The method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof for both the emergency period and the post-emergency period shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

(i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (5) below); provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(5) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(6) No depreciation, rental, or use charge shall be allowed on the contractor's assets which have been fully depreciated when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against Government contracts or subcontracts. Otherwise, a

mutually agreed upon use charge may be allowed. (But see ASPR 15-204.1(b).) In determining this charge, consideration should be given to cost, total estimated useful life at time of negotiation, and effect of any increased maintenance charges or decreased efficiency due to age.

(j) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, recreational activities, and employee counseling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to

all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(k) Entertainment Costs. Costs of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see (j) and (pp)).

(l) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(m) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(n) Food Service and Dormitory Costs and Credits. Food and dormitory services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations or similar types of services for the contractor's employees at or near the contractor's facilities. Reasonable losses from the operation of such services are allowable if they are allocated to all activities served. Where it is the policy of the contractor to operate such services without cost to the employee, reasonable costs of such operations are allowable if they are allocated to all activities served. (But see ASPR 15-204.1(b).) Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for

the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated to all activities served.

(o) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, employee insurance and supplemental employment benefit plans, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor.

(p) Insurance and Indemnification.

(1) Insurance includes (i) insurance which the contractor is required to carry, or which is approved, under the terms of the contract, and (ii) any other insurance which the contractor maintains in connection with the general conduct of his business.

a. Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

b. Costs of other insurance maintained by the contractor in connection with the general conduct of his business are allowable subject to the following limitations:

(i) types and extent of coverage shall be in accordance with sound business practice and the rates and premiums shall be reasonable under the circumstances;

(ii) costs allowed for business interruption or other insurance shall be limited to exclude coverage of profit, interest, and any other items of cost unallowable under this Part;

(iii) costs of insurance or of any contributions to any reserve covering the risk of loss of or damage to Government-owned property are allowable only to the extent that the Government shall have required or approved such costs;

(iv) contributions to a reserve for an approved self-insurance program are allowable to the extent that the types of coverage, extent of coverage, and the rates and premiums would have been allowed had insurance been purchased to cover the risks; and

(v) costs of insurance on the lives of officers, partners, or proprietors are allowable to the extent that the insurance represents additional compensation (see (f) above).

c. Actual losses which could have been covered by permissible insurance (through an approved self-insurance program or otherwise) are unallowable unless expressly provided for in the contract, except;

(i) costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound business practice, are allowable; and

(ii) minor losses not covered by insurance, such as spoilage, breakage and disappearance of small hand tools, which occur in the ordinary course of doing business, are allowable.

(2) Indemnification includes securing the contractor against liabilities to third persons and other losses, not compensated by insurance or otherwise. The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract, except as provided in (1)c above.

(q) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and pro-

fessional fees paid in connection with the preparation of prospectuses, costs of preparation and issuance of stock rights, and costs related thereto, are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in (oo) below. (But see (x).)

(r) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities, are allowable.

(s) Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under cost-sharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable.

(t) Maintenance and Repair Costs.

(1) Costs necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see ASPR 15-204.2(i)):

(i) normal maintenance and repair costs are allowable;

(ii) extraordinary maintenance and repair costs are allowable, provided such are allocated to the periods to which applicable for purposes of determining contract costs. (But see ASPR 15-204.1(b).)

(2) Expenditures for plant and equipment which, according to generally accepted accounting principles as applied under the contractor's established policy, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(u) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with the following, are allowable:

(i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

(ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production.

(v) Material Costs.

(1) Material costs include the costs of such items as raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing material costs consideration will be given to reasonable overruns, spoilage, or defective work (for correction of defective work, see the provisions of the contract or proposed contract relating to inspection and correction of defective work). These costs are allowable subject, however, to the provisions of (2) through (5) below.

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to the cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts need not be so credited.

(3) Reasonable adjustments arising from differences between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided such adjustments (i) do not include "write-downs" or "write-ups" of values and (ii) relate to the period of performance of the contract.

(4) When the materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. If material is issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable. When estimates of material costs to be incurred in the future are required, either current market price or anticipated acquisition cost (if reasonably certain and determinable) may be used, but the basis of pricing must be disclosed.

(5) Costs of materials, services, and supplies sold or transferred between plants, divisions or organizations, under a common control, ordinarily shall be allowable to the extent of the lower of cost to the transferor or current market price. However, a departure from this basis is permissible where (i) the

item is regularly manufactured and sold by the contractor through commercial channels and (ii) it is the contractor's long-established practice to price inter-organization transfers at other than cost for commercial work; provided that the charge to the contract is not in excess of the transferor's sales price to its most favored customer for the same item in like quantity, or the current market price, whichever is lower.

(w) Organization Costs. Expenditures, such as incorporation fees, attorneys' fees, accountants' fees, brokers' fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (q) above).

(x) Other Business Expenses. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, normal proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies; and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

(y) Overtime, Extra Pay Shift and Multi-shift Premiums.

(1) This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Preferably such premiums should be separately identified and handled as indirect costs to be allocated to all work of the contractor. However, where it is the normal practice of the contractor to handle these premiums as direct costs, such practice is acceptable if it does not result in the Government absorbing a disproportionate share of costs. The same considerations govern their inclusion in or exclusion from the base for overhead

distribution. Such premiums, when allowable, shall be equitably allocated in light of (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(2) Overtime, extra pay shift and multi-shift premium expenses may arise in two distinct ways in connection with the contract: (i) by initial agreement between the contractor and the contracting officer that known conditions warrant the use of such premium labor; and (ii) to meet unexpected conditions or emergencies arising in the course of the contract, not contemplated by the contracting parties.

(3) The allowability of overtime, extra pay shift and multi-shift premiums will be determined as follows:

(i) to the extent that the contractor and the contracting officer initially agree that such premiums are necessary in view of known conditions, and the contracting officer so authorizes in writing, such costs are allowable; and

(ii) with respect to unexpected conditions or emergencies arising in the course of the contract, such costs are --

(A) unallowable if the contractor is already obligated to meet the contract delivery schedule without additional compensation therefor;

(B) allowable to the extent authorized in writing by the contracting officer, in the case of cost reimbursement type contracts; and

(C) allowable to the extent authorized in writing by the contracting officer prior to final pricing, in the case of fixed-price redeterminable or incentive type contracts.

(z) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. In accordance with the clauses of the contract relating to patents, costs of preparing documents and any other patent costs, in connection with the filing of a patent application where title is conveyed to the Government, are allowable. (See also (ii) and (jj) below.)

(aa) Pension Plans. See (f) above.

(bb) Plant Protection Costs. Costs of items such as (i) wages, uniforms, and equipment of personnel engaged in plant protection, (ii) depreciation on plant protection capital assets, and (iii) necessary expenses to comply with military security requirements, are allowable.

(cc) Plant Reconversion Costs. Plant reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same condition existing immediately prior to the commencement of the military contract work, fair wear and tear excepted. Reconversion costs are unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal.

(dd) Precontract Costs. Precontract costs are those incurred prior to the effective date of the contract directly pursuant to the negotiation and in anticipation of the award of the contract where such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract. (But see ASPR 15-204.1(b).)

(ee) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see (w) above).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

(i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;

(ii) the impact of Government contracts on the contractor's business (i.e., what new problems have arisen);

(iii) the nature and scope of managerial services expected of the contractor's own organizations; and

(iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(ff) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see (i) (2) above as to basis for depreciation).

(gg) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(hh) Rental Costs. (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement. Application of these factors involves comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(ii) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories for the purpose of contract costing -- (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below. Reasonableness of the cost should be determined in light of the pattern of the cost of past programs, particularly those existing prior to the placing of Government contracts.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production

engineering (see (1) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below, under any production contract to the extent that the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line. Such costs are unallowable under research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

(6) The reasonableness of expenditures for independent research and development must be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Where such expenditures are not subject to the restraints of commercial product pricing, there must be assurance that these expenditures are made pursuant to a planned research program which is reasonable in scope and is well managed. The costs should not exceed those which would be incurred by an ordinarily prudent person in the conduct of a competitive business. (See ASPR 15-204.1(b).)

(jj) Royalties and Other Costs for Use of Patents.

(1) Royalties on a patent or amortization of the cost of acquiring by purchase a patent or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable, unless:

(i) the Government has a license or the right to free use of the patent;

(ii) the patent has been adjudicated to be invalid, or has been administratively determined to be invalid;

(iii) the patent is considered to be unenforceable; or

(iv) the patent is expired.

(2) Special care should be exercised in determining reasonableness where the royalties may have been arrived at as a result of less than arm's length bargaining; e. g.:

(i) royalties paid to persons, including corporations, affiliated with the contractor;

(ii) royalties paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded; or

(iii) royalties paid under an agreement entered into after the award of the contract.

(3) Special care should also be exercised with respect to royalties paid to unaffiliated parties, including corporations, upon patents the cost of which, or the cost of research and development work thereon, were substantially recovered through Government grants or charges against Government contracts or subcontracts.

(4) In any case involving a patent formerly owned by the contractor, the amount of royalty allowed should not exceed the cost which would have been allowed had the contractor retained title thereto.

(5) See ASPR 15-204.1(b).

(kk) Selling Costs.

(1) Selling costs arise in the marketing of the contractor's products

and include costs of sales promotion, negotiation, liaison between Government representatives and contractor's personnel, and other related activities.

(2) Selling costs are allowable to the extent they are reasonable and are allocable to Government business (but see ASPR 15-204.1(b)). Allocability of selling costs will be determined in the light of reasonable benefit to the Government arising from such activities as technical, consulting, demonstration, and other services which are for purposes such as application or adaptation of the contractor's products to Government use.

(3) Notwithstanding (2) above, salesmen's or agents' compensation, fees, commissions, percentages, or brokerage fees, which are contingent upon the award of contracts, are allowable only when paid to bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business.

(11) Service and Warranty Costs. Such costs include those arising from fulfillment of any contractual obligation of a contractor to provide services, such as installation, training, correcting defects in the products, replacing defective parts, making refunds in the case of inadequate performance, etc. When not inconsistent with the terms of the contract, such service and warranty costs are allowable. However, cate should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

(mm) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

(i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and

(ii) abnormal or mass severance pay is of such a conjectural nature that measurement of cost by means of an accrual will not achieve equity to both parties. Thus accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, allowability will be considered on a case-by-case basis in the event of occurrence.

(nn) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special

taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts, is allowable and shall be allocated to the specific Government contract or contracts.

(oo) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see (q));

(iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and

(iv) special assessments on land which represent capital improvements.

(2) Unadjudicated taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

(i) promptly requests instructions from the contracting officer concerning such taxes; and

(ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such action undertaken by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to assure timely direction after prompt request therefor, are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government, provided any interest actually paid or credited to a contractor incident to a refund of tax, interest or penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, or penalties.

(pp) Trade, Business, Technical and Professional Activity Costs.

(1) Memberships. This category includes costs of memberships in trade, business, technical, and professional organizations. Such costs are allowable.

(2) Subscriptions. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

(3) Meetings and Conferences. This item includes cost of meals, transportation, rental of facilities for meetings, and costs incidental

thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or stimulation of production. Such costs are allowable.

(qq) Training and Educational Costs.

(1) Costs of preparation and maintenance of a program of instruction at noncollege level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

(i) salaries of the director of training and staff when the training program is conducted by the contractor; or

(ii) tuition and fees when the training is in an institution not operated by the contractor;

are allowable.

(2) Costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, including only:

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

(iv) tuition charged by the educational institution, or in lieu of tuition, instructors' salaries and the related share of indirect cost of the educational institution to the extent that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution; and

(v) straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours;

are allowable.

(3) Costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with fulltime scientific and engineering education at a post-graduate (but not under-graduate) college level related to the job requirements of bona fide employees for a total period not to exceed one school year for each employee so trained, are allowable. In unusual cases where required by military technology, the period may be extended.

(4) Maintenance expense, and normal depreciation or fair rental, on facilities owned or leased by the contractor for training purposes are allowable to the extent set forth in (t), (i), and (hh) above, respectively.

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see (h) above).

(rr) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. These costs are allowable. When such costs can readily be identified with the items involved, they may be drected costed as transportation costs or added to the cost of such items (see (v) above). Where identification with the materials received cannot readily be made, inbound transportation

costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent, equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(ss) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs may be based upon actual costs incurred, or on a per diem or mileage basis in lieu of actual costs, or on a combination of the two, provided the method used does not result in an unreasonable charge.

(3) Travel costs incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(4) Travel costs directly attributable to specific contract performance are allowable and may be charged to the contract in accordance with the principle of direct costing (See ASPR 15-202).

(5) Necessary, reasonable costs of family movements and personnel movements of a special or mass nature are allowable, subject to allocation on the basis of work or time period benefited when appropriate. (But see ASPR 15-204.1(b).)

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Schedule A

Areas In Which There is Failure to Recognize True Costs in Whole or in Part

15-204.2 (a)	1.	Advertising Costs
(b)	2.	Bad Debts
(d)	3.	Civil Defense Costs
(f)(3)	4.	Compensation for Personal Services - Bonuses Other Than Cost
(4)	5.	" " " " - Payments in Stock
(5)	6.	" " " " - Stock Options
(6)	7.	" " " " - Profit Sharing Plans
(7)	8.	" " " " - Deferred Compensation including Pension and Profit Sharing Plans
(g)	9.	Contingencies
(h)	10.	Contributions and Donations
(i)(4)(ii)	11.	Depreciation - Unrecovered True Depreciation
(5)	12.	" - Idle or Excess Facilities
(6)	13.	" - Use Charge on Fully Depreciated Assets
(k)	14.	Entertainment
(l)	15.	Excess Facility Costs
(n)	16.	Food Service and Dormitory Costs and Credits
(p)(1)b(ii)	17.	Insurance and Indemnification - Business Interruption
(1)b(iii)	18.	" " " - Government Owned Property
(1)c	19.	" " " - Losses Not Covered
(2)	20.	" " " - Indemnification
(q)	21.	Interest and Other Financial Costs
(s)	22.	Losses on Other Contracts
(t)(1)(ii)	23.	Maintenance and Repair Costs - Deferred
(v)(2)	24.	Material Costs - Credits
(3)	25.	" " - Write-Downs or Write-Ups
(5)	26.	" " - Interdivisional Transfers
(w)	27.	Organization Costs
(y)(3)(ii)	28.	Overtime, Extra Pay Shift and Multi-Shift Premiums
(z)	29.	Patent Costs
(cc)	30.	Plant Reconversion Costs
(dd)	31.	Precontract Costs
(ee)(1)	32.	Professional Service Costs - Contingency on Reasonableness
(3)	33.	" " " - Successful & Unsuccessful Claims
(gg)	34.	Recruiting Costs
(hh)(1)	35.	Rental Costs - Excess over Ownership
(2)	36.	" " - Interdivisional
(3)	37.	" " - Sale and Leaseback
(ii)(2)	38.	Research and Development Costs - Limited to Past Pattern
(3)	39.	" " " " - Limited to Production Contracts
(5)	40.	" " " " - Precontract Costs
(6)	41.	" " " " - New Test of Allowability

Schedule A (Continued)

15-204.2 (jj)(1)	42.	Royalties and Other Costs for Use of Patents - C.O. Determination of Invalidty or Unenforceability
(3)	43.	" " " " " " " " - Unaffiliated Parties
(4)	44.	" " " " " " " " - Patents Formerly Owned
(kk)(2)	45.	Selling Costs
(mm)(2)	46.	Severance Pay
(pp)(3)	47.	Trade, Business, Technical & Professional Activity Costs
(qq)(2)	48.	Training and Educational Costs - Limitation of Hours
(3)	49.	" " " " - No salary allowance; time limit.
(4)	50.	" " " " - Limitation on maintenance, depreciation and rents.
(5)	51.	" " " " - Grants
(ss)(5)	52.	Travel Costs - Allocable to period benefited.

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Schedule B

Areas in Which Specific Contractual Coverage or Authorization is Required

15-204.2	(f)(4)	1.	Compensation for Personal Services
	(7)b	2.	" " " "
	(g)	3.	Contingencies
	(i)(6)	4.	Depreciation
	(n)	5.	Food Service and Dormitory Costs and Credits
	(p)(1)c	6.	Insurance and Indemnification
	(p)(2)	7.	" " "
	(t)(1)(ii)	8.	Maintenance and Repair Costs
	(y)(3)	9.	Overtime, Extra Pay Shift and Multi-Shift Premiums
	(z)	10.	Patent Costs
	(dd)	11.	Precontract Costs
	(ee)(3)	12.	Professional Service Costs
	(hh)(3)	13.	Rental Costs
	(ii)(6)	14.	Research and Development Costs
	(jj)	15.	Royalties and Other Costs for Use of Patents
	(kk)(2)	16.	Selling Costs
	(ss)(5)	17.	Travel Costs

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Schedule C

Areas in Which Reference is Made to Lack of Competitive Restraint in Case of Government Contractors

15-201.3		1. Definition of Reasonableness
15-204.1	(b)	2. General
15-204.2	(f)(b)	3. Compensation for Personal Services
	(4)	4. " " " "
	(7)(b)	5. " " " "
	(i)(6)	6. Depreciation
	(n)	7. Food Service and Dormitory Costs and Credits
	(p)(1)c	8. Insurance and Indemnification
	(p)(2)	9. " " "
	(t)(1)(ii)	10. Maintenance and Repair Costs
	(y)(3)	11. Overtime, Extra Pay Shift and Multi-Shift Premiums
	(z)	12. Patent Costs
	(dd)	13. Precontract Costs
	(ee)(3)	14. Professional Service Costs
	(hh)(3)	15. Rental Costs
	(ii)(6)	16. Research and Development Costs
	(jj)	17. Royalties and Other Costs for Use of Patents
	(kk)(2)	18. Selling Costs
	(ss)(5)	19. Travel Costs

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Schedule D

Areas Dictating Accounting System to be Employed and/or Constituting Audit Manual Approach

15-202	(a)	1. Direct Costs
	(b)	2. " "
15-203	(b)	3. Indirect Costs
	(d)	4. " "
	(e)	5. " "
15-204.2	(d)	6. Bidding Costs
	(e)(1)	7. Civil Defense Costs
	(f)(4)	8. Compensation for Personal Services
	(7)	9. " " " "
	(i)(4)	10. Depreciation
	(j)	11. Employee Morale, Health, and Welfare Costs and Credits
	(t)	12. Maintenance and Repair Costs
	(v)	13. Material Costs
	(y)	14. Overtime, Extra Pay Shift and Multi-Shift Premiums
	(ee)	15. Professional Service Costs
	(ii)(2)	16. Research and Development Costs
	(3)	17. " " " "
	(4)	18. " " " "
	(5)	19. " " " "
	(jj)(2)	20. Royalties and Other Costs for Use of Patents
	(3)	21. " " " " " " " "
	(4)	22. " " " " " " " "
	(kk)(2)	23. Selling Costs
	(oo)(3)	24. Taxes
	(rr)	25. Transportation Costs
	(ss)(5)	26. Travel Costs

NATIONAL SECURITY INDUSTRIAL ASSOCIATION APPENDIX I

Comments on DOD Proposed Revision of Section XV
Comprehensive Contract Cost Principles
(Draft of September 10, 1957)

15-000 Scope of Section

References in this section should be limited to the determination of historical costs, and to review, audit, and evaluation of cost data. It should not govern the preparation and presentation of cost estimates by contractors nor should it be controlling in negotiation of price.

15-100 Scope of Part

The references to "contracting and subcontracting", when read with Sections 15-101 and 15-200 indicate that the cost principles are intended to apply to all prime contracts and subcontracts other than those with non-profit institutions and construction and facilities contracts. Use of the section should be limited to those prime contracts and subcontracts under which the Government has the right of audit review.

15-101 Applicability of Part 2

5-101(a)(i)(B) This section needs clarification to indicate that it will come into play in a terminated fixed-price contract only after the negotiation required under ASPR Section VIII has failed and settlement is therefore to be made by determination.

15-101(a)(ii) The wording should be changed to read "serve as a guide only for --". It is inappropriate for any listing of allowable and unallowable costs to be the basis for pricing negotiations.

15-101(a)(ii)(A) This subparagraph should be deleted in its entirety and the section should not control "the development and submission of cost data and price analyses by contractors". Such data and analyses should be developed in accordance with the contractor's established accounting system. To do otherwise would necessitate changing established and accepted accounting systems, which would be costly to both the contractor and the Government and would produce chaotic conditions.

15-101(a)(ii)(B) This section should not apply to progress payments or settlements of termination claims by agreement.

15-101(a)(ii)(C) This subparagraph should be deleted in its entirety. No set of allowable or unallowable costs which fails to recognize the normal and legitimate costs of doing business can be accepted as the basis for resolving questions of acceptability of specific items of cost in retrospective pricing.

101(a)(iii) Delete for the reasons stated above.

SIA Comments on Contract Cost Principles

-101(b) Use in Retrospective Pricing and Settlements

The references in the second sentence to using part 2 as the basis for the development of cost data and for the resolution of questions of acceptability should be removed for reasons stated above. At most, the section should be used only as a guide for the evaluation of cost data.

15-101(c) Use in Forward Pricing

The same references should be eliminated from this section for the same reasons.

15-101(d) "Allowable" and "Unallowable" in Connection with Fixed-Price Type Contracts

No normal and legitimate items of cost should be considered either "unallowable" or "unacceptable" in fixed-price contracting.

15-200 Scope of Part

This section should be clarified to indicate that the part does not apply to fixed-price type contracts or to subcontracts under which the Government does not have the right of Government review. Actually, in fixed-price contracts costs are not subject to "determination", rather price is negotiated. As to subcontracts, clearly there would be no right on the part of the Government to assert the section as against a subcontractor because there is no privity of contract. Accordingly, its application, of necessity, would be limited to those subcontracts on which the government has a right of audit review.

15-201.1 Composition of Total Cost

This section can be applied only to cost-reimbursement type contracts and it should be so stated.

15-201.2 Factors Affecting Allowability of Costs

This paragraph should be modified to delete from (iii) the words "appropriate to the particular circumstances". The application of generally accepted accounting principles and practices should be consistent and should not be modified to particular circumstances. Similarly, factor (iv) should be deleted. Where deviations from established practices are made, they should be justified and approved and should not effect the allowability of individual cost items.

15-201.3 Definition of Reasonableness

The second sentence should be deleted. The assumption that companies are not subject to competitive restraints because of preponderance of their business is with the Government is fallacious. It is also felt

15-201.3 Definition of Reasonableness (Continued)

that the definition of reasonableness, as contained in this entire paragraph, is not a true or valid definition. The reasonableness of specific items of cost should be tested against such factors as the established policies and practices of the contractor, the prior experience of the contractor, and the prevailing level of comparative types of cost in similar concerns or in indurstry in general. Any cost should be presumed reasonable, unless it is patently unreasonable as to type or amount when measured by applying the factors mention above.

15-201.4 Definition of Allocability

At the end of (i) there should be added the word "or" to clearly indicate that the three provisions are alternative. It is also suggested that there be inserted at the beginning of (ii) the words "is of a nature which".

15-201.5 Credits

In the first line, the words "actual or anticipated" should be deleted. Otherwise, the Government would be entitled to a double credit; once when the credit was anticipated, secondly, when it was actually received.

15-202 Direct Costs

Subparagraph (a) - Direct costs may be incurred for the benefit of a single cost objective or a group of objectives when such costs can reasonably be directly allocated thereto. The first sentence should be revised accordingly. The third sentence of subparagraph (a) should be deleted because it would require changes in any presently accepted accounting systems which produce reasonable results and should be permitted. Subparagraph (b) should be rewritten to provide flexibility. As stated, it doesn't fit processed cost systems, and the established accounting practice should be acceptable if it achieves reasonable results.

15-203 Indirect Costs

Subparagraph (b) is considered to be restrictive and could be interpreted by field personnel to permit dictation of the accounting system to be employed. In this instance also established methods of allocation should not be disturbed when reasonable results are obtained.

Similarly, in subparagraph (d) the material after the third sentence should be deleted.

In paragraph (e) there should not be a requirement that the base period must necessarily represent the exact period of contract performance. The base period should be sufficiently long to avoid inequities and should be established at the contractor's discretion as long as the results are reasonable.

TIA Comments on Contract Cost Principles

-204	Application of Principles and Standards
-204.1(a)	This paragraph should be recast in the affirmative to indicate that costs are allowable to the extent they are reasonable.
.5-204.1(b)	This paragraph should be deleted in its entirety. The allocability of costs incurred incident to the performance of a contract or in the normal operation of the contractor's business should not be contingent upon the ability of individual contractors to specifically negotiate their allowance into individual contracts. See paragraphs 20 - 23 of the letter of transmittal.

National Security Industrial Association
Comments on Selected Costs Section of
Proposed DOD Comprehensive Contract Cost Principles
(Draft of September 10, 1957)

15-204.2 Selected Costs

(a) Advertising Costs

The draft of this paragraph fails to properly recognize legitimate advertising expenses which contribute substantially to the contractor's ability to perform and which should be allowable to the extent allocable to Government business.

Industry and the accounting profession generally, from World War II to the present, have repeatedly emphasized that normal advertising costs are necessary in the conduct of business and that the benefits resulting therefrom accrue to all lines of the business and all customers. The benefits derived from sound advertising are not limited to stimulating sales. In fact, more important objectives, such as prestige, purchasing power, recruitment of high calibered personnel, pride of workmanship and integrity of product are essential realizations, particularly from advertising of an institutional nature.

In addition to the advertising costs allowed by the draft, it is a minimum need of contractors that the Government assume its share of reasonable and allocable costs of exhibits, product advertising, general (institutional) advertising, and employment advertising (not merely "help-wanted"). The Government should especially allow the costs of exhibits requested by it, such as at military display areas, small business opportunity exhibits, etc.

SIA Comments on Selected Costs Section

9-204.2 Selected Costs

(b) Bad Debts

Contractors sustain many types of credit losses as the result of handling Government business. These losses include uncollectible debt balances against vendors and customers on Government work, disallowed freight claims, advances to employees, etc.. Such losses should obviously be construed as allowable costs.

Recently, the Army has instituted new procedures which can result in credit loss to a contractor. We refer to Army Procurement Procedure Change 32 which requires a prime contractor to pay the invoices of CPFF subcontractors prior to Government audit. The post audit can result in disallowed subcontractor costs which are not recoverable by prime contracts. Credit losses from this and similar causes are a Government responsibility and should be borne by the Government. We also think the Government should provide for costs of collection in cases of "slow pay" borne by a contractor as a result solely of Government action.

(c) Bidding Costs

This Paragraph as written does not recognize all costs incidental to the preparation of bids and proposals or assure in the last sentence that all costs shall be allowable if reasonable. Therefore, the words "and other costs" should be inserted following "cost data" in the first sentence; also in the last sentence the words "only" and "equitable" might be interpreted to impose undue restrictions on the allowability of this class of expenses and should be deleted. The word "may" should be changed to "shall".

(d) Bonding Costs

No comment.

NSIA Comments on Selected Costs Section

-204.2 Selected Costs

(e) Civil Defense Costs

(1) This sub-paragraph contains three phrases which are too restrictive and should be deleted.

(a) The phrase "undertaken on the contractor's premises" should be eliminated since company sponsored civil defense training often occurs away from company owned areas.

(b) The phrase "pursuant to suggestions or requirements of civil defense authorities" should be eliminated since a contractor's judgment of necessary civil defense measures should not be questioned if such costs are reasonable. Cost principles should not destroy the prerogative of management.

(c) The phrase "when allocated to all work of the contractor" dictates the accounting system of the contractor and, as it clearly takes an audit manual approach, should be deleted.

(2) No comment.

(3) The reference in this sub-paragraph to "(h) below" makes it clear that contributions to local civil defense funds and projects are unallowable. Notwithstanding the provisions of paragraph (h) such costs should be allowable as Civil Defense Costs and not as contributions.

Contributions to local civil defense funds and projects are an unavoidable cost of conducting business in a community. The contractor has an obligation in the public and national interest to assist in civil defense measures which are not limited to the contractor's premises, and which may include contributions of funds, equipment and personnel. There is more definitely an obligation if the contractor is a prominent industry in the community. The benefits resulting from such participation accrue to all customers and products of the contractor and should be allowable costs allocable proportionately to Government as well as other business.

SIA Comments on Selected Costs Section

5-204.2 Selected Costs

(f) Compensation for Personal Services

This particular section on Compensation for Personal Services is one of the most objectionable areas in the entire draft. Instead of allowing compensation subject to the test of reasonableness of the total compensation for the services rendered, the proposal departs radically from this concept and would subject total compensation to numerous other factors which would have the effect of inquiring into and rejecting certain specific elements or methods of compensation. In effect the proposal would substitute the judgment of Government personnel for the judgment of management of industrial concerns in determining the methods used in compensating employees. This approach is completely at variance with generally accepted accounting principles and practices which have always regarded any form of compensation for personal services rendered by employees as an ordinary and necessary cost of doing business. This has also been recognized consistently by the Internal Revenue Code as well as under various regulations and court decisions.

The allowability of compensation paid individuals for Government contract cost purposes should be tested only by the reasonableness of the total compensation paid in the light of services rendered. The manner in which the compensation is determined or paid is a matter of management judgment which the Government should not question or attempt to usurp. Where the total compensation is reasonable and necessary to attract and retain capable personnel, it should be allowable. The presumption of reasonableness should be accepted unless the cost is patently unreasonable as to type or amount. Prior to making a determination of unreasonableness the contractor should be given the opportunity to submit data sustaining the cost. The burden of proof should be regarded as having been made if the evidence submitted sustains the reasonableness of the cost and unless proof to the contrary is established by the Government.

The proposed section completely fails to recognize that over the years a number of definite techniques have been developed for arriving at the total compensation of individuals. These techniques which are widely employed by different contractors today, include bonuses and incentive plans, profit sharing plans, retirement and pension plans, insurance programs, deferred compensation contracts and stock option programs. These programs generally have been adopted with an emphasis on incentive features and the selection of the particular plans has been dictated by the needs of the business and by variations in the complexity, volume, and other aspects of the business. Adoption of such plans provide stability in basic salaries while offering flexibility and incentive for stimulating efficiency in meeting production schedules, maintaining high standards of quality, and keeping operating costs within budgets. All of these results have been of a very real and direct benefit to the Government.

12/16/57

NSIA Comments on Selected Costs Section

5-204.2 Selected Costs

(f) Compensation for Personal Services (continued)

In its treatment of specific elements of total compensation the proposed section contains provisions which in their application would, of necessity, be arbitrary, discriminatory and wholly inequitable as between contractors. It would discriminate particularly against contractors having a preponderance of Government business on the fallacious presumption that they are not subject to competitive restraints and therefore their costs are subject to particular scrutiny which could lead only to arbitrary disallowances.

Therefore paragraphs (2) through (11) should be deleted in entirety with corresponding deletion of cross references contained in subparagraph (1). The resulting paragraph (1) would then contain an adequate description of the economic (and reasonable) compensation cost which a contractor is entitled to recover.

A few of the objections to the paragraphs are stated below:

(1) a This paragraph would make certain elements of compensation subject to restrictions imposed by paragraph (f) and therefore the reference "Except as otherwise specifically provided in paragraph (f)" should be deleted. With this correction and the additional test contained in the first sentence of paragraph (b) adequate tests are existent for determining the allowability or acceptability of compensation.

(1) b The last sentence of this paragraph (b) should be deleted because of the fallacious presumption that certain contractors are not subject to competitive restraints. Our objections to this are set forth fully in the transmittal letter.

(1) c No comment.

(1) d This paragraph should be deleted in its entirety since it relates to the further requirements as specified in (2) through (11) below which also should be deleted in entirety.

(2) No comment.

(3) This paragraph limits bonuses and awards to the cash type and fails to recognize bonuses which may be paid in other forms. Moreover, suggestion awards and safety awards should not be includable in total compensation against which the reasonableness test is applied since such items are not considered compensation for personal services but are normal allowable business expenses. Also the terminology "pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment" could lead to disagreement as to its meaning and should be deleted.

15-204.2 Selected Costs

(f) Compensation for Personal Services (continued)

(4) This paragraph, which is limited to bonuses and incentive compensation paid in stock, would subject such costs to the tests set forth in paragraph 7 as well as to the provisions of paragraph 15-204.1 (b) which could only lead to disallowances in most cases. The applications of these tests is inequitable for reasons stated above and in the transmittal letter.

(5) The cost of stock options which can be measured by several acceptable methods is very clearly an element of compensation and should be allowable. The issuance of stock options to key employees of corporate management is an accepted business practice and is used as an inducement for such employees to stay in continuous service in their businesses and to share in the corporate successes achieved. It is recognized as a legitimate business expense and should be allowed as an expense of doing business under Government contracts.

(6) This paragraph contains the inference that a profit sharing plan is a distribution of profits. This inference is incorrect. Such plans provide a part of total compensation essential to attract and retain managerial talent under present day conditions. The amounts credited to employees under a profit sharing plan are necessary costs to a company measured by its financial performance. Once a plan has been adopted, liability for the incurrence and payment of these costs is fixed and unavoidable. Accordingly, contributions to such plans are in no economic sense profits but are compensation and should be allowable whether the plan is an immediate payment or a deferred distribution one. The third sentence of this paragraph states the events which result in distributions under deferred profit sharing plans. This fails to recognize "termination of employment" as well as the events of retirement, death or disability.

(7) This paragraph contains the inference that certain conditions typical of deferred compensation plans would result in disallowed costs which is unacceptable. For example subparagraph (a) would not recognize "normal end of accounting period accruals"; (b) contains the parenthetical reference to paragraph 15-204.1 (b) which is highly objectionable for reasons stated in the transmittal letter. In addition, this subparagraph would apply additional and unwarranted tests for determining the allowability of deferred compensation. Such tests should be limited to reasonableness in amount and whether a plan has been approved by the Internal Revenue Service. If the plan is an approved one it should not be questioned. Subparagraph (c) would require forfeitures to be taken into consideration in determining deferred compensation costs currently allocable

5-204.2 Selected Costs

(f) Compensation for Personal Services (continued)

(7) (continued)

and would require that a distinction be made between possible future abnormal forfeitures which are immediately forseeable and those which are not. The effect of forfeitures under deferred compensation plans is so infinitesimal in relation to total contract costs and so small in dollar amount as to make it unwise to require any special agreements regarding them. It would be much easier to administer a policy which would merely call for their being taken into account in determining currently allocable cost. Subparagraph (d) contains provisions which are inconsistent with deferred profit sharing plans and in any event contributions to an approved and irrevocable plan should be recognized.

NSIA Comments on Selected Costs Section

3-204.2 Selected Costs

(g) Contingencies

Although this Paragraph recognizes as allowable any contingency reserves arising from presently known or existing conditions which have frequently been considered by auditors to be unallowable contingencies, the Paragraph should contain general language making allowable an accrual for any true liability when the only element of uncertainty is the time of payment or the definite amount of payment. As to the latter, reasonable accrual should be permitted. In other words, where a definite liability is accruing the cost should be recognized and accepted in reasonable amount. A cost should not be considered contingent if there is little doubt as to the existence of the liability.

(1) No comment.

(2) This sub-paragraph should be revised to provide that contingencies are allowable if the liability is admitted and the only question open is the amount of the contingency and the time at which it must be paid. It is commonplace that the costs of past performance cannot be known at some historical costing point. For example, there may be in process union contract wage negotiations, the result of which will be applied retroactively. It is essential that historical costs include an estimate of the effect of future events.

(3) No comment.

[A Comments on Selected Costs Section

-204.2 Selected Costs

(h) Contributions and Donations

The flat disallowance of all contributions and donations is very inequitable. The accounting profession, the Internal Revenue Service and industry in general have long recognized that charitable contributions and donations are necessary and recurring costs of doing business. It is inherently essential under the country's economic system that support of charitable and philanthropic organizations must be borne by the people and a substantial portion of this cost burden must be borne by business enterprises. An impelling civic obligation to the local and national community makes it mandatory for industry to contribute to these causes. These contributions augment good public relations, aid in the development of technical education and scientific research, and are essential for the public welfare. The cost of these contributions are properly allocable to the cost and price of goods and services sold. It is equitable that Government business should bear its fair share of such costs. The Armed Services Board of Contract Appeals has ruled that contributions to recognized charitable agencies, when an established practice of the contractor, are acceptable as an ordinary business expense.

The present atmosphere and environment on the need for scientific training and for additional scientific educational institutions, makes it wise and desirable that the Government support contributions made to the proper institutions of learning. This should include grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships which are specifically disallowed under Paragraph (qq) (5). The tests of reasonableness and allocability provide adequate tests for the determination of allowability.

NSIA Comments on Selected Costs Section

-204.2 Selected Costs

(i) Depreciation

(1) This paragraph is unacceptable since it implies non-recognition of provisions for obsolescence and would make mandatory adjustments of costs of assets for residual values even though recognition may have been given to such factors in establishing depreciation rates.

(2) (i) This qualification should be deleted in its entirety. The test of subsequent item (iii) is fully adequate. The present wording would require, in many instances, minor corrections to restate property cost basis to a tax basis; these are frequently not known for many years because of open tax years.

(2) (ii) This qualification should be deleted in its entirety for the reasons stated above under (2) (i).

(2) (iii) No comment.

(3) No comment.

(4) The phrase in (4) (ii) reading "provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered 'true depreciation'" should be deleted. The contractor should be allowed to recover the full cost of all assets. This matter has been commented on at great length in letters previously submitted.

(5) This paragraph would limit depreciation on idle or excess facilities to the extent that such facilities are reasonably necessary for current and immediately prospective production. It should also recognize facilities reasonably necessary for stand-by purposes for Government work.

(6) The reference in this paragraph to ASPR 15-204.1 (b) should be deleted for the reasons stated in the transmittal letter. The words "a substantial portion of" in the first sentence should be deleted since these are unnecessarily restrictive.

(j) Employee Morale, Health and Welfare Costs and Credits

The last two sentences of this paragraph dictate the contractor's accounting system and should be deleted for the reasons set forth in the transmittal letter.

(k) Entertainment Costs

To the extent that expenses of a purely personal nature are paid by a contractor, it is appropriate that they be disallowed; however, many so-called "entertainment" costs are ordinary and necessary in today's business atmosphere. It is only appropriate that a realistic policy of the contractor in reimbursing an employee for such expenses be recognized, and costs incurred under such a policy be allowed.

SIA Comments on Selected Costs Section

5-204.2 Selected Costs

(l) Excess Facility Costs

It is felt that this paragraph should take a positive approach and provide that reasonable costs of maintaining, repairing, and housing idle and excess contractor-owned facilities be allowable. It is unreasonable and inequitable to limit allowability to those necessary for current and immediately prospective production purposes or to condition allowability on separate contractual coverage.

(m) Fines and Penalties

No comment.

(n) Food Service and Dormitory Costs and Credits

The reference to Paragraph 15-204.1 (b) should be deleted for reasons stated in the transmittal letter.

(o) Fringe Benefits

No comment.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(p) Insurance and Indemnification

(1) Paragraph b (ii) should be deleted as a contractor should be permitted to carry business interruption insurance at his discretion and having done so, the full premium paid should be allowable. Further, from a practical standpoint it is not possible to exclude profit, interest and unallowable cost items from standard insurance policies.

Paragraph b (iii) should provide that costs of insurance or of any contributions to any reserve covering the risk of loss of or damage to Government-owned property are allowable to the extent that the Government has not relieved the contractor of liability. Moreover, it is a usurpation of management prerogative to demand as a condition of allowability that the Government require or approve such insurance.

Paragraph c should be deleted in its entirety as it is another instance of the failure of the Government to recognize a true cost of doing business. This is discussed fully in the transmittal letter.

(2) It is recommended that this paragraph be deleted. It is logical to assume that normally both the Government and the contractor will desire to insure that adequate coverage is obtained. In the absence of negligence on the part of the contractor, indemnification by the Government against liabilities not compensated by insurance would therefore of necessity result from some totally unexpected occurrence which neither party could reasonably anticipate. For this reason, it is patently unfair to make the contractor responsible for insertion of express provisions to cover such contingencies when it is impossible to determine them in advance of their occurrence.

SIA Comments on Selected Cost Sections

5-204.2 Selected Costs

(q) Interest and Other Financial Costs

The case for the allowability of interest has frequently been presented by Industry to the Government in letters previously filed by this Association. We feel quite strongly that at least interest costs related to securing working capital which is to be used in the operation of the contractor's business should be acceptable as a cost to Government contracts and the Government should participate to the extent that such borrowing is required for the performance of Government contracts. As is well known, the recent funding problems of the Government and the current change in the regulations relating to progress payments and reimbursement of costs under the cost reimbursement type contracts has made it mandatory upon the contractor to increase the extent of borrowings.

Although it is recognized that the Government has stated increased borrowings will be recognized in negotiation of the contract fee or profit, this leaves the subject open to negotiation between Contracting Officers and contractors. In most instances, it is our belief that where individual negotiations are involved, the Government representative will not adequately recognize this factor. In addition, as a matter of equity, all contractors should be entitled to equal treatment in reimbursement of costs and the appropriate method of doing this is to make interest costs to Government contracts allowable.

(r) Labor Relations Cost

No Comment

(s) Losses on Other Contracts

This Paragraph should be revised to permit the allowability of losses or costs incurred under participating research and development contracts where it is intended. As written the paragraph is inconsistent with the Court of Claims decision in Bell Aircraft Corporation, v. U. S., 100 F. Supp. 661 (Ct. Cls. 1951) aff'd. per curiam, 344 U.S. 860 (1952), where a Government Contractor was allowed to capitalize losses on experimental contracts and allocate them as costs to other Government contracts.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(t) Maintenance and Repair Costs

(1) Sub-paragraph (ii) would limit the allowability of extraordinary maintenance and repair costs to the portion directly allocable to the period to which applicable for purposes of determining contract costs. This could result in the disallowance of deferred maintenance expenses allocable to precontract periods. This is a very inequitable treatment and such cost should be recognized in the period in which incurred. In any operating plant there is usually some element of deferred maintenance, and a combination of engineering and management skills is necessary if undue wear, plant breakdowns or other undesirable results are to be avoided. Management's decision as to when to repair is usually based on whatever action, or inaction, as to maintenance will produce a minimum effect on cost. Deferred maintenance arises from such causes as:

(a) Inability to close a plant or part thereof, or remove a machine for repair without interfering with a production schedule.

(b) The scheduling of periodic repair periods during which accumulated repairs and overhauls are made.

(c) The relatively high cost of overhauling a single item as compared with the collective overhaul of a group of items during or following an operating period.

(d) The lack of need for future efficiency as in the case of an item which is to be disposed of.

Moreover, it will be administratively difficult for military auditors and contracting officers to determine (a) deferred maintenance arising out of abnormal operating conditions and (b) when deferred maintenance has been delayed to a future period. It is believed that the retention of this provision in sub-paragraph (1) (ii) will cause an increase in the number of "costs questioned" and can only result in prolonged justification and argument and undue delay in settlement.

The reference to Sub-paragraph 15-204.1 (b) should be deleted for reasons stated in the transmittal letter.

(2) No Comment

(u) Manufacturing and Production Engineering Costs

No Comment

IA Comments on Selected Costs Section

3-204.2 Selected Costs

(v) Material Costs

(1) No comment.

(2) This paragraph would require adjustment for credits whether or not they are actually received. The last sentence also suggests that discounts lost by a contractor are to be credited to the Government. These provisions could be very unfair. A contractor should be required to exert diligence to take advantage of cash discounts, but it must be recognized that perfect performance in taking such discounts is seldom attainable.

(3) This paragraph excludes "write-downs" and "write-ups" of values and is inconsistent with generally accepted accounting principles and practices. It is also inconsistent with the requirement in paragraph (5) which requires interdivisional transfers to be made at the lower of cost or market.

In combination these two paragraphs would require the contractor to charge the Government less than cost for materials. It is difficult to justify this requirement in a statement which intends to describe the basis for charging cost. In this situation it would be preferable to allow market write-downs as cost in order to conform to generally accepted accounting principles and practices.

It is recognized industrial and commercial accounting practice to reduce the value of inventory for the effect of losses resulting from technological advances, engineering changes, defects, obsolescence, shelf wear and other causes; and to charge such losses to the cost of current operations. A proportionate share of such costs should be allowable on Government contracts by reasonable apportionment, such as allocation by product class and customer groups.

(4) This paragraph should be revised to provide that the cost basis should be in accordance with generally accepted accounting principles and practices. In shops where manufacturing is done on a project or program basis, material may be purchased specifically for and identifiable solely with a contract, but costs on the contract may be accumulated on the basis of standard costs adjusted for material price variation, rather than actual purchase cost for that particular lot of material or supplies. This paragraph as now worded makes it mandatory for the contractor to record purchase costs on a direct job order basis, even when this is not his established accounting practice.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(y) Overtime, Extra Pay Shift and Multi-shift Premiums

Extra pay shift premiums and multi-shift premiums differ in fundamental origin and nature from overtime premium and should be excluded from the same treatment as overtime premium. Moreover, the paragraph as written would subject these types of premiums to the same standards for approval of overtime premium which is inequitable and unnecessary. The practice of granting premium pay for unpopular multi-shift operations is a standard operating procedure; in fact, it is normally made a provision in union contracts. Therefore, a separate paragraph covering shift premiums should be inserted with the understanding that shift premiums are allowable if in accordance with the contractor's practices and procedures.

(1) The last sentence of this paragraph should be deleted since it dictates the accounting system of the contractor. This point is discussed fully in the transmittal letter. Moreover, the word "disproportionate" could be misinterpreted and it is suggested that the word "inequitable" be substituted.

(2) This paragraph should recognize a third category of overtime origin, namely administrative overtime which should be allowed without any specific approval requirement.

(3) This paragraph fails to recognize that authority higher than the contracting officer may authorize overtime.

For the above reasons, we believe that paragraphs (2) and (3) should be deleted in entirety. The provisions not only impose restrictions greater than those in the current DOD Directive 4105.48 but we also believe that the definition should not be written around such directive since it is only a temporary measure.

(z) Patent Costs

The wording of this paragraph is unduly restrictive inasmuch as it indicates that only those costs specifically mentioned are allowable. All costs leading to the issuance of patents as well as infringement, investigation and litigation should be regarded as allowable costs. In addition the last sentence adds two more restrictions (contract clause coverage and conveyance of title to the Government) which would limit allowable costs to those related to patent applications where title is conveyed to the Government; these are very inequitable.

(aa) Pension Plans

No comment.

(bb) Plant Protection Costs

No comment.

NSIA Comments on Selected Costs Section

1-205.2 Selected Costs

(v) Material Costs

(5) The requirement of this sub-paragraph that interdivisional sales or transfers be priced at the lower of cost or market is inequitable unless the write-down to market (replacement value) has been recognized as an allowable cost (see paragraph (3) above). Moreover, this paragraph states that a departure from the basis of the lower of cost or market is permissible where "(i) the item is regularly manufactured and sold by the contractor through commercial channels and (ii) it is the contractor's long established practice to price inter-organization transfers at other than cost for commercial work". It is impossible for both conditions under (i) and (ii) to exist concurrently and therefore the word "and" before (ii) should be changed to "or". The requirement that interdivisional pricing policy be "long established" is also inequitable since it would fail to recognize changed economic conditions.

There does not appear to be any provision which permits the transfer of components and parts between plants or shops at incurred shop cost without the necessity of determining whether that cost is lower than the current market price. When sufficient reasons exist, such as availability of material and parts required to meet schedules, quality of work and material, and other considerations, the contractor should not be forced to check the supplier market for cheaper prices. Ordinarily, except in cases of flagrant failure to protect the interests of the Government or deliberate abuse of responsibility, the judgment of the contractor as to sources of supply should be accepted if exercised in good faith.

(w) Organization Costs

All true costs of business must be recovered by a contractor in his business operations. Organization costs are no exception to this and should be allowable, if they are amortized on a reasonable basis.

(x) Other Business Expenses

No Comment

'SIA Comments on Selected Costs Section

5-204.2 Selected Costs

(cc) Plant Reconversion Costs

Costs of removing the contractor's facilities and the restoration or rehabilitation caused by such removal are legitimately as much a part of restoration costs as are similar costs occasioned by the removal of Government property. Both types of costs are due to the impact and discontinuance or diminution of Government business. There seems to be no valid reason why a distinction should be made between Government property and contractor property. Moreover, since such expenditures will not be made until some time after the completion and final settlement of the contracts which caused them, it is not realistic to limit allowability to costs incurred, which infers that only actual expenditures made during the period of contract performance will be allowed. It is quite obvious that it is not feasible to hold all contracts open until all expenditures are finally made, which may be a number of years after completion of Government work, especially where a number of successive contracts are involved. Reconversion costs determined and charged to current operations during the periods of contract performance on the basis of reasonably substantiated accruals should be allowable.

(dd) Precontract Costs

The limiting clauses "directly pursuant to the negotiation" and "where such incurrence is necessary to comply with the proposed contract delivery schedule" should be eliminated. The condition of allowability contained in the second sentence should be the only condition of allowability of cost of this nature.

The reference to ASPR 15-201.4 (b) should be deleted for the reasons given in the transmittal letter.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(ee) Professional Service Costs - Legal, Accounting, Engineering, and Other

(1) This paragraph would regard the costs of professional services rendered by members who are not employees of the contractor, as allowable "when not contingent upon recovery of the costs from the Government". This phrase should be deleted since adequate tests for allowability are provided without this added factor.

(2) The past pattern of such costs, the impact of Government contracts on his business, the nature of his own organization, etc., should also be removed as additional determining factors as to allowability. The scope and extent of Government regulations, the changing requirements of contract clauses and peril or loss in connection therewith frequently make it necessary that a contractor avail himself of professional assistance which is strictly a management decision. As a class, such costs should be allowable subject to the application of the basic principles and standards of reasonableness and allocability. In addition, retainer fees should also be allowable as a normal business expense without the qualification indicated.

(3) The cost of successful defense of anti-trust suits and the successful prosecution of claims against the Government should also be allowable since such costs are incurred through no fault of the contractor. The last sentence appears unduly restrictive. Rather than restricting allowability to those instances in which provision is made in the contract, such costs should be subject only to the tests of reasonableness and allocability.

(ff) Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets

No Comment

(gg) Recruiting Costs

Allowable recruiting costs should be broadened to include advertising in magazines, etc., where the sole purpose is to keep the name before the public and to attract good personnel to the company, unless these costs are allowed under advertising in paragraph 204.2 (a).

3-204.2 Selected Costs

(hh) Rental Costs

(1) Since the general test of reasonableness is specified for all costs, particular considerations should not have to be spelled out in that regard for rental costs. If specific tests became a requirement, it is essential that the test of competitive rental for similar properties be added. The requirement for a comparison of costs which would be allocable if the facilities were owned by the contractor gets into the realm of conjecture and is inequitable. Normal tests of reasonableness of rental costs should preclude the specific limitations proposed.

(2) This paragraph should be deleted since it would penalize contractors leasing from common control compared with contractors who have conventional leases, even though the rental charges are the same for both or where the charges under the former are actually lower. It would be very rare indeed to find a conventional lease where the rental rate is equivalent to normal costs, such as depreciation, taxes, insurance and maintenance expenses.

(3) This paragraph is also inequitable and should be deleted. Its provisions would discourage economic growth. The leaseback is an established method for raising capital and would often not be used by a contractor under the conditions imposed, since a substantial loss could be involved. The basic rule of reasonableness recommended above gives the Government complete protection.

NSIA Comments on Selected Costs Section

5-204.2 Selected Costs

(ii) Research and Development Costs

The need for adequate research and development activity is of such importance that adequate recognition should be given to this cost of industry in the performance of this vital function. The benefits accruing to the Government and to the nation as a whole from industry's research and development efforts are immeasurable when it is realized that these efforts are of vital concern to the welfare, defense and security of the nation. It is therefore strongly recommended that the Government give favorable recognition to all of such costs.

(1) No Comment

(2) The last sentence of this paragraph should be deleted since it would base the test of reasonableness on the patterns of cost of past programs, which is an unduly restrictive limitation.

(3) The definition of "development" as being "the systematic use of scientific knowlege directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing and production engineering" is not sufficiently clear and distinct from the definition of general and basic research. Research which is directly basic could be misconstrued as coming within this definition of development and therefore the language should be changed accordingly. In addition, there is just as much benefit accruing to a research and development contract as accrues to a production contract and therefore the words "under any production contract" should be deleted.

(4) This paragraph should be deleted as it dictates the accounting system of the contractor (see transmittal letter for details).

(5) This paragraph is inequitable and should be deleted. Such costs are true costs of doing business, and must be recovered by a contractor in his operations. Moreover, to say that such programs do not benefit current Government contracting is completely erroneous and unjustifiable.

(6) This paragraph referring to 15-204.1 (b) should be deleted for the reasons stated fully in the transmittal letter.

AIA Comments on Selected Costs Section

5-204.2 Selected Costs

(jj) Royalties and Other Costs for Use of Patents

(1) Under this paragraph, item (iii) should be eliminated since the determination of unenforceability of a patent is a judicial function and not that of a contracting officer or of an auditor. Moreover, in item (ii) the phrase "or has been administratively determined to be invalid" should also be deleted for the same reason. Royalties which are legal obligations of the contractor should be allowable. The contractor should be protected in his legal obligations and costs should be disallowed only in instances where the Government has specifically assumed any liability for nonpayment of royalties by the contractor.

(2) This paragraph should be deleted for the reasons set forth in the transmittal letter as dictating an audit manual approach.

(3) This paragraph, which also constitutes an audit manual approach, should be deleted for the reasons set forth in the transmittal letter.

(4) This paragraph should be deleted. This paragraph could result in the disallowance of royalties which the contractor must legally pay under a patent which he in the distant past sold, where he did not reserve any right to use such patent for the reason that he did not foresee the necessity of its use in Government business at a future date. This is an unjustifiable penalty and fails to recognize a true cost of doing business.

(5) This reference to ASPR 15-204.1 (b) should be deleted for reasons set forth fully in the transmittal letter.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(kk) Selling Costs

(1) No comment.

(2) This paragraph as presented in unacceptable. It would permit an allocation of only those expenses which consist of "technical, consulting, demonstration, and other services which are for purposes such as application or adaptation of the contractor's products to Government use". This is an unwarranted limitation on this category of expense which should be fully allowable subject to the tests of reasonableness and allocability.

The philosophy that selling and distribution expenses are generally unnecessary in securing government business is a viewpoint that is completely erroneous and unjustified. Although some contracting officers do recognize certain direct selling expenses, they endeavor to limit them to the portion which can be directly connected with government orders. However, the Government fails to recognize the indirect benefits it has taken advantage of in being able to place orders for either standard commercial or especially designed products with companies which, through expenditures for advertising, sales promotion and selling activities, have the capacities to produce efficiently and quickly the requirements of Government that otherwise could not be possible without tremendous expenditures and extended delays. This paragraph states that selling and distribution expenses are allowable only if a "reasonable benefit to the Government" can be shown. All types of selling and distribution expenses should be treated as allowable.

(3) Delete the words "Not withstanding (2) above" for the reasons stated above under (2).

(ll) Service and Warranty Costs

No comment.

(mm) Severance Pay

No comment.

(nn) Special Tooling Costs

No comment.

'IA Comments on Selected Costs Section

3-204.2 Selected Costs

(oo) Taxes

(1) (ii) This paragraph should be deleted as it is inconsistent with the allowability of financing costs.

(1) (iii) This paragraph should not require that the contracting officer determine the extent of the administrative burden. This is clearly a usurpation of a management prerogative.

(2) This paragraph should not require that the contractor take the actions required therein "prior to payment of such taxes." Frequently, due to the length of time required to obtain contracting officer action, the contractor would be in default in payment of taxes. In addition, the contractor should only be required to take all "reasonable" action directed by the contracting officer. This paragraph should be modified to define more specifically what types of tax assessments must be dealt with only under the Contracting Officer's instructions. Almost any taxes may be illegally or erroneously assessed and the provisions as currently worded could conceivably require the contractor to request instructions concerning payment of every tax encountered, even though apparently qualifying under the general definition of allowability in order to be assured of reimbursement. Undoubtedly the intent is more to provide a procedure for dealing with attempted assessments of Government property in the contractor's possession by attributing fee title or taxable possessory interest to the contractor. If this is the case, the wording should be changed to encompass the actual conditions which necessitates the Contracting Officer's instructions in order to preserve the tax payments status as an allowable cost.

(3) No comment.

SIA Comments on Selected Costs Section

3-204.2 Selected Costs

(pp) Trade, Business, Technical and Professional Activity Costs

(1) This paragraph would, by its definition, exclude service organizations and Chambers of Commerce which are also necessary costs of doing business. The definition therefore should be amplified to include such organizations.

(2) No comment.

(3) This paragraph as proposed is unduly restrictive in that it refers only to technical information or information that is aimed at the stimulation of production. We feel very strongly that meetings, conferences, and exhibits for the purpose of improving overall coordination of the business or various segments thereof, or the dissemination of information about the business to the trade, the public, prospective employees, etc. is just as important to the successful performance of Government contracts as are technical and production meetings. This paragraph should therefore be expanded accordingly.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

(qq) Training and Educational Costs

The details in this paragraph are unjustifiably restrictive. These include such items as (1) specifying the number of hours an employee may attend classes on a part-time basis during working hours, (2) specifying that postgraduate but not undergraduate tuitions will be allowable costs in connection with full-time educational programs, (3) limiting reimbursement for full-time participation to one year for each employee except in unusal cases, (4) disallowing as a cost "subsistence, salary or any other emoluments" of employees pursuing full-time scientific and engineering education at post-graduate college level, and (5) prohibiting grants to educational institutions. In addition to limiting severely the needed flexibility of basic principles, this particular paragraph can have even more far-reaching implications for other reasons.

We are, now, in a reappraisal of why the nation is falling behind in education of scientists and engineers and in support of basic research. Industry is the principal source of aid, especially to private educational institutions of both secondary and collegiate levels. This definition, however, would force industry to severely curtail its support of educational programs if the Government fails to carry its proportionate share. All true costs of business must be recovered by a contractor in his business operations; all training and educational costs are no exception to this and should be allowed.

(rr) Transportation Costs

The last three sentences of this paragraph should be deleted as they dictate the contractor's accounting system.

(ss) Travel Costs

(1), (2), (3) and (4) No comment.

(5) The reference to ASPR 15-204.1 (b) should be deleted for the reasons set forth in the transmittal letter. Moreover, the phrase "subject to allocation on the basis of work or time period benefitted when appropriate" should be deleted as dictating the contractor's accounting system.

NSIA Comments on Selected Costs Section

15-204.2 Selected Costs

Termination Claims

Recognition should also be given in the cost principles to the following additional items of cost which are experienced by contractors under termination claims:

Initial costs
High start up costs
Loss of useful value on special machinery and equipment
Post Termination Expense, including costs of handling, packing and shipping material returned to suppliers, or diverted to other uses at other locations of the contractor
Preparatory Costs
Special leases
Subcontract Settlements

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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December 13, 1957

Honorable W. J. McNeil
Assistant Secretary of Defense
Department of Defense
Washington 25, D. C.

Dear Mr. McNeil:

The committee on national defense of the American Institute of Certified Public Accountants has reviewed the September 10, 1957 draft of the revision of Armed Services Procurement Regulation, Section XV, Contract Cost Principles. The following comments represent the consensus of the members of the committee on various parts of the draft.

We concur in the idea of a single broad set of cost principles, providing that in their application, recognition is given to the circumstances created by each type of contract as a part of the conditions and factors which have a bearing on reasonableness, relevancy, allocability, etc.

The committee feels, however, that revisions are necessary in this proposed draft in order to make it entirely workable and sufficiently flexible to be applicable to all types of contracts in which cost is a factor in price negotiations.

The suggestions which follow cover the points on which our committee differs materially with the position taken in the draft, or where it was felt that clarification was needed.

15-204.1(b) The language used in this paragraph might be interpreted as meaning that the more controversial costs to which this section refers would be disallowed in the case of negotiated fixed-price type contracts unless covered by an agreement in the contract file. The mere fact that nothing is done in advance should not result in disallowance of such costs if the facts indicate otherwise. The committee felt that this point should be clarified.

15-204.2(a) Advertising Costs. It was believed that the rules as to advertising costs were unnecessarily restrictive.

It would seem that advertising costs should be allowed where benefits to government contracts can be shown. For example, it would seem reasonable to allow the cost of advertising for scarce materials, or for second-hand machinery when new machinery is hard to obtain.

15-204.2(f)(6) Profit Sharing Plans. The members of the committee found it difficult to see why "Profit sharing plan costs under plans of the immediate distribution type are unallowable." The ruling-out of any specific method of determining a portion of executive or employee compensation seems out of place in a definition of cost principles. The committee felt that if the total compensation is reasonable, such distributions should be allowed.

15-204.2(f)(7)b Deferred Compensation. The phrase "it is for services rendered during the contract period" might be misinterpreted so as to exclude provisions for currently accrued pension costs which are calculated in part on the basis of past services. It is suggested that a clarifying statement be added to the effect that the amortization of pension costs based on past services which is permitted for federal income tax purposes, is an allowable cost.

The committee also felt that the paragraph was not clear as to the application of the carry-forward provisions in connection with profit-sharing plans of Section 404(a)(3)(A) of the Internal Revenue Code of 1954.

A minor point - the Internal Revenue Service is twice referred to under its old name, Bureau of Internal Revenue.

15-204.2(h) Contributions and Donations. The members of the committee were unanimous in feeling that reasonable amounts of contributions and donations should be allowed. They suggested that the maximum could be the equivalent of that allowed for corporate federal income tax purposes.

15-204.2(i) Depreciation. While it was agreed that under generally accepted accounting procedures, and for tax purposes, depreciation is based on original cost, sound competitive pricing of products may require the recognition of depreciation based on current cost. The committee suggests that further consideration be given to permitting, as an allowable cost, depreciation calculated on the current cost of assets used in government contract operations. The committee realizes, however, that such a departure from cost determination for financial and tax accounting purposes may create difficult

problems in trying to apply this concept to Government contracts.

Referring to sub-paragraph (2)(i), it was assumed that "property cost basis" generally means original cost basis. Also, it was felt that what is to be done in the case where the depreciation taken on the books differs from that shown on the tax return should be clarified as to the application of this section.

It was also suggested that, in connection with sub-paragraph (iii) on Page 19, it be made clear that the approved types of depreciation calculation are not limited to those included in this reference to the Internal Revenue Code of 1954. For example, depreciation based on use or production would presumably be allowable. The committee assumes that, insofar as one of the methods listed in sub-paragraph (iii) is used, the amount cannot exceed the amount permitted for federal income tax purposes.

15-204.2(a) Interest and Other Financial Costs. The committee agrees with the disallowance of interest costs if it is made clear that the profit allowed is to be large enough to cover interest on the turnover of borrowed capital in addition to a return on equity capital, thus assuring equitable treatment of contractors employing different methods of financing.

15-204.2(v) Material Costs. The committee felt that more leeway should be allowed for the use of current material costs. Specifically, it recommended that the following statement, which appeared in an earlier draft, be restored: "When materials in inventory at the commencement date of a Government contract have a provable replacement cost significantly different from book cost, either the contractor or the Government may elect to use such replacement cost in lieu of book cost in pricing materials issued from such inventory." (Applications of Cost Principles and Standards to Supply Contracts and Research and Development Contracts with Commercial Organizations - Draft HWB 15 Mr. 1954).

15-204.2(y) Overtime, Extra Pay Shift and Multi-shift Premiums. Referring to sub-paragraph (3)(ii)(A) and (C), the committee calls attention to the fact that overtime operations do not necessarily increase unit costs since the higher labor costs are often offset, or more than offset, by lower amounts of assignable fixed overhead. It believes that, in the case of negotiated fixed-price type contracts, special authorization for the inclusion of overtime and similar premiums should be required only when unit costs will be increased.

15-204.2(hh) Rental Costs. Sub-paragraph (3) seems to the committee to be unnecessarily restrictive. If the sale and lease-back is an "arm's length" agreement and if the rentals are reasonable and in line with those charged for similar properties, it was felt that the amount of rent paid should be an allowable cost.

*****

The committee wishes to express its appreciation of the opportunity to review the draft. It has attempted only to make suggestions that would constitute constructive proposals leading to the goal of equitable treatment of both the Government and the contractor. If we can be of any further service to you in this matter, or if you have any questions as to our suggestions, we hope you will let us know.

Respectfully submitted,

Committee on National Defense
American Institute of
Certified Public Accountants

H. T. McAnly, Acting Chairman

HTM:Bm
cc: Honorable Perkins McGuire, Assistant Secretary of Defense
Mr. Kenneth K. Kilgore, Director, Audit Division, Office of the Assistant Secretary of Defense

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

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R. N. McFARLANE
Executive Director

16 December 1957

The Honorable E. Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon - Room 3 E 810
Washington 25, D. C.

Dear Mr. Secretary:

The National Security Industrial Association greatly appreciates the opportunity to comment on the proposed revisions of Parts 1 and 2 of Section XV of the Armed Services Procurement Regulation. The draft, of September 10, 1957, has been distributed widely among our membership, and has been intensively reviewed by our Contract Finance Task Committee and our Procurement Advisory Committee. It has evoked a very strong and unfavorable reaction both from these Committees and from our membership at large, which, as you know, represents an extensive cross-section of all sections of American industry supplying the Military Departments. Adoption of the draft would constitute a drastic change in procurement practices, so broad in its impact that we earnestly solicit your detailed consideration of the attached material reflecting the attitude of our membership. Set forth below is a brief summary of these feelings.

A. The proposed revision should not be adopted in its present form nor in any revised form incorporating the same concepts.

B. Adoption of the draft would have the following impact on military procurement:

1. It would discourage industry participation in the defense program at a time when the greatest degree of industrial participation is needed in the interest of National security.

2. It would prove particularly burdensome and inequitable to small business organizations.

3. It would increase audit and accounting burdens on both the Government and Industry at a time when both are striving to achieve the utmost in economy of operation.

4. It, in fact, would result in a lack of uniformity of treatment among contractors, thus defeating its primary objective.

C. The draft has the following specific features which are basically fallacious and objectionable:

1. It would extend the theory of cost allowance and disallowance to all types of prime contracts and subcontracts, whereas, legally and contractually this theory can be applied only to cost reimbursement type contracts. Uniformity of treatment of contractors, without regard to the specific type of contract involved, is, undoubtedly, a desirable goal. However, when this goal is to be achieved through the application of questionable and arbitrary rules of cost acceptability, it ceases to be desirable. In a fixed-price contract, a contractor is entitled to be paid the price provided for in the contract, or as redetermined pursuant thereto. In any such redetermination, the negotiated price should not be unilaterally reduced by the disallowance of legitimate costs incurred by the contractor.

2. By its terms the draft dictates the accounting system to be employed by contractors in that it governs the development and submission of price analyses and cost statements and, hence, it precludes from price negotiation any consideration of costs set forth as unallowable in whole or in part.

3. It fails to recognize that reasonableness in amount and allocation in accordance with an acceptable accounting system are the proper tests of allowability of cost, and it substitutes instead arbitrary determinations with regard to individual items.

4. If implemented, it would, in effect, change all contracts to a cost-reimbursement nature, because it becomes the basis for the resolution of questions of acceptability of specific items of cost in all contractual situations.

5. Rather than giving recognition to all normal and legitimate costs of doing business, it provides specific treatment for 45 selected items of cost, of which 30 are disallowed in whole or in part, or made subject to specific negotiation. By comparison, only 17 of these items are "unallowable" on cost type contracts under the present Section XV; and only 9 of them are "unallowable" under the present Section VIII.

6. It imposes a requirement that 16 specific elements of cost must be negotiated into each contract to be allowable. Such requirement for negotiation (a) favors any company in a strong negotiating position, (b) Opens the door to special treatment, and (c) limits management's discretion to make sound decisions during the course of performance of the contract merely because cost coverage had not previously been negotiated.

7. Finally, the draft incorporates a new test of acceptability. It establishes that companies with a preponderance of Government business are not subject to competitive restraints, and, accordingly, costs of such companies must be scrutinized with great care, and, in many cases, allowed only if specifically negotiated into the contract. This would promote a lack of uniformity in treatment among contractors through the disallowance of such costs to companies predominantly engaged in Government work, and the allowance of them to other companies not so engaged.

We are sympathetic to the Department's desire to adopt a single comprehensive set of cost principles. However, a comprehensive set can be applied to all types of contracts only if the Department of Defense is prepared to recognize the allowability of all normal and legitimate costs of doing business. We believe that many of the differences of opinion are susceptible to resolution if fully explored across the conference table by representatives of Government and Industry. Accordingly, we strongly urge that no action be taken on the present draft and that a joint Government-Industry conference be called for the purpose of reaching agreement on the basic principles, around which a set of cost principles should be developed. We are prepared to participate in such a conference at any mutually acceptable time.

We appreciate the opportunity you have afforded us to submit these comments and sincerely hope that they will be constructive in developing a mutually acceptable solution.

Cordially,

R. N. McFarlane

R. N. McFarlane
Executive Director

RNMcF/rm

Attachments:
General Comments -
Schedule A
Schedule B
Schedule C
Schedule D
Appendix 1

We could allow all normal costs of doing business in all types of contracts, only if we necessarily unallowable in any type of contract should be identified and agreed to in advance.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

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Chairman, Executive Committee

R. N. McFARLANE
Executive Director

General Comments
of the

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

on the
DOD Proposed Revision of Section XV,
Comprehensive Contract Cost Principles
(Draft of September 10, 1957.)

- - -

1. Because of the vital interest this draft has to members of NSIA, it has been reviewed intensively by our Contract Finance Task Committee and the NSIA Procurement Advisory Committee consisting of more than 200 members, and therefore, the comments submitted below are representative of a cross section of American industry both large and small, and of every major segment of suppliers to the Military Establishment.

2. It is the opinion of all members who reviewed the draft that its provisions are so drastic and objectionable as to make it unacceptable for the following reasons, as explained fully later in these comments:

(a) Its provisions would hurt Government contractors, particularly small business, many of whom would be driven out of Government business, thus narrowing the military base for procurement.

(b) It fails to give adequate recognition to the risks of Government business assumed by contractors which has

the effect of diluting abnormally the profit and fees of contractors engaged in Government business as compared with other types of business.

(c) It represents a radical departure from currently existing procurement policies and practices.

(d) It multiplies the controversial areas involved and would result in lack of uniformity of treatment thus defeating its primary objective.

(e) It would require drastic revisions in existing and accepted accounting systems of contractors.

(f) It would be burdensome and costly to administer because of the increased requirements for negotiation and audit of numerous specific cost elements.

3. It is therefore strongly urged that it should not be released until there has been a full and complete across-the-table review made of the basic philosophies involved between representatives of the Department of Defense and of American business. These basic issues must be satisfactorily resolved by such a joint approach before any results can be obtained which are fair and reasonable and in the best interests of both the Government and Industry. Of necessity, any approach must be predicated upon a mutual understanding of the problems inherent in this undertaking based upon bilateral and not unilateral decisions.

4. The comments presented below are directed towards setting forth the basic issues involved. The attached Appendix 1 presents more detailed comments which are general in nature on each of the paragraphs of the proposed regulation. If you so desire we are prepared to submit specific line-by-line recommended changes in wording at a later date.

5. Our Industry Association is very much aware of the views of the General Accounting Office and the Committees of Congress, and that you have concluded that it would be more advantageous to have one set of cost principles which are applicable to all types of contracts with industry. However, our Association believes that a single statement of cost principles would be acceptable to industry only if it adheres to certain basic premises as set forth in our letter of September 17, 1956 to Mr. Thomas Wolfe. As stated more fully in the letter, the approach to and the framework for a comprehensive set of cost principles demands an entire new evaluation, one which should not be hampered, confined or influenced by policies presently enunciated in ASPR Section XV, Section VIII, or in any memoranda or implementations of the individual Services as to particular elements of cost. Such an acceptable set of cost principles should recognize the following basic principles:

(a) The approach to a set of cost principles must be based on the Government's willingness to recognize and accept all normal and legitimate costs of doing business. The determination of such costs should not be subject to shadings, gradations, or special circumstances, nor should allowability be conditioned on the ability of a contractor to previously negotiate special cost allowances into individual contracts.

(b) The cost principles should be concerned primarily with the underlying principles of allocation or apportionment to a Government contract of indirect costs of doing business. Such costs must include expenses necessary to the over-all operation

of the business, even though a direct relationship to specific contracts cannot be determined.

(c) The framework around which a statement of cost principles is developed should be based on generally accepted accounting principles and practices consistently followed. For the purpose of this comment "generally accepted accounting principles and practices" can be said to be represented by an accounting system which in the opinion of the contractor and the accounting profession produces proper segregation of costs and equitable allocations of expenses to all segments of a Contractor's business and is consistently followed. Emphasis should be on reasonableness and fairness with flexibility as to system as long as the accepted principles are reflected in the over-all results. Abuses can best be prevented by the application of normal tests of reasonableness and allocability, and the disallowances of unreasonable or improperly allocated costs.

(d) The application of an acceptable statement of cost principles once established should be limited to contracts in which cost is a factor in negotiating price and should not be applied to contracts let under formal advertised bids or negotiated contracts in which reasonableness of price can be established based upon evidence of competition or other supporting data without reference to costs.

(e) Audit instructions should be put into a separate document completely divorced from any statement of cost principles.

6. The proposed statement of cost principles fails to accomplish any of these fundamental objectives. The basic reasons therefore are set forth more fully below.

EXTENSION OF COST PRINCIPLES APPLICABLE TO COST REIMBURSEMENT TYPE CONTRACTS

7. Fundamentally, the draft is a listing of allowable and unallowable costs most of the definitions of which have been adopted from earlier highly objectionable proposals for the revision of Part 2 of Section XV of ASPR with respect to cost reimbursement type contracts, a proposal which merely extends such provisions across the board to practically all types of contracts. Even in comparison with these earlier drafts the current proposal represents a definite backward step from the standpoint of both Government and Industry since it has multiplied the number of controversial provisions as indicated below.

8. By its very terms, as defined in paragraphs 15-000, 15-100 and 15-101, the proposed regulation would apply to all Government contracts and subcontracts thereunder, with the exception of construction contracts, research and development contracts with non-profit institutions, and facilities contracts which are covered under other parts of Section XV. This would therefore include all contracts let by formal advertising, negotiated contracts in which reasonableness of price can be established by competitive or other pertinent factors, and all fixed price subcontracts, which we believe should be excluded from the scope of the cost principles in any event.

9. Obviously, the scope of the application of the cost principles should clearly define the types of contracts and the particular situations in which the proposed principles are to apply. The principles for the determination of cost should be limited in their application to situations where costs are a factor in determining reasonableness of price. The application of the cost principles to subcontracts should also be clearly defined with due consideration given to the preservation of the privity of subcontractors.

CHANGE IN BASIC PHILOSOPHY OF NEGOTIATION

10. The format of these principles changes the basic philosophy with respect to the pricing of negotiated contracts. As indicated in paragraph 15-101 (d), the statement endeavors to provide for the reimbursability, allowability, acceptability, and the like (by whatever name called) on a common basis for all fixed price type contracts and accordingly calls for cost determinations under fixed price contracts. Thus identity as to type of contract would be lost, and as a practical matter, every contract would become a cost type contract either on an estimated basis or an actual basis. This type of mathematical pricing is incompatible with the intent of fixed price contracts and would result in pricing on the illegal basis of cost plus a percentage of cost.

11. Sub-paragraph 15-101(a)(ii)(A) states that the cost principles are to "serve as the basis for the development and submission of cost data and price analyses by contractors in support of pricing, repricing, negotiated overhead rates, requests for progress payments and termination settlement proposals." This indicates that contractors are to omit from

submissions of actual cost data, estimates, or price analyses those items of cost that are arbitrarily determined by the Government to be unallowable but which are in reality normal legitimate costs of doing business. Under no circumstances can we agree to omit from submissions of cost data or price analyses, any costs that are incurred as legitimate costs of doing business, and which are properly allocable to a contract, even though the Government may be disinclined to share in such costs. Moreover, to do so would require drastic revisions of existing and accepted accounting systems.

12. The use of cost principles should be limited to being a guide in fixed price contracts (where cost is a factor in negotiating price) rather than an absolute basis for final determination (which determination would be unilateral) of questions of allowability or acceptability of costs. In sub-paragraph 15-101(a)(ii)(B) and (C) the use of the words "basis" and "resolution of questions" implies that controversial issues cannot be negotiated and that they will be unilaterally settled by the Government.

13. Sub-paragraph 15-101(b) makes the statement that "In negotiating firm fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation . . . . . the treatment of costs is a major factor in arriving at the amount of the price or settlement." Again this emphasis on cost as a major factor indicates a curtailment of pricing by negotiation and the adoption of price by formula based upon cost plus a percentage of cost. This is completely inconsistent with the principles of negotiation of

fixed prices as set forth in ASPR Section III, Part 8 on Price Negotiation Policies and Techniques. The only area in Paragraph 15-101 which appears to be left open for negotiation is where cost is a factor in forward pricing, but even here Part 2 is specified as the basis for resolution of questions of acceptability of costs.

14. As set forth in ASPR Section III Part 8, the primary objective of the Government is to procure supplies and services from responsible sources at fair and reasonable prices to both the Government and the contractor, calculated to result in the lowest ultimate overall cost to the Government, giving due consideration to such factors as capability or quality of performance, ability to meet specifications, delivery in accordance with required schedules, and improvement in the knowledge of the art. This principle is applicable to the negotiation and administration of fixed price type contracts, including price redeterminable and incentive types. In establishing prices under negotiated contracts, educated judgment and not mechanical rules or mathematical formulae based on cost should be used. It follows that pricing decisions should not be made solely on the basis of a determination of costs and profits.

FACTORS AFFECTING ALLOWABILITY OF COST

15. In 15-202.2 reference is made to factors affecting allowability of cost, one of which is "significant deviations from the established practices of the contractor which would substantially increase the contract costs". This factor is completely unrealistic and should be deleted. Deviations may be necessary and required, as for example, to isolate pre-production costs and to properly determine post-termination costs and expenses. Actually, the factors of "reasonableness in amount" and "allocation in accordance with generally accepted accounting principles and practices" are adequate in

considering the determination of allowability of cost.

16. Although this paragraph includes reference to the "application of those generally accepted accounting principles and practices appropriate to the particular circumstances", the proposed cost principles do not in fact agree with general commercial accounting practices in many important respects. Moreover, the factor is qualified by the words "appropriate to the particular circumstances" with the consequence that generally accepted accounting principles and practices could be very narrowly applied at the discretion of Government personnel. Although generally accepted accounting principles and practices should be the standard for allocability, the proposed draft does not itself adhere to this standard, and is so incompatible with it that it is frequently both inequitable and uneconomic from the overall standpoint of the Government.

FAILURE TO RECOGNIZE NORMAL AND TRUE COSTS

17. The incompatibility of the proposed principles with generally accepted accounting principles and practices is exemplified by the expressed disallowance in whole or in part of many elements of costs which are generally considered to be normal costs of doing business, costs which cannot be avoided merely because the Government chooses to call them unallowable and which in Non-Government business are normally recovered in the market place in the price of the article sold. Forty-five (45) specific items of cost, with additional subdivisions under many, are dealt with in detail in these newly proposed regulations. In spite of the emphasis on reasonableness and allocability, the draft would disallow in whole or in part 30 out of 45 of these specific items of cost. The attached Schedule A lists these items broken down into 52 subdivisions.

18. By comparison, 17 of these 30 items are unallowable under the present ASPR Section XV, and only 9 of the 30 are unallowable in settlements by determination of terminated fixed price contracts under the present Section VIII. In other words, in comparison with the present treatment of cost-type contracts, almost twice as many specific items of cost would be subject to disallowance in whole or in part on all types of contracts covered by the draft.

19. These unallowable costs are not only in contravention of normally accepted commercial accounting principles, but are also in violation of the proposed revision's own general standard of reasonableness and allocability in determining the allowability or acceptability of contract costs. All types of expenses listed in Schedule A are customary costs of doing business and are related to the continuing growth and vigor of a business enterprise, and as such contribute materially to the whole of a company's productive potential. Even though some of these costs cannot be directly related to any Government contract work, the Government is the beneficiary of substantially lower overall productive costs made possible by the volume and scale of operations which the contractor has attained by incurring such expenses. Therefore, to disallow categorically any of these costs is unjustifiable and their curtailment would not be in the best interests of the Government.

ITEMS REQUIRING SPECIFIC CONTRACTUAL COVERAGE OR AUTHORIZATION

20. In addition, Paragraph 15-204.1 refers to other elements of cost which are made allowable or acceptable only if they are subject to specific contractual provisions or advance authorization and even then some of these are allowable only in a limited way. It is not clear why the items mentioned are specifically singled out, nor is the listing in this paragraph all

inclusive since frequent cross reference is made to this provision in other paragraphs throughout the proposed regulation. There are 17 such areas of cost involved as listed in the attached Schedule B.

21. This requirement would be combersome, administratively burdensome, and in fact would not achieve uniformity of treatment, as actual practice would soon show some contracting officers willing and others unwilling to negotiate these special provisions. Companies in a strong negotiating position would undoubtedly achieve some manner of success in negotiating such allowances while those in a weaker negotiating position would not. Moreover, this requirement limits management's discretion to make sound business decisions during the course of performance by requiring prior approval to incur legitimate business expenses. Just as important, however, is the fact that rather than using the basic principles of reasonableness and allocability in accordance with generally accepted accounting principles and standards as the tests to determine costs, special provisions are required to determine allocability. Inasmuch as uniformity and equity in the allowance of costs is one of the objectives of a set of cost principles, these requirements for obtaining special contractual coverage or advance agreements should be removed from all of these items of costs. Our small business membership has expressed particular concern over this requirement.

INSERTION OF NEW TEST OF ACCEPTABILITY OF COSTS

22. The draft also incorporates a new test of acceptability of costs in paragraphs 15-201.3 and 15-204.1(b) by stating that companies with a preponderance of Government business are not subject to competitive restraints. It admonishes that their costs must be scrutinized with great care as to

reasonableness and allocability, and with respect to such companies certain costs are to be allowed only if they are specifically negotiated into contract or agreed to in advance of the contractor's incurring of such costs. Reference is made to this philosophy 19 times in the proposed draft as listed in Schedule C, based upon the fallacious assumption that such companies are not subject to competitive restraints. That this is far from true could be readily demonstrated.

23. Why these specific cost elements should be singled out for this test is not apparent, nor is it conceivable why such costs would be allowable to one company which is not predominantly engaged in Government work, and not allowed to another, merely because it is predominantly Government. This test is highly inequitable and should be deleted throughout the draft.

CHANGES IN ACCOUNTING METHODS AND PROCEDURES AND/OR AUDIT MANUAL APPROACH

24. As in earlier drafts of Part 2 of Section XV there continue to be many provisions in the new proposal which either dictate the accounting system to be used by the contractor or spell out such detail as to constitute an audit manual approach. These areas totaling 26 are listed in the attached Schedule D which is an increase of 6 over previous drafts with respect to cost-type contracts. Indicative of the audit manual approach is the direction throughout the draft that the Government take into account other factors in addition to the usual tests of reasonableness and allocability. To add these new and most nebulous criteria, the application of which would necessarily be even more vague and nebulous in character, will lead only to confusion, and inconsistency of treatment.

25. In the initial award of a Government procurement contract, the contractor's general business reputation, management know-how, responsibility, and productive efficiency are generally taken into consideration. It is totally contrary to good contracting policy, in the interest of Government as well as to the contractor, to superimpose upon this general review authority additional criteria involving retroactive review of individual business judgments with respect to the incurrence of costs. This is particularly true since audits are generally removed from the existing circumstances underlying the business judgments at the time they are exercised. Moreover, the insertion of these additional factors is unnecessary in the light of the existing tests of reasonableness in amount and allocability in accordance with generally accepted accounting principles and practices. Such factors should therefore be completely removed from the proposed revision.

TREATMENT OF INDIVIDUAL COSTS TO COVER SPECIAL CASES

26. The draft has entered into a detailed treatment of certain items of cost, which obviously is an attempt to cover peculiar circumstances of special cases. It should be recognized that emphasis should be placed on the basic principles of "reasonableness in amount" and "allocability in accordance with generally accepted accounting principles and practices" rather than the injection of rigid detailed treatment of various cost elements to cover such special cases. It is undoubtedly the intent of these detailed instructions to provide Government auditors and contracting officers with guides. However honorable the intent, detailed treatment of various cost items generally leads to arbitrary, unilateral, and artificial determinations which are not consistent with sound business practice nor with

the basic principles of reasonableness and allocability. Therefore, we feel that this has no part in a statement of cost principles and seriously limits the flexibility of the basic principles in addition to creating costly administrative problems and many misunderstandings.

* * * *

27. In conclusion, the application of the provisions of the proposed cost principles to fixed price type contracts on much the same basis as cost-reimbursement type contracts would impose burdensome administrative controls thus increasing costs to the Government as well as impair management responsibility, authority, flexibility and incentive.

28. We are grateful for the opportunity of presenting these comments. However, we believe that a fundamental problem of Government relations exists which results from the lack of general understanding and agreement between the parties involved which will never be resolved by an exchange of correspondence. It is therefore requested that a conference be arranged to explore fully and reach agreement on the basic philosophies around which a Comprehensive Set of Cost Principles should be developed. Once this mutually acceptable philosophy is reached it is suggested that a joint Government-Industry drafting committee be established to reduce these previously defined policies and objectives to a detailed written form. Our Association is ready to lend support to this undertaking and is willing to devote its talents in whatever way is necessary to bring about a mutually agreeable conclusion.

29. Because of the importance attached to this effort our Contract Finance Committee has devoted extensive effort for more than a year to the

development of an industry proposal for a Comprehensive Set of Cost Principles. This is nearing the final stage of completion and we will be prepared to present it for consideration in the very near future. It is our opinion that this draft might provide the basis for resolution of many of the problem areas discussed herein.

- o -

Attachments:

Schedule A
Schedule B
Schedule C
Schedule D
Appendix 1

ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

SUPPLY AND LOGISTICS

CP

Dear

We have completed our staff analysis of the views of industry as expressed in connection with the draft of the comprehensive set of cost principles dated 10 September 1957.

We believe that the next step should be to consider with industry certain issues which have been raised by industry comment and which are basic to the realization of a mutually acceptable document. The issues have been separated into twelve questions, four of which are basic to the use of a comprehensive set of cost principles and the remainder of which relate to those individual items of expense which were most widely commented on.

There is attached a listing of the major issues which were taken from the prior comment of industry. This, together with a consideration of certain sections of the September 10, 1957 draft which have been rewritten, will be used as the agenda for the meeting. We believe that it is necessary to adhere to this agenda in view of the extent of the questions raised. We believe that the conclusions reached with respect to these questions will serve as a basis for the solution of whatever other questions of lesser significance may remain.

We are inviting industry to meet with us on Wednesday, 15 October at 9 a.m. in room 3E 869, The Pentagon for a discussion of the principles in order to permit their early publication. It is believed that a small representative group can be most effective in maintaining the meeting at a productive level. In terms of participation, each Association should limit itself to a single spokesman and it is suggested that attendance be confined to the minimum necessary to assist the spokesman. As indicated in my letter last February, it is my plan to attend this meeting, along with the Assistant Secretary of Defense (Comptroller) and the Materiel Secretaries of the Military Departments, in order that we may have a clear understanding of Industry's position and of the proposed revisions as they now stand.

For your ready reference there is attached a copy of the draft dated 10 September 1957. In addition, there are attached revised drafts of the following paragraphs which will constitute part of the agenda:

Paragraph or Part	Purpose of Change
Part 1, "Applicability"	To clarify intent that Part 2 has application to "negotiated" pricing and to clarify the nature of the evaluation of cost data in such pricing.
15-204.1(b)	To express the intent that contractors should negotiate in advance the reasonableness and allocability of the enumerated items of expense under certain conditions; that failure to do so involves grave risks for the contractor with respect thereto; and that the option to negotiate may be exercised by the contracting officer as well as the contractor or prospective contractor.
15-204.2(f) Compensation	To simplify the coverage; to modify it to provide for the allowability of management incentives to the extent that the total compensation is reasonable; and to sharpen the guidance with respect to reasonableness of compensation.
15-204.2(y) Overtime	To provide compatibility with the principles contained in ASPR 12-102.
15-204.2(ii) Research and Development Costs	To provide that independent applied research and development may be allocated to appropriate sponsored applied research and development contracts in instances in which a contractor's normal course of business does not involve production work.

A similar letter is being sent to the other industry Associations which have been active in assisting the Department of Defense in the solution of this complex problem.

Sincerely yours,

Inclosures

21 August 1958

A G E N D A

Meeting with Industry Representatives
Contract Cost Principles

October 15, 1958

A. Differences in general concepts between industry comments and September 10 draft:

1. Applicability -

   Concern evidenced that the application to fixed-price type contracts may lead to formula pricing. Discussion of revised Part 1.

2. "All Costs" concept -

   Contention that Government should accept a share of all normal business costs.

3. Reasonableness and allocability -

   Feeling expressed that the terms "reasonableness" and allocability" need no further amplification in the principles. Contractor's normal practice and accounting system should govern acceptance of specific costs.

4. Advance understandings -

   Objections were raised to the provision encouraging advance negotiations to reach agreement on the basis for allowing certain costs. Discussion of clarifying revision of Paragraph 15-204.1(b).

B. Specific items of cost:

1. Advertising
2. Compensation for personal services -

   Discussion of revision of Paragraph 15-204.2(f).

3. Contributions and donations
4. Interest
5. Overtime -

   Discussion of revised Paragraph 15-204.2(y).

6. Plant reconversion costs
7. Research and development -

   Discussion of revised Paragraph 15-204.2(ii).

8. Training and education

Draft
21 August 1958

Proposed Amendments to Draft Dated 10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section contains general cost principles and standards for use in connection with (i) the determination of ~~historical~~ costs, (ii) the preparation and presentation of cost estimates by prospective contractors, contractors and subcontractors in negotiated procurement and in termination for convenience of the Government, and (iii) the audit of cost in the negotiation and administration of contracts, and (iv) the evaluation of cost data in procurement and contract administration.

Part 1 - Applicability

15-101 Scope of Part. This Part prescribes the use of the cost principles and standards set forth in the several succeeding Parts of this Section in contracting and subcontracting and delineates the nature of such use under different circumstances.

15-101.1 Use. Part 2 is prescribed for use:

(i) As a contractual basis, by incorporation by reference in the contract, for determination of:

(A) reimbursable costs under cost-reimbursement type contracts including cost-reimbursement type subcontracts thereunder and the cost-reimbursement portion of time and materials contracts;

(B) terminations when the amounts thereof are determined unilaterally by the contracting officer;

(C) costs of terminated cost-reimbursement contracts.

(ii) As a basis for:

(A) the development and submission of cost data and price analyses by contractors and prospective contractors as required in support of negotiated pricing, repricing, negotiated overhead rates, requests for progress payments, and settlement proposals under termination;

(B) audit reports prepared by the Audit Agencies in their advisory capacity of providing accounting information respecting negotiated pricing, repricing and termination.

(iii) By Contracting Officers in the evaluation of cost data, as follows:

(A) In Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contract, redetermination of price after completion of the work, ~~negotiation of final overhead rates,~~ or negotiation of a settlement agreement under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. Accordingly, ASPR, Section XV, Part 2, shall serve as the basis for evaluation of cost data. However, the finally agreed price or settlement represents something other than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the

evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

(B) In Forward Pricing. To the extent that costs are a factor in forward pricing, ASPR, Section XV, Part 2, ~~shall~~ serve as a guide in the evaluation of cost data. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while Part 2 will be used to evaluate cost data, it will not control negotiation of prices for work to be performed in the future, e.g., negotiation of a firm fixed-price contract, an intermediate price revision covering, in whole or important part, work which is yet

to be performed, or a target price under an incentive contract.

(iv) As the basis for the resolution of questions of acceptability of individual costs whenever such questions become issues.

15-101.2 "Allowable" and "Unallowable" in Connection with Fixed-Price Type Contracts. As used in ASPR, Section XV, Part 2, the words "allowable," "unallowable," and the like, shall, in connection with any fixed-price type contract, mean "acceptable," "unacceptable," and the like.

Negotiation Requirement

Modify 15-204.1(b) to read as follows:

(b) The extent of allowability of the selected items of cost covered in ASPR 15-204.2 has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in the case of contractors whose business is predominantly or substantially with the Government. In order to avoid possible subsequent disallowance based on unreasonableness or non-allocability, it is important that prospective contractors, particularly those whose work is predominantly or substantially with the Government, seek agreement with the Government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Such agreement may be initiated by the contracting officer. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. Included are such elements as:

(i) compensation for personal services (ASPR 15-204.2(f));

(ii) use charges for fully depreciated assets (ASPR 15-204.2(i)(6));

(iii) food and dormitory service furnished without cost to employees or involving significant losses (ASPR 15-204.2(n));

(iv) deferred maintenance costs (ASPR 15-204.2(t)(1)(ii));

(v) pre-contract costs (ASPR 15-204.2(dd));

(vi) research and development costs (ASPR 15-204.2(ii)(6));

(vii) royalties (ASPR 15-204.2(jj));

(viii) selling and distribution costs (ASPR 15-204.2(kk)(2)); and

(ix) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)).

Compensation for Personal Services

Modify 15-204.2(f) to read as follows:

(f) Compensation for Personal Services.

(1) General. a. Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses, incentive awards, employee stock options, employee insurance, fringe benefits, and contributions to pension, annuity, stock-bonus and plans for incentive compensation of management employees. Except as otherwise specifically provided in this paragraph (f), such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and are not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

b. Compensation is reasonable to the extent that the total amount paid or accrued, is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following:

(i) Compensation paid to owners of closely held corporations, partners, sole proprietors, or members of the immediate families

thereof, or to persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that such compensation is reasonable for the actual personal services rendered rather than a distribution of profits.

(ii) Any change in a contractor's compensation policy resulting in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the ratio of Government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in Government policy.

(iii) The contractor's business is such that his compensation levels are not subject to the restraints normally occurring in the conduct of competitive business.

c. Compensation for services rendered paid to partners and sole proprietors in lieu of salary will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.

d. In addition to the general requirements set forth in a through c above, certain forms of compensation are subject to further requirements as specified in (2) through (10) below.

(2) Salaries and Wages. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and are allowable subject to the qualifications of (y) below.

(3) Cash Bonuses and Incentive Compensation. Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable to the extent that the overall compensation is

determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1(b).) Bonuses, awards and incentive compensation when any of them are deferred are allowable to the extent provided in (6) below.

(4) Bonuses and Incentive Compensation Paid in Stock. Costs of bonuses and incentive compensation paid in the stock of the contractor or of an affiliate are allowable to the extent set forth in (3) above (including the incorporation of the principles of paragraph (6) below for deferred bonuses and incentive compensation), subject to the following additional requirements:

(i) valuation placed on the stock transferred shall be the fair market value at the time of transfer, determined upon the most objective basis available; and

(ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (6)c. below. (But see ASPR 15-204.1(b).).

(5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate is unallowable.

(6) Deferred Compensation. a. As used herein, deferred compensation includes all remuneration, in whatever form, for services currently rendered,

for which the employee is not paid until after the lapse of a stated period of years or the occurrence of other events as provided in the plans, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension, annuity, stock bonus, and profit sharing plans, (ii) contributions to disability, withdrawal, insurance, survivorship, and similar benefit plans, and (iii) other deferred compensation, whether paid in cash or in stock.

b. Deferred compensation is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all other compensation paid to the employee, reasonable in amount; (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payments; and (iv) for a plan which is subject to approval by the Internal Revenue Service, it falls within the criteria and standards of the Internal Revenue Code and the regulations of the Internal Revenue Service. (But see ASPR 15-204.1(b).).

c. In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally

give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible future abnormal forfeitures shall be effected according to the following rules:

(i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and

(ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the contractor either as to an equitable adjustment or a method of determining such adjustment.

d. In determining whether deferred compensation is for services rendered during the contract period or is for future services, consideration shall be given to conditions imposed upon eventual payment, such as, requirements of continued employment, consultation after retirement, and covenants not to compete.

(7) Fringe Benefits. See (o).

(8) Overtime, Extra-Pay Shift and Multi-Shift Premiums. See (y).

~~In general, the~~ Total compensation of individual employees will be deemed to be reasonable unless the cost is clearly unreasonable as to type or amount.

(9) Training and Education Expenses. See (qq).

(10) Insurance and Indemnification. See (p).

(ii) Research and Development Costs.

(1) Research and development costs are divided into two major categories for the purpose of contract costing — (i) basic research, also referred to as general research, fundamental research, pure research, and blue-sky research and (ii) applied research and development, also referred to as product research and product line research.

(2) Basic research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent basic research (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below and subject also to their being allocated to all of the work of the contractor.

(3) Applied research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of or improvements in useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering. Costs of a contractor's independent applied research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below, under any production contract to the extent that such applied research and development are related to the product lines for which the Government has contracts and such costs are allocated as indirect costs to all production work of the contractor on such contract product lines. Costs of independent applied research and development are unallowable under research and development contracts. However, in cases where a contractor's normal course of business

does not involve production work, the costs of independent applied research and development work (that which is not sponsored by contract, grant or other arrangement) are allowable, subject to (6) below, to the extent that such work is related and allocated as an indirect cost to the field of effort of the Government applied research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

(6) In addition to the definition of reasonableness provided in ASPR 15-201.3, the reasonableness of expenditures for independent research and development should be determined in light of the pattern of the cost of past programs (particularly those existing prior to the placing of Government contracts), with due consideration to changes in science and technology. Such expenditures must be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Where such expenditures are not subject to the restraints of commercial product pricing, there must be assurance that these expenditures are made pursuant to a planned research program which is reasonable in scope and is well managed. The costs should not exceed those which would be incurred by an ordinarily prudent person in the conduct of a competitive business. (See ASPR 15-204.1(b).)

(y) Overtime, Extra-Pay Shift and Multi-Shift Premiums. Overtime, extra-pay shifts, and multi-shift work is allowable to the extent approved pursuant to ASPR 12-102.4, or authorized pursuant to ASPR 12-102.5.

RAYTHEON MANUFACTURING COMPANY
WALTHAM 54, MASSACHUSETTS

ERNEST F. LEATHEM
ASSISTANT TO THE PRESIDENT

October 29, 1958

Comdr. J. M. Malloy, SC, USN
Office of the Assistant Secretary of Defense (S&L)
Washington 25, D. C.

Dear Pete,

I have not replied to your letters of October 21 and 23 because I wanted to complete my review of the transcript and get it off to the printer's before writing you. This has been done, and I expect that the first copies will be available tonight, and all of them will be available tomorrow. I shall send 200 copies to you in bulk as soon as they are available. In order to provide legibility, it was necessary to retype the entire job, so you will understand that it does not show the interpolations you and I made to correct the text or to make it more readable. Actually, I have made absolutely no change in substance whatsoever. I have, however, corrected grammar and made a few eliminations to avoid redundancy. I have also revised the list of attendees in order to show those who were officially representing associations as being from the association, with their company name in parenthesis, but showing all other industry attendees merely with the name of their company - or their association if they are employed on the staffs of these associations. I am sure you will have no objection to this revision.

When I send you the 200 copies I shall also enclose the transcript which you sent me. This will show you the changes which I made, if you care to run through it for that purpose. I would appreciate it if you would save this for me as I would like to retain it as our official copy of the transcript. I can get it back from you the next time I see you in Washington. I am returning herewith the portions of the transcript which were duplicated, these being for the most part copies of the presentations delivered by various industry personnel.

Our schedule is as follows: I am in the middle of preparing a first draft to be sent summarizing the industry position. This will go forward, before the end of the week, to the conferees at the industry meetings. Another meeting of industry conferees will be held on Thursday, November 6, in New York, at which time I would hope that final agreement

can be reached on the text of the statement. If this is so, it will then be typed on Friday, the 7th, and mailed that evening, which should mean that it will be in the hands of Secretary McGuire on the morning of Monday, the 10th. I assume this timetable is completely satisfactory as it is within the 15-day limitation imposed by Secretary McGuire, beginning from the date of receipt of the transcript. After you have had a chance to study it I will talk with you or Secretary McGuire further about it.

In the meantime, could you let me know how many copies you would like to have of the statement, and whether all of these need to be in Secretary McGuire's hands on November 10?

With highest personal regards, I am

Cordially yours,

Frank F. Gaither

EFL:K

Encs.

cc. Secretary McGuire ✓

November 7, 1958

The Honorable E. Perkins McGuire
Assistant Secretary of Defense
(Supply & Logistics)
The Pentagon
Washington 25, D. C.

Subject: Comprehensive Cost Principles

Dear Mr. Secretary:

Pursuant to the suggestion made by you at the joint DOD-Industry conference on Cost Principles held at the Pentagon on 15 October 1958, this letter is submitted to amplify and explain further the industry views expressed at the conference, and to comment also in some cases upon contrary views expressed by government spokesmen. It has been prepared after the receipt of written comments from each industry spokesman, and after a detailed review at a conference on 6 November among industry spokesmen or representatives of the associations who participated in the preparation of the industry statements on 15 October. This document represents the unanimous views of these people.

You and the other Assistant Secretaries have before you the task of deciding upon issues on which wide differences seem to exist between government and industry viewpoints as expressed at the 15 October conference. In preparing the industry statements for the conference, the views of the conferees (which included managers, controllers, and professional accountants) were remarkably in accord with each other. It is difficult to believe that this consensus of so many different interests and viewpoints can be as wholly wrong as the government spokesmen would lead one to believe, for these industrial and professional views are based upon years of actual experience. We shall, therefore, try to show you where we think we are truly apart, where implementations negate apparent intentions with which we are in accord, and why we think a complete and exhaustive review of the proposals outstanding are essential. In considering these, we know you will show the same thoughtfulness and patience which has characterized your handling of this complex problem to date.

The responsibility which you and the other Assistant Secretaries bear in making these decisions is of the utmost gravity, as they affect the cost recoveries and profit potentials of every company engaged in defense contracting - not, as in the past, just those which undertake cost reimbursement type contracts. At the same time, however, this obligation to decide also provides a unique opportunity - to cut through past disputes, to reassert principles basic to our economic system, and to reaffirm that the prime objective of our Government is to be fair and equitable in carrying out its business transactions. We feel that you agree with us in this fundamental principle. For example, the definition of allocability included in the latest draft (paragraph 15.201.4) does in fact express a fair and reasonable approach. The problem lies, however, in that much of the remainder of this draft of "Cost Principles" completely negates this definition. To correct this defect, you must make "fairness" a concept more

fundamental than "reasonableness," or than "applicability," or than "allocability," even though each of these three is of real importance and significance. You must also be ready to separate principle from interpretation, and to require the clear subordination of interpretation to policy. This can be done, we submit, without taking precipitate action, without conclusively binding the DOD or contractors finally as to any specific element of cost, and without now attempting to perfect every interpretation. This is, we sincerely believe, the only fair and practical way to issue comprehensive cost principles soon which will not evoke a storm of protest, criticism and bitterness from many sources.

There are other compelling reasons for such a reconsideration of the general aspects of these proposed regulations even at this late date. When they are made effective, they will have virtually the same effect as the enactment of new legislation, for they will change the ground rules from what they have ever been before. If made applicable to current contracts to any extent, the regulations, as proposed, would materially revise the basis under which every present contractor agreed to perform his obligations. Undoubtedly they would also cause greatly added costs of administration and of audit and negotiation both to contractors and to the Government, and would force extensive delays in placing original contracts or definitizing necessary actions under other contracts. Any regulations must, therefore, deal fairly with the entire spectrum of types of contracts, whether now in existence or placed in the future. They may well become a precedent for later extension to all non-defense Government procurement. Surely, then, a self-imposed time schedule must yield to the necessity for being right.

We strongly urge that the whole body of general principles of cost determinations be stated separately and apart from any official interpretations or detailed instructions. We recognize that interpretations and instructions are essential in the management and control of Government personnel, but these personnel should all perform their work within the framework of policies and principles determined at the Secretarial level. Thus the general would govern the specific, whereas in the proposed document, the specific governs the general. A clear way to draw this distinction, and to enforce it, would be to leave interpretations and instructions out of ASPR, confining it to principles and policy - and making this the limit of a contractor's obligation through incorporations by reference into specific contracts. Auditors' manual would be an adequate place for detailed interpretations or instructions, provided these were approved by a central source to assure conformity to principle and policy, and uniformity among the several Services.

While many particular differences between Government and industry were disclosed at the 15 October conference, and others remain which were not discussed there, the fundamental differences relate to the basic approach to be taken, mentioned above, and to seven other factors, which are: 1) recognition of all normal and legitimate costs, 2) reasonableness and allocability as adequate tests and controls, 3) applicability, 4) effective date, 5) requirements of public interest, 6) advance understandings, and 7) individual items of cost. We believe that all differences as to particulars would be readily resolvable if ways can be found to reach agreement on the first five of these points. We shall, therefore, devote most of the balance of this statement to them.

I. RECOGNITION OF ALL NORMAL AND LEGITIMATE COSTS

Industry believes that the Government should start from the proposition that it is willing to accept any cost which has been incurred or accrued in good faith by a responsible contractor exercising its best management skills in the

conduct of its business. Then the Government might properly say that although it will accept such costs, they must be appropriately and fairly allocated among the contracts in question and other work of the contractor, in accordance with accepted principles and an established method of accounting; that the Government will accept such costs only in so far as they are not unreasonable in amount, and are not objectionable from the established standards of public policy. This would provide a uniform and positive approach to the problems of cost analysis, in marked contrast to the proposed regulations, which confuses principle with practice, and policy with instruction.

Contrast this, however, to what has been actually done. The Government's draft, in Section 15-201.1, shows that the Government starts from the premise we have proposed above (if one word - "allowable" - is eliminated), but then the balance of the proposed regulations whittle away at this to such an extent as to render Section 15-201.1 meaningless. This, we believe, is because that in the proposed regulations, some costs are dealt with according to their functions, and others according to their objects. The distinction here is as between, one the one hand, the purpose of the goods or services purchased, and, on the other, the kind of goods or services purchased. This distinction is considered to be as between the function of the cost (its purpose) and the object of expenditure (the kind of thing purchased). Among professional accountants, it is a basic principle of cost determination that all costs incurred by a contractor should be judged for validity according to the function performed by the goods or services they represent. It is unfair to disallow reimbursement of cost incurred for a valid function merely because they are costs of an "object of expenditure" which Government auditors or other critics deem to be generally objectionable by its nature.

A single example of the distinction being drawn is illustrated by the problems of advertising. If costs incurred to buy advertising may fairly be associated with performance of a Government contract because of the nature of the results sought or achieved by the advertising, then these costs should not be deemed invalid for reimbursement merely because of the tradition that "it is not necessary to advertise to get Government business."

The Government's own internal accounting practices, developed since the endorsement by the Hoover Commission in 1948 of the accounting distinctions between "functions" and "objects," are utilizing more and more the approach we advocate. An example is "performance budgeting."

It is axiomatic that contractors must recover all of the costs they incur somehow and somewhere. If they do not, it is only a question of time when their funds, capital and credit will be exhausted, their business insolvent and closed, and the employment they have provided lost forever. This is why management must, and always will, exercise judgment in incurring costs. Obviously, if fairness is the overriding consideration, the Government should bear its fair share of all of these costs - not just of some of them. To the extent that it fails to do so, it is not only seeking or demanding special favors for itself, but is asking its suppliers to handicap themselves when they go out in the market place to compete with other companies for commercial or other non-Government business, because they would have to recover Government-disallowed costs from commerical prices.

To what extent is the Government, in these proposed regulations, refusing to bear its fair share? It would disallow 23 items entirely, of which only 18 are disallowed by the provisions of the present Section XV of ASPR. It would partially

disallow 20 other items, of which only 6 are disallowed by the present ASPR. It would subject 19 other items to special tests or reviews (not "principles") which would, by definition or tests applied, lead to still more partial or total disallowances. Of these 19 items, 3 are disallowed and 7 are subject to "special consideration" under the present ASPR. The proposed new regulations also suggest advance negotiation of 9 items of which 7 are on the list for "special consideration" under the present ASPR. Elsewhere in the document, however, advance negotiation is stated as a requirement of cost allowance in 6 additional cases. The identification of the above statistics are included in the attachment hereto.

These figures demonstrate conclusively that the new regulations would not only subject cost data to substantially more detailed and lengthy analyses and reviews, with added costs to both Government and contractors, but that the negotiation process would likewise be lengthened. They also show that contractors must expect to recover substantially less of their costs than they have heretofore obtained under cost reimbursement type contracts, and to the extent the proposed regulations are applied to other types of contracts, contractors must expect disallowances of cost equivalent to the new measure of disallowances under cost type contracts. If applied to terminations, the allowable recovery would also be much less than under the provisions of Section VIII of ASPR. It is impossible to predict the measure of such non-recoveries under the new regulation, but they would aggregate a substantial portion of profits.

At the 15 October conference, the propriety of industry's position has been recognized from time to time by Government spokesmen, but these sixty-two departures from "principle" into "instruction," from "function" into "object," were justified - to the extent they were specifically discussed - on one or more of the following grounds: statutory prohibition, public policy (whether expressed officially, unofficially or merely implied), or unallocability to Government contracts. Implicit also were disallowances or limited allowances provided for solely because of supposed difficulties in measuring reasonableness, allocability or equality of treatment between competing contractors.

An examination of the disallowed or partially disallowed items, however, discloses only one - "contingent fees for securing government orders," which is forbidden by statute governing expenditure of DOD funds. Statutory prohibitions, therefore, have created none of the disagreements.

Public policy is a subject we shall discuss more fully later. Allocability should be a wholly separate question from allowability. If no allocability can be shown or reasonably implied, industry does not expect recovery from the Government. It does not, however, wish to be foreclosed from even the opportunity to prove or show allocability, and any disallowances on a premise of total unallocability are, therefore, objectionable. It is the height of accounting by "object" rather than by "function."

Equality of treatment among competing contractors is, of course, required by the paramount test of fairness. It is not accomplished, however, by total or partial disallowance. Rather it must be realized through a recognition of all normal and legitimate costs and judicious price negotiations. One company is not superior to another because it may not have incurred a cost that the other company has - the test should be, what is the best overall price to the Government for what it is buying? Competition is hampered - not encouraged - by arbitrary cost disallowances.

Neither is disallowance a solution to difficulty of measurement or control. Ways acceptable to both industry and government can be found to provide equitable measurements for allowing the costs of such things as contributions, the maintenance of excess facilities, interest, grants to educational institutions, advertising, civil defense, reconversions, applied research and development, and many other kinds of costs proposed to be disallowed or specially reviewed. Let us recall Commander Malloy's admonition at the start of the 15 October conference that "any problem can be solved by reasonable men who are in possession of the facts and who are motivated to a common purpose". So far as we know, a specific joint effort to agree on such measurements has never been undertaken, face to face. If the concept advocated at the outset of this statement were adopted, these determinations need not be made before cost principles are issued - because they would each be interpretations and instructions for auditors and not a portion of the "principles" in ASPR.

In concluding discussion on this point, let us be sure that the Government does not conclude that industry is seeking a blank check. If such an impression has been left, please re-read the first paragraph of this Section I, and consider the tests and limitations therein suggested.

II. REASONABLENESS AND ALLOCABILITY AS ADEQUATE TESTS AND CONTROLS

Government spokesmen at the 15 October conference, on several occasions, justified specific instructions, limited allowances or disallowances on the grounds that "reasonableness" and "allocability" are not sufficient, definable or usable tests. Such a position is not only contrary to the experience of industry, the opinions of every professional accountant who certifies to the accuracy and propriety of corporate books and records, the history of Anglo-Saxon and American jurisprudence, but also to the words of the proposed regulations themselves. "Reasonableness" or "allocability" as tests are used 49 times throughout the 10 September 1957 draft, as amended by the 21 August 1958 draft. They were also used by almost every Government spokesman at the 15 October conference.

One Government spokesman at the 15 October conference quoted excerpts from an article by Dr. Howard Wright in THE FEDERAL BAR JOURNAL of April-June, 1958 as proof that "generally accepted accounting principles" are not a suitable base for cost determination. This was curious, however, because this phrase or its equivalent was used 19 times throughout the DOD draft. He failed also to quote Dr. Wright's conclusion and recommendation, in the same article, as to what the primary cost accounting principle applicable to Government contracts should be. This is quoted from pages 167 and 168 of the JOURNAL, as follows:

> ". . . . Cost principles used in contract pricing if they are to apply in many situations should, in my opinion, be based on the following assumptions:
>
> (1) Cost is something to be determined, not negotiated;
> (2) Competition in the market place will create equity;
> (3) The Government should recognize its share of the operating costs of the supplier;
> (4) The Government will not exercise its sovereign rights in a contractual situation.

Based on these assumptions, the author would propose the following as the primary cost accounting principle applicable to Government contracts:

> "All costs incurred solely for the benefit of the Government contract shall be charged directly thereto; all cost incurred solely for the benefit of other classes of work shall be charged directly to such classes of work. Other costs incurred benefit both classes of work and shall be allocated to each in proportion to the benefits derived or reasons for incurring."

Obviously, Dr. Wright's position is much closer to that of industry than it was portrayed to be.

These are, therefore, usable tests recognized by all parties to the present discussions. All that remains to resolve these differences, then, is to agree on the kinds of tests to be applied in utilizing such terms as "reasonableness", "allocability", "standard accounting principles", and "consistently applied." We believe a joint effort can also resolve these problems. As requested, there is included in the attachments hereto recommended tests of "reasonableness". This has been drafted carefully and has recognized agreements with much that is contained in the DOD proposed definition (Section 15-201.3).

The use of "reasonableness", "allocability" and like concepts as tests are wholly consistent with accounting by "function", and the separation of "principles from interpretations and instructions, as heretofore recommended. When recognized as adequate tests, they also go far to justify the recognition of all normal and legitimate costs, as we have urged.

III. APPLICABILITY

In preparing a single set of comprehensive cost principles and providing that they will be applicable clear across the procurement spectrum from cost reimbursement type contracts on one side to price analyses submitted with bids for firm fixed price negotiated contracts, including termination or change order repricing claims against any type of contract, however placed initially, the Department of Defense has made the fundamental assumption that cost allowability is an identical problem throughout this spectrum and in each of the covered types of transactions. We agree that a cost is a cost wherever incurred. Because the proposed regulations arbitrarily exclude certain normal or legitimate costs from consideration, the Government's proposals of areas of applicability become impractical and patently unjust.

If "fairness" is the ultimate test, as we have recommended, then it must be conceded that there is nothing fair about both retaining the unilateral right to cancel a contract for the Government's convenience, and then - when that right is exercised - changing the ground rules of allowable costs of termination even though the initial contract may have been placed through advertised bidding, or on a negotiated firm fixed price, or at a time long before the new regulations were even promulgated! Yet in the absence of language to the contrary, this is a sure result of the presently proposed language. Similarly, it is not fair to require

a contractor to certify that something less than legitimate costs, actually incurred, are "total costs." Such costs do not become a "profit" merely because they are "disallowable" under arbitrary Government regulations. This is another inevitable result of blindly accepting these proposed regulations.

It is also interesting to contemplate the regulation's effects upon the "growing-in-popularity" incentive type contract. Consider the incentive contractor who, against a $1000 target cost, is to be paid $100 profit, or a total of $1100. It actually performs the contract with total costs of $950 but which, under these regulations, might well result in allowable costs of only $900. If the incentive profit division is 80% to the Government and 20% to the contractor, the contractor would receive a price of $1020, thus being required to give $80 of the "savings" back to the Government, even though he had already actually paid out $50 of that $80 as costs incurred. On his basis of costs, he would have received a price of $1060 and a profit of $110. Thus his absolute and actual profit is reduced from the target of $100, or from the deserved profit of $110, to $70, but the Government would report to a Renegotiation Board that he had received a profit of $120! This simple example, we submit, clearly demonstrates the unfairness of applying to incentive contracts any cost principles which do not recognize all normal and legitimate costs of doing business.

We cannot emphasize too strongly that experience of the last decade indicates that to the extent that costs are rigidly decided to be allowable or unallowable, formula price fixing is automatically involved. Despite the sincere instructions in this draft that costs shall be only one factor of pricing, the draft actually requires that many costs called "unallowable" be eliminated from the submission from the outset. Thus such costs will never be considered in negotiation, and will never become a factor in pricing. To this degree, formula pricing has already occurred. In this atmosphere, an increased use of formula pricing will be an inevitable result of putting regulations out in this format and of this character. The Hoover Commission, in 1955, recognized this in its recommendations for revisions in ASPR, Section XV, when it recommended cost principles only for cost reimbursement type contracts, and that there only be "guidelines for auditors" as to everything else.

Are "costs a factor" in any negotiation before such costs are incurred? They are not then costs, but only estimates of what costs will be - and one may argue, but never decide, as to which is the most accurate of different estimates. A final meeting of the minds occurs on price, not on costs - and this necessitates each party taking a risk of being wrong. This, however, is nothing to fear, or to be ashamed of, for this has been the trading technique of centuries, and has provided the highest incentives to efficiency. To go to or toward rigid formula pricing is to diminish or remove such incentives.

Implication exist that these proposed regulations may broadly apply to subcontractors and vendors. There is no privity of contract between the Government and a subcontractor on any tier below the prime contractor itself. There can be no assurance, therefore, that a prime contractor can, even in the best of faith, in all cases obtain necessary goods or services from subcontractors under contracts containing Government clauses or incorporating by reference Government cost or other regulatiions. Nor can it always require its subcontractors so to contract with their vendors and suppliers. This has been the repeated experience in many instances where such attempts have been made. Also it is impossible to predict

or anticipate at the time of initial negotiations, all such problems which may arise with subcontractors. Thus, if applied to subcontractors' costs, this regulation would appear in some cases to have the effect on the prime contractor of forcing it to accept not only the disallowances of some of its own costs, but also of some of its subcontractors' costs. In other cases, it would deny the availability of subcontractors to primes, thus forcing the use of second-best sources.

For these reasons, and those advanced at the 15 October conference, we strongly urge, at the very least, that this regulation not apply to fixed price negotiations, or to the preparation of cost estimates or price analyses in negotiated procurements or terminations, and that its use in such circumstances be specifically negated; and that it not apply to any determinations of costs or prices under any contract or subcontract in which it is not specifically accepted by the contractor. If, however, the regulations are redrafted on the principle of recognizing all normal and legitimate costs, reasonable in amount and fairly allocated, then their applicability could be expanded. We oppose in principle, however, any use of cost data as a formula basis for negotiating prospective firm fixed prices.

IV. EFFECTIVE DATE

The regulations as proposed are completely silent on when and how they will be made effective. This is a matter, however, which cannot be left undecided.

If the regulations are applied, in any way, to contracts in being, the Government should be prepared to negotiate equitable adjustments of price. This applies to contracts placed by advertised bids as well as by negotiation, for the applicability to termination settlements and pricing change orders affects these contracts, too. We see no other way of being fair in making these regulations effective. To say that they shall apply only to contracts negotiated after a certain date, or executed after such a date, will not suffice - for then a contractor is left with two different sets of cost accounting rules to apply - one as to old contracts, and one as to new. This would continue until all present contracts are run out, which could be years ahead. Experience under ASPR, Section XV has shown that auditors and negotiators would try to apply the new regulations to existing contracts, whether the contractors had agreed to accept them or not. This would only cause confusion, more delay, and more friction between Government and business.

To be fair, then, the Government must be prepared to pay for taking away rights to cost recovery. Parenthetically, but also of importance, it must also be prepared to accept and pay indefinitely for materially longer times for cost and price presentations, audits, and negotiations, and substantial delays in completing procurement and pricing actions. It just takes longer to isolate, review, audit, discuss and decide about over 60 elements of cost than it does 18, or none. This will cost money to both the Government and the contractor in higher administrative costs and time delays.

V. REQUIREMENTS OF PUBLIC INTEREST

At the 15 October conference, it was pointed out that Government officials "must weigh rather carefully and rather heavily the public interest factor." Several

spokesmen alluded to this, and to "public policy" or such phrases, directly or by implication. For example, one said, "are based not necessarily on public policy stated in law, but on public policy which we derive from many sources, from committee hearings, for example, personal conversations, and formal memos from the various members of the legislative branch."

We are sure that few of us in industry can appreciate the extent or the nuances of pressures of many kinds which must be placed upon you and your staff, directly or indirectly - including those from industrialists! As citizens, we want the public interest protected, and public officials placed under pressure to protect them. At the same time, however, we want to be sure it is public interest, or that it is public policy - and not merely some individual's concept of it, that causes a decision to be made adverse to the interests of industry, and ultimately to the Government itself.

In this area of cost principles, of allowable or unallowable costs for contracts, etc., we do not know of any official or clearly identified legislative expression of public policy. We do know of an expression of policy by an agency of Congress - the Hoover Commission - which we have already quoted and endorsed. We know of some individual rulings of the General Accounting Office on cost allowability - but each of necessity is narrowly restricted to the facts of the particular case, and is not unchangeable, overriding policy, nor should these be deemed to be the establishment of policy. The same is true of rulings by the Boards of Contract Appeals.

The proposed regulations depart from and are more restrictive then all of these, in one way or another. Where, then, is the public policy or public interest dictating such action? We fear that it is in the minds of staff personnel, overly concerned with the attitudes or expressions, however well considered or not, of vocal or powerful legislators or other Government officials. Let us recognize that public policy in this field does not exist, and will not exist until you and the other Assistant Secretaries make your decisions identifying the official public policy of the Defense Department on which you are relying. It is our belief that you have not been restricted in your decisions by any official of the Government, even though certain members of Congress and of the Administration may be impatient to have you reach decisions. This is why we have put forth, successively, such efforts to try to apprise you of industry's sincere and objective views on these problems.

We may be considered by some to be biased, but we believe very deeply that the welfare of our country's 20,000 defense contractors, large and small, is important not only to defense, and maintaining our armed might, but also to the overall economy and welfare of our cities, towns, states and nation. These will be hurt by these proposed regulations - not vitally, but significantly - and their profits, already below those of other industry, will be still less. Before the action is taken, therefore, we request that you weigh very carefully whether any public policy requires or makes desirable the infliction of this hurt.

VI. ADVANCE UNDERSTANDINGS (Section 15-204.1(b))

Industry welcomes any opportunity to agree in advance on cost principles, cost allowances or any other points of potential controversy which might arise during or after contract performance. If the intentions of this section as we were given to understand on October 15 is truly to make available to contractors

the privilege of taking up questionable items in advance and will not be deemed to be a requirement, we believe it to be desirable. However, the language of the section does not make this sufficiently clear and we are fearful that the good intentions at the Secretarial level may not be carried out in the field.

Such agreements to be practical, can be on a contract-by-contract basis as to only three of the cost elements listed. These are: (v) pre-contract costs (ASPR 15-204.2(dd)); (vii) royalties (ASPR 15-204.2(jj)); and (ix) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)). All others must of necessity be treated uniformly and on an overall basis. No forum is provided for such overall negotiations, nor is any basis provided for effecting agreements binding for all Government end-use work, whether as a prime or subcontractor. The latter is especially burdensome for small businesses doing business as subcontractors to many large primes.

Comparisons to custom under Part 5 of the present ASPR, Section XV are invalid, as such discusssions have often been with auditors and not contract officers, and not always embodied in formal contracts or agreements. Nor are such overall agreements favoritism to contractors, for no special advantages are sought - only uniform treatment of these kinds of indirect costs.

This section, then, should be deleted in its entirety, for the reasons outlined at the 15 October conference. If retained, however, it should affirm that failure to negotiate in advance does not lead to disallowance, that initially negotiated amounts or clauses may be reopened on showing of necessity or changed circumstances, and it should provide a forum in which contractors might negotiate these factors on an overall basis.

VII. INDIVIDUAL ITEMS OF COST

We could extend our remarks at the 15 October conference and debate further on each individual item discussed. This would be unnecessary if you accept our basic premises, as heretofore outlined, for then you would not issue, as an ASPR, any statement on allowances, disallowances, or review requirements for individual elements of cost. If, on the other hand, you should decide to continue the present format and approach implicit in the outstanding drafts, then, though in overall disagreement, and in addition to the comments herein above expressed, we would want to be heard on individual items as completely as possible. Towards this purpose, we have prepared and attached an illustrative list, with only a minimum of justification, stating industry's position both on those items discussed at the 15 October conference, and on those items not discussed but as to which disagreements still exist. We shall, of course, be glad to amplify these in writing or in person to any extent you or the other Assistant Secretaries may wish.

Apart from these items, it was apparent at the 15 October conference that considerable redrafting of the proposed regulations is necessary to clearly express the matters on which there is no disagreement except as to semantics. When your overall decisions are reached, we hope that their implementation, as well as these corrections, can be made the basis of a joint drafting effort by a very few persons from Government and industry who are not committed to the old words and the old

cliches. Such a procedure has been expeditious on other subjects - it should be on this one, too.

In conclusion, may we express again our appreciation for your sincerity and patience in hearing us out on these difficult issues. You have an opportunity to make a unique and lasting contribution to the health and welfare of our defense effort and the industries which are participants in it. We hope that we have helped to show you how that can be done.

Sincerely yours,

Ernest F. Leathem
Associate Chairman
October 15, 1958 Conference

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ATTACHMENTS

I. TEST OF REASONABLENESS

We propose the following:

(a) In evaluating estimates or actual costs of performance of specific contracts, the application of the test of reasonableness requires a flexibility in understanding and the exercise of sound judgment in dealing with the specific item after consideration of all influencing or related factors.

(b) Evaluations of reasonableness, of necessity, involve consideration of 1) the function of the cost, 2) the amount of the cost, and 3) circumstances under which it was incurred.

(c) These elements may then be tested against one or more of the following factors as appropriate:

1) Whether the cost is recognized as an ordinary type of expense in the conduct of the contractor's business.

2) Whether the cost makes a functional contribution to the conduct of the contractor's business.

3) Whether the cost was incurred in accordance with established policies and practices of the contractor.

4) Whether the level of the cost is consistent with the prior history or experience of the contractor with regard to the cost, adjusted for changed conditions.

5) Whether the cost is compatible with the prevailing level of comparable costs incurred in similar concerns, in the same geographic area, or in industry in general.

6) Whether the cost exceeds that which would be incurred by an ordinary prudent person in the conduct of competitive business giving recognition to the circumstances under which it was incurred.

(d) In the negotiation of fixed price contracts, the presumption of reasonableness, of costs, as such, is not applicable inasmuch as the controlling element in such negotiation is the overall price.

(e) As to allowability of costs under cost reimbursment type contracts, the presumption of reasonableness shall be accepted unless the cost is patently unreasonable either as to type or amount when measured by applying the appropriate factors of those listed in (c) above. Prior to making a determination of unreasonableness, the contractor shall be given the opportunity to submit data sustaining the reasonableness of the cost. The burden of proof shall be regarded as having been met if the evidence submitted sustains the reasonableness of the cost under the circumstances in which it was incurred.

II. ADVERTISING - Section 15-240.2(a)

Industry recognizes that some forms of advertising are seldom, if ever, properly allocable to Government contracts, but these are far narrower than the areas of advertising, and other types of costs, absolutely excluded and made unallowable by this section. It protests, therefore, such absolute exclusions and wants the right to present its case in negotiations to show whether and to what extent its advertising is of benefit to the Government, is reasonable in character and amount, and is fairly allocable to Government contracts. This is especially necessary in view of the breadth of definition given to advertising in this section and the artificial distinction drawn among varying advertising media.

Here, as in all specific elements of costs, we recommend that there be no exclusions by definition, and that the tests of allowability should be defined, and not the tests of unallowability. This would relieve cost elements of the stigma of unallowability in general.

III. COMPENSATION FOR PERSONAL SERVICES - Section 15-204.2(f)

The 21 August 1958 revisions to this section are a great improvement, but a few needs for clarification remain, as pointed out specifically by the industry spokesman at the 15 October conference. As no serious disagreement seems to have evolved at the 15 October conference, this seems to be purely a drafting problem. It would be helpful, however, to reduce the quantity of needless reviews by shifting the burden from the contractor (to prove reasonableness) in part to the Government (to allege unreasonableness).

IV. RESEARCH AND DEVELOPMENT - Section 15-204.2 (ii)

We propose the following specific language to substitute for this clause:

> "1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which 1) normally follows basic research, but may not be severable from the related basic research, 2) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and 3) represents efforts to 'advance the state of the art'. Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale.
>
> "2. Development is the systematic use of scientific knowledge which is directed toward the production of or improvements in useful products to meet specific performance requirements, but exclusive of design, manufacturing, and production engineering.
>
> "3. A contractor's costs of independent research as defined in (1) above (not sponsored by a contract, grant or other arrangement,) shall

be allowable as indirect costs, provided they are incurred pursuant to a broad planned program reasonable in scope, with due regard to expansion when justified by changes in science and technology, and which is well managed. Such costs should be charged off as incurred, and not capitalized, and shall be equitably allocated to all the work of the contractor, but in appropriate cases, such allocations may be made separately for each of acontractor's organizational segments.

"4. Cost of contractor's independent development, as defined in paragraph (2) above (which are not sponsored by a contract, grant, or other arrangement), are allowable to the extent that such development is related to the product line for which the government has contracts and provided such costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. Such costs may either be allowed as incurred, or capitalized and amortized over a reasonable period, but the method of recovery chosen by the contractor must be uniform and consistently applied.

"5. If provided for under the contractor's accounting system, independent research and development costs may, but are not required to include amounts representing appropriate shares of indirect or administrative costs."

This supports the basic industry position that applied research should be grouped with basic research, and not with development (which Mr. Holaday's comments supported). These costs should be recoverable against the base of all contracts of any type to the proportion which Government business bears to total business or in accordance with other acceptable methods of allocations. Development should be recoverable against all types of contracts, included within the product line toward which the development is directed.

On study we believe this clause will be seen to provide the overall controls sought by Messrs. Munves, Golden and others at the 15 October conference. On the other hand, the proposed language in the 21 August 1958 draft would exclude entirely all applied research cost recovery unless it was related to production work in contract product lines. This is impractical because such research begins long before such a relationship can be identified. Also it excludes any recovery of that portion allocable to research and development contracts. This is manifestly unfair, especially to those companies whose Government work is largely, but not wholly, on that form of contract. Moreover, the requirement for applying departmental overhead to R&D jobs should be permissive and not mandatory since the proposed draft would force a contractor to perform his accounting in a prescribed way.

V. CONTRIBUTIONS AND DONATIONS - Section 15-204.2(h).

It is contrary to every instinct of humanity and fails completely to recognize industry's public and community responsibilities to deny acceptance of its expenditures for contributions and donations as normal and legitimate costs. The fear of the Government seems to be excessive gifts or improper objects of giving. These certainly can be defined, and tests of reasonableness established which are acceptable to both industry and Government. Every other branch of the Government recognizes such expenditures as costs, except the Defense Department and GAO.

This is a very small percentage of total costs for most contractors, but is a very vital one in maintaining external and community relations.

VI. INTEREST - Section 15-204.2(g)

The Government spokesman at the 15 October conference took a position contrary to all fact when he said that interest "is not a price paid for something used in production." It is incredible for anyone to think that a business can be run or a Government contract produced without money, and that there is not a price to be paid for money. The simple fact is that interest is a vital cost of doing business. Indeed, this cost of capital ranks with the cost of material, the cost of labor, the cost of overhead, etc., as the fundamental costs of conducting any business operation.

The most frequently presented arguments against interest recovery hinge primarily upon the thesis that the Government should not favor those companies which engage in substantial borrowing over those companies which rely primarily upon equity capital. The proponents of such a thesis are ignorant of the peculiar set of economics in military business as opposed to the acceptable economics of ordinary commercial business. This separate set of economics must dictate to the sophisticated and competent management of a military company that the best interests of their stockholders are served by engaging in an optimum amount of borrowing to finance the working capital requirements of military sales. This "leverage approach" is not used for the purpose of pyramiding the earningson stockholders' equity, but rather because of the cyclical, expandable and contractible, nature of military business. Since most borrowings are of the short-term or V-Loan nature, which too is expandable and contractible, management can to some extent insulate the company's financial status against the cyclical hazards inherent in military business. To do otherwise, i.e., to rely solely or primarily upon additional stockholders' capital for the financing of military sales, would, by an professional investor standards, represent poor management policy. Very simply, to have committed the corporation to a broadened stockholder capital base and to be faced subsequently with a contraction in its military sales would result in a diluted and weakened corporate status. Indeed, the corporation would at that time look like an "uninvested" investment trust.

If, however, the financing of this business was pursued intelligently via optimum borrowings, rather than additional stockholder capital solely, the corporation would have its stockholder capital reasonably undiluted after both the military sales and the aforementioned borrowings have been contracted and its financial status, although reduced, would still be one of a going business. It is for the Government's protection that these military contractors remain going businesses, following any contraction periods, since it might have to call upon these contractors again in the event of a sudden outbreak of hostilities. Financing solely through stockholders' capital will result in the virtual destruction of these companies following a contraction period because stockholders will have descended upon these corporations and divided the swelled cash purses. However, if these corporations remain financially sound and flexible with an undiluted equity base during any interim contraction periods, they will retain the capability of meeting any new military requirements at short notice.

Therefore, the granting of interest recovery by the Government is <u>not</u> a subsidy for weakly managed and weakly financed corporations, but instead represents compensation to the well managed and well financed corporation for very properly

incurred costs. Such management cannot ignore the fact that by their very nature defense contracts often generate more requirements for working capital than any other kind of business.

Finally, this is another instance in which all that industry seeks is an opportunity to make its case in negotiations freely conducted, and not to be foreclosed arbitrarily from such negotiations.

VII. PLANT RECONVERSION COSTS - Section 15-204.2(cc)

Industry believes that there are circumstances not within the limited allowability provided in this section, and that these should be left open for negotiation. This is another instance of unreasonable and arbitrary disallowance in an area where adequate controls upon allowability should be readily devisable, or could be negotiated in advance on a case-by-case basis. This matter can be resolved by a joint drafting committee.

VIII. OVERTIME COMPENSATION - Section 15-204.2(y)

Industry's recommendations are limited to requesting a clarification between overtime premium pay and shift premium pay, both in ASPR, Section XII and any new Section XV.

This matter can be resolved by a joint drafting committee.

ITEMS NOT DISCUSSED AT 15 OCTOBER 1958 CONFERENCE

IX. RENTAL COSTS - Section 15-204.2(hh)

The provisions of this section, both as to normal rentals and lease-back rentals, are unrealistic and inequitable in that the tests of reasonableness are much too narrow. The ultimate test should be the rental value of comparable properties, and not comparisons to costs which the contractor would have sustained as owner. For example, the actual owner is entitled to a profit, to be included in his rental, and not just a bare cost recovery.

Full recovery of actual lease or lease-back costs have been maintained and allowed in decisions of the Armed Services Board of Contract Appeals.

It would be unfair as to present lease or contractual commitments which cannot be altered to disallow now legitimate costs incurred thereunder. This is a typical example of the injustice of changing rules in mid-stream.

X. CIVIL DEFENSE COSTS - Section 15-204.2(e)

It is unrealistic, and a detriment to the perfection of civil defense plans for a community or area as a whole (which certainly must be done under threats of A or H bomb damage), to deny allowability to reasonable expenditures undertaken off or away from the contractor's premises, and for contributions to local civil defense funds and projects. The latter usually consist of employee time and

equipment (trucks, mobile radios, etc.) rather than cash, and are closer to plant protection costs than to charitable contributions.

The limitation that expenditures must be made at the suggestion or requirement of civil defense authorities is not only unrealistic, but a direct violation of management's right and duty to protect its properties.

This item is of insignificant dollar value in most companies, but is illustrative of a number of items where partial disallowance is accomplished by definition.

XI. CONTINGENCIES - Section 15-204.2(g)

As to "historical contingencies," industry requests that they not be categorically disallowed, but left open for negotiation. The proposed regulation, in subparagraph (2), is based on the erroneous assumption that because the event giving rise to the cost is in the past, then the actual cost can be definitely known. This is not true in many normal business situations. One typical example is warranty expense.

XII. DEPRECIATION - Section 15-204.2(i)

This section is replete with technical changes requiring the type of language revisions which could be accomplished by a joint drafting committee. The principal matter of substance which, in fairness, should be revised is subsection (5) in order to recognize the national interest in maintaining stand-by defense facilities, even though these are not necessary to current or "immediately prospective" production.

XIII. EXCESS FACILITY COSTS - Section 15-204.2(l)

Limiting the allowance of excess facility costs to "current and immediately prospective purposes" is too restrictive and does not serve the Government's best interests. We feel that those facilities "reasonably necessary for stand-by production purposes" should be the criteria.

XIV. INSURANCE AND INDEMNIFICATION - Section 15-204.2(p)

Industry's objections to this paragraph are technical but vital. These are based upon the premises that (1) the portion of business interruption insurance which is disallowed cannot be avoided by contractors as a normal and legitimate business cost and should be allowed in full, (2) actual losses incurred through an approved self-insurance program or otherwise should be allowed without being contingent upon contractual coverage since these cannot be foreseen in advance of occurrence, and (3) the contractor should not be prohibited from purchasing insurance covering the insurable risk that a contractor has in Government property unless there is a complete relief of liability granted to the contractor.

XV. FINANCING COSTS OTHER THAN INTEREST - Section 15-204.2(q)

Financing and refinancing costs are an inevitable part of the costs of doing business. These costs should not be shoved over entirely against commercial business. Government should bear its fair share.

Does anyone really believe that financing is not required to do business with the Government?

XVI. MAINTENANCE AND REPAIR COSTS - Section 15-204.2(t)

Industry recommends an unqualified allowance of such costs, and hence, the deletion of subparagraphs (1)(i) and (ii).

XVII. MATERIAL COSTS - Section 15-204.2(v)

Technical revisions are required in subsections (2), (3) and (4) to assure that the contractor is entitled to recover its full costs of materials, and to recognize varying acceptable accounting practices. As to subsection (5), the allowability of prices in interdivisional transactions is too narrowly defined and needs extensive revision, especially to recognize the fact that competitive costs exist as to wholly Government end-use components as well as to commercial components.

XVIII. ORGANIZATION COSTS - Section 15-204.2(w)

True costs of organization are an inescapable cost and should be allowable if amortized on a reasonable basis. Without them, the contractor would not exist to undertake contracts for the Government.

XIX. PATENT COSTS - Section 15-204.2(z)

This section is unduly restrictive in its wording, and could be materially improved by a joint drafting committee. The Government certainly should not, directly or by implication, disallow the costs of obtaining and protecting patents to which it wants or claims license rights and, in addition, it should bear its allocable share of patent costs incurred by the contractor.

XX. PROFESSIONAL SERVICES COSTS - Section 15-204.2(ee)

The success of a suit against the Government, or of defending a suit brought by the Government, is proof of the contractor's inherent rights. The professional costs of defending these rights should, in all fairness and equity, be allowable.

Technical corrections and changes are also desirable in the tests of reasonableness and allowability contained in subsections (1) and (2) of this section.

XXI. RECRUITING COSTS - Section 15-204.2(gg)

We would prefer to see the subject of "special benefits or emoluments" dealt with affirmatively. As presently written the use of "standard practices in the industry" as a criteria for allowance would be most difficult if not impossible to administer and determine. Therefore we recommend changing the last sentence in this paragraph to read: "Reasonable costs of special benefits or emoluments offered to prospective employees are allowable."

XXII. ROYALTIES - Section 15-204.2(jj)

This section needs material revisions and deletions. The determination of the unenforceability of a patent (see subsection (iii)), or of its invalidity (see subsection (ii)), are judicial functions, which under no circumstances should ever be left to the determination of a contracting officer.

Royalty payments are usually based upon contractual obligations freely negotiated at arms length. There is no reason why it is not enough to subject them to ordinary tests of reasonableness.

XXIII. SELLING COSTS - Section 15-204.2(kk)

The philosophy that selling and distribution expenses are generally unnecessary in securing Government business, and hence are unallowable, fails to recognize the many indirect benefits the Government gains from a contractor's sales, distribution and sales engineering functions. The paragraph as written would permit an allocation of only those expenses which consist of "technical, consulting, demonstration and other services" for purposes of adaptation of the contractor's product to Government use. This is an unwarranted limitation and this category of expense should be fully allowable, subject only to tests of reasonableness and allocability.

XXIV. TAXES - Section 15-204.2(oo)

This section requires technical revisions to bring it into accord with recent court decisions, and to permit a contractor to protect property against tax lien enforcement, and to protect its interests in a timely manner when the Government fails to meet date deadlines.

XXV. TRADE, BUSINESS AND PROFESSIONAL ACTIVITY COSTS - Section 15-204.2(pp)

Here again, exclusions by definition occur. One omits from allowability membership costs in service organizations which in fact are required to preserve a corporation's status in its plant communities. The other places overly narrow qualifications (i.e., "dissemination of technical information or stimulation of production") upon meeting and conference expense allowability.

XXVI. ADDITIONS NEEDED FOR TERMINATION SETTLEMENTS

Recognition should also be given in the Cost Principles to the following additional types of costs which are experienced by contractors under termination claims:

Common claims of subcontractors
Costs continuing after termination
Initial costs (including high start-up costs)
Interest on borrowings
Loss of useful value of special machinery and equipment
Preparatory expenses
Settlement expenses
Special leases
Subcontract settlements

Item	Paragraph of Proposed Cost Principles	Made Unallowable by Present ASPR Section XV
Accruals for mass or abnormal severance pay	(Sec. 15-204.2(mm)(2)(ii))	
Commissions and bonuses	(Sec. 15-204.2(f))	yes
Unrecovered true depreciation	(Sec. 15-204.2(i)4(ii)	yes
Insurance	(Sec. 15-204.2(p)	
Deferred maintenance	(Sec. 15-204.2(t)1(ii)	
Material costs - credits	(Sec. 15-204.2(v)2)	
" " - writeups or writedowns	(Sec. 15-204.2(v)3)	yes
Lease-back costs	(Sec. 15-204.2(hh)(3))	
Memberships	(Sec. 15-204.2(pp)(1)	
Training and educational costs	(Sec. 15-204.2(qq)(1,2&3)	

XXIX COST ELEMENTS FOR WHICH SPECIAL TESTS OR REVIEWS ARE REQUIRED

Item	Paragraph of Proposed Cost Principles	Made Unallowable By Present ASPR Sec.XV	Special Consideration Required by ASPR Sec.XV
Bidding costs	(Sec. 15-204.2(c))		
Compensation for personal services	(Sec. 15-204.2(f))		yes
Future contingencies	(Sec. 15-204.2(g)(3))	yes	
Emergency depreciation or amortization	(Sec. 15-204.2(i)(4)		
Use charge on fully depreciated assets	(Sec. 15-204.2(i)(6))		yes
Insurance	(Sec. 15-204.2(p))		yes
Costs of materials transferred between plants or affilitates	(Sec. 15-204.2(v)(5))		yes
Overtime, extra-pay shift and multi-shift premiums	(Sec. 15-204.2(y)		yes
Pre-contract costs	(Sec. 15-204.2(dd))		yes
Professional service costs	(Sec. 15-204.2(ee)(1) and (2))		
Recruiting costs	(Sec. 15-204.2(gg))		
Rental costs	(Sec. 15-204.2(hh)(1) and (2)		
Research and development costs	(Sec. 15-204.2(ii))	yes	
Royalties	(Sec. 15-204.2(jj))		yes
Selling costs	(Sec. 15-204.2(kk))	yes	
Severance pay	(Sec. 15-204.2(mm))		
Unadjudicated taxes	(Sec. 15-204.2(oo)(2))		
Meeting or conference expense	(Sec. 15-204.2(pp)(3))		
Travel costs	(Sec. 15-204.2(ss)(5))		

XXX ITEMS ON WHICH ADVANCE NEGOTIATION IS REQUIRED AS A REQUIREMENT OF COST ALLOWANCE

Contingencies	(Sec. 15-204.2(g))
Insurance and indemnification (losses not covered by insurance - Sec. 15-204.2(p)(1)c) (Indemnification - Sec. 15-204.2(p)(2))	
Patent Costs	(Sec. 15-204.2(z))
Professional service costs	(Sec. 15-204.2(ee)(3))
Rental Costs	(Sec. 15-204.2(hh)(3))

XXVII COST ELEMENTS MADE WHOLLY UNALLOWABLE

Item	Paragraph of Proposed Cost Principles	Made Unallowable by Present ASPR Section XV
Bad debts	(Sec. 15-204.2(b))	yes
Stock options	(Sec. 15-204.2(f)(5))	
Historical contingencies	(Sec. 15-204.2(g)(2))	yes
Contributions and donations	(Sec. 15-204.2(h))	yes
Entertainment	(Sec. 15-204.2(k))	yes
Excess facility costs	(Sec. 15-204.2(l))	
Interest	(Sec. 15-204.2(q))	yes
Bond discounts	(Sec. 15-204.2(q))	yes
Costs of financing and refinancing	(Sec. 15-204.2(q))	yes
Legal and professional fees paid in preparation of prospectus	(Sec. 15-204.2(q))	yes
Costs of preparation and issuance of stock rights	(Sec. 15-204.2(q))	yes
Losses on other contracts	(Sec. 15-204.2(s))	yes
Organization costs	(Sec. 15-204.2(w))	yes
Reorganization costs	(Sec. 15-204.2(w))	yes
Costs of raising capital	(Sec. 15-204.2(w))	yes
Legal, accounting and consulting services (of certain types)	(Sec. 15-204.2(ee)(3))	yes
Federal income taxes	(Sec. 15-204.2(oo)(1)(i))	yes
Taxes in connection with financing, refinancing or refunding	(Sec. 15-204.2(oo)(1)(ii))	yes
Special assessments	(Sec. 15-204.2(oo)(1)(iv))	
Taxes for which exemptions are available etc.	(Sec. 15-204.2(oo)(1)(iii))	
Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships	(Sec. 15-204.2(qq)(5))	
Losses from sales or exchanges of capital assets	(Sec. 15-204.2(ff))	yes
Contingent fees for securing government orders		yes

XXVIII COST ELEMENTS MADE PARTIALLY UNALLOWABLE

Advertising Costs	(Sec. 15-204.2(a))	yes
Civil defense costs	(Sec. 15-204.2(e))	
Depreciation on idle or excess facilities	(Sec. 15-204.2(i)(5))	
Use charge in fully depreciated assets	(Sec. 15-204.2(i)(6))	yes
Fines and penalties	(Sec. 15-204.2(m))	
Insurance on lives of officers, partners or proprietors	(Sec. 15-204.2(p)1(v))	yes
Patent costs	(Sec. 15-204.2(z))	
Reconversion costs	(Sec. 15-204.2(cc))	
Costs of special benefits or emoluments offered to new employees	(Sec. 15-204.2(gg))	
Applied research and development costs	(Sec. 15-204.2(ii))	

DUnkirk 8-7195

STRATEGIC INDUSTRIES ASSOCIATION
3780 WEST SIXTH STREET • LOS ANGELES 5, CALIFORNIA

November 17, 1958

Hon. Perkins McGuire
Assistant Secretary of Defense (S&L)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

Unfortunately, I could not take part in the November 6 and 7 industry meetings which resulted in Mr. Leathem's comprehensive letter to you--industry's final "rebuttal" on Cost Principles. Our President and our Cost Principles Committee have reviewed Mr. Leathem's letter and wish me to express to you our general support of its contents.

There is one additional aspect which they would like me to stress--the situation respecting fixed-price contractors. We believe you are sold, so to speak, on the inequitable effect of applying the principles in their present state to the settlement of fixed-price terminations where the principles were not embodied in the original letting of the contract. But we believe further emphasis on the hazards, both to industry and government, should be made with regard to any application in the area of fixed-price contracting.

To illustrate the harm to government, as well as industry, we should note that the word "unallowable" with respect to a cost reimbursement-type contract is to be taken to mean "unacceptable" with regard to a fixed-price contract (13-101.2.) In negotiating a new fixed-price contract, therefore, it is evident that all "unallowable" items must be automatically excluded from the area of negotiation.

This places the prospective fixed-price contractor in one of two positions, both of which are untenable:

(a) He must conduct "negotiation" solely within the area of "acceptable" items--<u>that is, be negotiated out of some of them</u> and hence wind up in a position inferior to that of a cost-reimbursement contractor, or

(b) he must consider a formula price--all acceptable costs, plus a percentage thereon--as the most desirable result of his so-called negotiation.

My statement at the defense-industry meeting on October 15 cited a specific instance of formula pricing. This was confined to a single instance merely for sake of brevity. Our experience has been that formula pricing is increasing on all fronts. It is particularly evident in the matter of repricing "negotiations" conducted by mail, a common circumstance as between the smaller contractors and government purchasing offices located remote from the plants involved.

In repricing, the formula approach seems particularly hazardous to government because it tiptoes dangerously close to the forbidden cost-plus-a-percentage-of-cost. From the contractor's standpoint, the limitations inherent in formula pricing are completely counter to the higher risk philosophy which normally does and should surround fixed-price work. Rather than accept a cost straight-jacket on a fixed-price contract, the incentive will be to seek a CPFF contract which, at least, guarantees payment of agreed costs.

To be constructive, we would like to suggest that the commitment to issue the Cost Principles be honored by proceeding on the basis of having a set of principles applicable only to cost-reimbursable type contract (as suggested by the Hoover Commission) making such minor modifications in the existing writing as to effectuate this change together with the handful of revisions necessary to bring equity into the treatment of certain specific costs as delineated in Mr. Leathem's letter and its attachments.

I want to thank you personally for your great courtesy during our time together in Washington. It added to the very sizeable respect our SIA people have for the guy who is sitting in your chair.

Sincerely,

John Marschalk
Executive Director

JM:bb

JOHN MARSCHALK
3780 WEST SIXTH STREET
LOS ANGELES 5, CALIFORNIA
DUNKIRK 9-8415

April 22, 1959

Hon. Perkins McGuire
Asst. Secretary of Defense (S&L)
Pentagon
Washington 25, D.C.

Dear Mr. Secretary:

It was certainly gracious of you to write as you did on April 8. Let me repeat what I said at the close of the session: Pete Mulloy is an excellent chairman and one of the most competent people I've met on your good staff. He never seemed to pre-favor either a Government or industry position, but showed highest regard for what seemed the most reasonable logic on any given point. In fact, he was so doggone deft that I found myself yielding on some points I had originally intended to be fairly noisy about.

As he probably told you, I never did get off my soap-box on certain aspects of handling fixed price. If I had my druthers, I'd like to see all references to fixed price contracting taken out of Section XV, Part 2 - some of them interfere with this part's use in cost-type contract language - and have these references picked up in the new Part 5. And as Pete also knows, I'm still afraid that the big majority of contracting officers are much too human to avoid falling back on formula pricing unless the fixed price language is less mandatory in tone.

In spite of the foregoing, I sincerely feel the language appropriate to cost-type contracts, if issued just as we left it at the conclusion of our session, would represent a job exceedingly well done from both industry and Government standpoints.

Thank you again for having me take part. It was no sacrifice at all, and it's always a pleasure to serve you.

Sincerely yours,

JM-la

John Marschalk

P.S. James Dunn sent me the copy of MIL-D-30727, the drawing control specification. I've written to tell him how delighted I am to see that the objectionable provisions were deleted...and much thanks to you, sir!

Draft - 23 April 1959

SECTION XV
CONTRACT COST PRINCIPLES ~~DRAFT 20 April 1959~~

15-000 Scope of Section. This Section contains general cost principles and procedures for the determination and allowance of costs in connection with the negotiation and administration of cost-reimbursement type contracts and contains guidelines for use, where appropriate, in the evaluation of costs in connection with certain negotiated fixed-price type contracts and contracts terminated for the convenience of the Government.

Part 1 - Applicability

15-101 Scope of Part. This Part describes the applicability of succeeding Parts of this Section to the various types of contracts in connection with which cost principles and procedures are used.

15-102 Cost-Reimbursement Supply and Research Contracts with Concerns Other Than Educational Institutions (ASPR 3-404). This category includes all cost-reimbursement type contracts for supplies or for experimental, developmental, or research work (other than with educational institutions, as to which ASPR 15-103 applies), except that it does not include facilities contracts (see ASPR 15-105) or construction contracts (see ASPR 15-104).

~~15-103.1 Applicability of Part 2.~~ The cost principles and procedures set forth in Part 2 of this Section shall be used in connection with cost-reimbursement supply and research contracts with other than educational institutions -

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimburseable costs under cost-reimbursement type contracts ~~(ASPR 3-404)~~, including cost-reimbursement type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts

<insert> (ASPR 3-405.1); →

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR Section VIII, Part 4), and for settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 2 is to be used as a guide where costs are to be considered in negotiating fixed-price type contracts, as indicated in Part 6 of this Section.

15-103 Cost-Reimbursement Research Contracts with Educational Institutions. This category includes all cost-reimbursement type contracts (ASPR 3-404) for experimental, developmental, or research work with educational institutions. The cost principles and procedures set forth in Part 3 of this Section shall be used in connection with cost-reimbursement research contracts with educational institutions —

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimbursable costs under cost-reimbursement type contracts, ~~(ASPR 3-404)~~, including cost-reimbursement type subcontracts thereunder;

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR Section VIII, Part 4), and for the settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 3 is to be used in determining the allowable costs of research and development performed by educational institutions under grants. Further, Part 3 is to be used as a guide where costs are to be considered in negotiating fixed-price type contracts with educational institutions, as indicated in Part 6 of this Section. [Editor's note: If this paragraph 15-103 is printed, ASPR 15-300 should be deleted.]

15-104 Cost-Reimbursement Construction Contracts. This category includes all cost-reimbursement type contracts (ASPR 3-404) for the construction, alteration, or repair of buildings, bridges, roads, or other kinds of real property. It also includes such contracts for architect-engineer services relating related to such construction. It does not include contracts for vessels, aircraft, or other kinds of personal property. The cost principles and procedures set forth in Part 4 of this Section shall be used in connection

with cost-reimbursement construction contracts —

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimbursable costs under cost-reimbursement type contracts, ~~CASPR 3-404~~ including cost-reimbursement type subcontracts ~~thereon~~ thereunder;

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR VIII, Part 4), and for ~~the~~ settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 4 is to be used as a guide where costs are to be considered in negotiating fixed-price construction type contracts, ~~with educational institutions~~, as indicated in Part 6 of this Section.

15-105 Cost-Reimbursement Facilities Contracts. (Reserved.)

15-106 ~~[illegible]~~ Reserved.

15-107 Advance Understandings on Particular Cost Items.

~~15-107.2 Advance Understandings on Particular Cost Items.~~ The extent of allowability of the selected items of cost covered in ~~ASPR 15-204.2 has~~ Parts 2 through 5 ~~205~~ has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly ~~in the absence of~~ effective competitive restraints. In order to avoid possible subsequent disallowance or dispute based on unreasonableness or non-allocability, it is important that prospective contractors seek agreement with the Government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Such agreement may also be initiated by contracting officers individually, or jointly for all defense work of the contractor, as appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts, or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost treatment covered thereby throughout the performance of the contract. But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. Examples of costs on which advance agreements may be particularly important:

(i) compensation for personal services; ~~(ASPR 15-204.2(f));~~

(ii) use charge for fully depreciated assets; ~~(ASPR 15-204.2 (i)(6));~~

(iii) deferred maintenance costs; ~~(ASPR 15-204.2 (t)(1)(11));~~

(iv) pre-contract costs; ~~(ASPR 15-204.2 (dd));~~

(v) research and development costs; ~~(ASPR 15-204.2 (11)(6));~~

(vi) royalties; ~~(ASPR 15-204.2 (jj));~~

(vii) selling and distribution costs; ~~(ASPR 15-204.2 (kk)(8));~~ and

~~and~~

(viii) travel costs, as related to special or mass personnel movement. ~~(ASPR 15-204.2 (ss)(5))~~

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

CR

SUPPLY AND LOGISTICS

4 May 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)
Through: Director of Procurement Policy

SUBJECT: Letter From John Marschalk With Respect to Contract Cost Principles.

In his letter of April 22, 1959, John Marschalk has repeated a recommendation which has been made many times in the past; namely, that the Cost Principles in Part 2 of Section XV be restricted to only cost-type contracts. In this instance, he has recommended that any and all non-cost type contract language be removed from Part 2, to be picked up in the new Part 5 dealing with fixed-price contracts. Both Mr. Kilgore and I feel that any such revision would in large part negate one of the principal objectives of the cost principles; namely, to provide a single useful document to be used whenever costs are a factor. The present draft of Part 2 does contain some language which is associated with fixed-type contracts. However, this language does not detract from the usefulness of Part 2 for Cost-type Contracts. If it were to be removed from Part 2 and placed in the new Part 5, it would be very confusing and difficult to work with. We have made one change, however, of this general character as the result of our recent Industry discussions. In the current draft, we have changed the location of the treatment of Advance Understandings by removing it from Part 2 and placing it in Part 1 of Section XV. In a small way, this partially accommodates Mr. Marschalk's recommendation. We feel that this is as far as we should go in this regard.

We have prepared a new draft of the Cost Principles, giving effect to the latest Industry recommendations and to certain editorial rearrangements which we have made in our further study of the Cost Principles. I am meeting with a departmental group on Tuesday, May 5th and Thursday, May 7th, to secure departmental reaction to the changes which we have made. I am hopeful that the departmental coordination work will be completed this week and that I will then be in a position to provide you with our recommendations.

J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

Incl.
Ltr. fm Mr. Marschalk
dtd 4/22/59

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

CR
SUPPLY AND LOGISTICS

4 May 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)
Through: Director of Procurement Policy

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J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

Incl.
Ltr. fm Mr. Marschalk
dtd 4/22/59

CR

29 July 1959

Dear Mr. Marschalk:

I am inclosing a copy of our latest draft of the contract cost principles for your information. This draft is furnished to you for your personal information in view of your helpful assistance in connection with our recent review of the language of the regulation. I am sure that you understand my request that you hold the contents of this draft confidential until its publication.

We are, I think, getting nearer to a publication date, although this depends on our success in dealing with the Comptroller General. We had scheduled a meeting with Mr. Campbell last week but it was cancelled at the last minute. It will probably be rescheduled shortly. We hope to convince Mr. Campbell that he should not get into the details of the cost principles because of our desire to publish them at an early date. If we are successful, we will be able to go forward shortly. If not, I can't predict it.

I am not furnishing the attached draft for comment. However, I am sure that you realize that we will always be happy to receive your suggestions for correction of any possible errors which might have crept into our efforts.

As we get closer to a publication date, I am becoming increasingly aware of the need for rather explicit instructions with respect to the cut-over to the new principles. We are currently experiencing some difficulties in this regard in connection with Section XV, Part 3 with the Universities. Our current thinking is to have the new principles effective on 1 January; however, if there is much further delay, we would have to put this off until 1 July 1960. They would apply only to new contracts or to amendments to existing contracts calling for new procurement. I think that the new principles can be used rather quickly in the fixed price area where they are for use only as a guide. It would seem that any difficulties that arise could be ironed out in the negotiation process.

We foresee a problem in connection with amending existing cost type contracts involving the legal question of adequate consideration. We are

currently working on this problem and if you have any ideas that may help us, please feel free to drop me a line.

Sincerely,

J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

Mr. John Marschalk
3780 W. 6th Street
Los Angeles, 5, Calif.

Identical letter sent to: Mr. Bellows Mr. McAnly and Mr. Haynes

HOllywood 9-9174

John Marschalk
2850 Belden Drive
Hollywood 28, California

August 18, 1959

Cdr. J. M. Malloy
Staff Director, ASPR Division
Office of Procurement Policy
Assistant Secretary of Defense (S&L)
Washington 25, D.C.

Dear Pete:

Thanks for your kind letter of 29 July and the enclosed latest draft of Cost Principles.

I'm much impressed with the physical changes, renumbering of paragraphs and so on. Also, it's good to see that a number of the wordings we sweated over found their way into print.

Only one major recommendation that didn't make the grade bothers me, the one which would deny reimbursement for a royalty payment on a patent "administratively determined to be invalid" or "considered to be unenforceable". Considered by whom?

Nearly all the other provisions as to reimbursement type contracts strike me as representing big improvement for both industry and government when compared with earlier drafts. On fixed price contracts, we appear to have lost another change that really ought to have stuck, the final sentence under 15-602(b)(i), in that "the final price accepted by each party should not reflect agreement on the evaluation of each element of cost"...etc. I go down with colors flying on the belief that any other wording denies the thesis of negotiation.

You may want to check a couple of apparent typo errors. On page 30, first line of paragraph (d) appears to have an omission. And on page 51, in the second line, the word preceding "settlement" seems like it ought to be "or" instead of "of".

As to effective dates, is it a worthwhile idea to consider permissive effectiveness immediately as to any contractor who agrees to accept it by modification of existing contracts? This might be very beneficial to companies with complicated contract structures. The hardest problem would be to work under two different standards of acceptability.

Thanks again for keeping me posted.

Sincerely,

John Marschalk

JM-1a

SOME PROBLEMS OF NEGOTIATION AND ADMINISTRATION

OF

COST REIMBURSEMENT TYPE CONTRACTS WITH COMMERCIAL ORGANIZATIONS

UNDER

THE NEW "COST PRINCIPLES" PROMULGATED BY THE REVISIONS TO SECTION XV

OF THE

ARMED SERVICES PROCUREMENT REGULATION

ISSUED ON

NOVEMBER 2, 1959

AN ADDRESS

DELIVERED BY ERNEST F. LEATHEM, ASSISTANT TO THE PRESIDENT, RAYTHEON COMPANY

AT A BRIEFING CONFERENCE ON GOVERNMENT CONTRACTS

SPONSORED BY

THE FEDERAL BAR ASSOCIATION AND ITS PHILADELPHIA CHAPTER

IN COOPERATION WITH

THE BUREAU OF NATIONAL AFFAIRS, INC.

AT

THE SHERATON HOTEL, IN PHILADELPHIA, PENNSYLVANIA

ON

FEBRUARY 19, 1960

Mr. Moderator, Fellow Panel Members, Ladies and Gentlemen:

It has been a long time since I have addressed an audience composed primarily of lawyers. For that matter, it has been a long time - almost thirteen years - since I have myself practised law. I am, therefore, rusty both as to the law itself and to any approach slanted solely or primarily toward lawyers. I would be doing you all an injustice were I to attempt to resurrect from the dim past such an approach in talking about the subject - or rather, that part of the subject - which has been assigned to me today. So expect no citations or Latin maxims, and few if any quotations.

Instead let us pick out and discuss just a few - four to be exact - areas in which problems have already been met, or will surely arise, in putting the new ASPR Section XV cost principles into effect under cost-reimbursement type contracts. I say these are just a few, because there are seven subsections under Sec. XV, Part 1, eight in the first four sections of Part 2, and forty-six under Sec. 15-205 alone. I predict that one or more problems will arise under each of these sixty-one within the next eighteen months. It must always be so as long as Government continues in its obstinate refusal to recognize as costs all true costs of conducting a business.

It is not my purpose today, however, to rehash the debates which went on for the eight years during which these new ASPR provisions were under study, preparation,

review and revision. For the time being, at least, these are all water over the dam. Now the new provisions are officially promulgated, and will become mandatorily effective on and after July 1. Nor do I propose to cover, however lightly, all of the principles as stated. Even if time should permit, I would not do it - for no one can wet-nurse you through this complex field. Whether you act for Government agencies, for defense contractors, or as private practitioners, there is no possible substitute for your own careful and painstaking reading and study of the document which spawned this monster, ASPR Revision No. 50 of November 2, 1959. In fact, from now on, I shall assume that you have read it, and not only it, but also the old rules in the present Section XV of ASPR, and even the last draft of the new provisions presented to industry for comment - that dated September 10, 1957. For ease of reference, I shall call these, respectively, the "new rules," the "old rules," and the "last draft."

The first problems I want to discuss are those created by making the new rules effective on July 1, 1960 to all contracts thereafter issued. The exact language used is as follows:

> "This Revision shall be effective at all applicable echelons with respect to contracts issued on or after 1 July 1960, but compliance is authorized upon receipt hereof. Existing cost-reimbursement type contracts may be amended, but only if the amendment will not be to the disadvantage of the Government.

Thus, if a proposed amendment would result in the allowance of greater costs, there must be an equivalent benefit to the Government in the form of improved delivery schedules, increased quantities of work, offsetting reductions in administrative expenses, or the like."

Elsewhere, in the news release issued by the Department of Defense, No. 1233-59 of November 2, 1959, announcing the issuance of the revised cost principles, and in the Question and Answer Sheet which accompanied the news release, it was stated that the "allowability of costs under cost-reimbursement type contracts is not materially changed from the previous regulation," and that "contractors can expect about the same result." Yet it is a fact, just to mention two items, that under certain circumstances, development costs are for the first time allowed as a cost, and the allowability of research costs is extended beyond mere "general research," which is all that the old rules permitted under any circumstances.

Now let us assume that contractor A, holding outstanding CPFF contracts which will extend to July 1, 1962, has never before sought recovery of general research but has in fact company-sponsored programs of applied research and of development which would qualify for cost allowability under the new rules. In order to amend its present contracts to incorporate by reference the new rules, must A match precisely the dollar value of its impending recovery of research and development costs by showing what lesser costs

will be allowed because of the more restrictive nature of the new rules, and if this does not yield enough dollars, then go on to undertake additional work, faster deliveries or other new cost-creating obligations? A strict reading of the quoted language leaves no doubt that this, and only this, is the price to him of an amendment. Thus it has no value to him, and he cannot be expected either to seek it, or to agree to it if proposed to him by a Government negotiator.

And yet, can it possibly be that the Government wants its regular defense contractors to have to keep two sets of overhead rates - one applicable to old contracts issued prior to July 1, 1960, and another applicable to new contracts issued after that date, and to keep these dual accounting systems in being so long as any old contracts continue or are extended? Does it really want to set up barriers as rigid as these, or does it want to get all cost-reimbursement contracts under the new rules, and to have uniformity of treatment, as soon as this practically can be done?

This is where you Government lawyers come into the picture, for if the past repeats itself, you will either volunteer or be called upon to say what is compliance with the quoted language, and to say whether a given set of circumstances does in fact yield "an equivalent benefit to the Government." Here you can receive little help from either the contractor or the contracting officer, for neither will honestly be able to assign a dollar value to savings from single, versus double, bookkeeping, audit, rate

preparation, negotiation and contractual amendment.

It seems proper, therefore, for me to suggest that the purpose may be more important than the words, and that the words should be interpreted and applied to carry out the purpose - and also, that perhaps the best solution of all would be for Commander Malloy and his associates in DOD to rewrite this language to recognize the real, though intangible, benefits to both Government and industry of having one set of rules and not two.

Already, defense contractors are being asked to incorporate by reference the new rules not only into new contracts now being negotiated for issuance prior to July 1, but also into amendments of present contracts occasioned by funding actions, changes in scope, extensions of work time, or other reasons. If the unwary contractor, being anxious to please and with no bargaining position to resist, agrees - is he later going to be met by a legal ruling of failure to provide adequate consideration? This has happened in the past - steps should be taken now to prevent it happening again in the future.

The next problem I want to discuss is the applicability of the new rules. I shall try to stay away from the tempting extension of this discussion to what happens about the various kinds of fixed-price contracts under the provisions of Part 6, and shall let that drop after merely saying that I am inherently suspicious of the use of

the phrase "guidelines for use in the evaluation of costs." But there are going to be problems, even in the applicability of the new rules to cost-reimbursement type contracts.

The new rules say that they "contain general cost principles and procedures for the determination and allowance of costs in connection with the negotiation and administration of cost-reimbursement type contracts," except facilities or construction contracts, and shall be "the basis for determination of reimbursable costs, ... including cost-reimbursement type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts." I am sure that this will be read by the auditors to mean that their findings are absolute, and that this language leaves no latitude for negotiating.

Yet the next subsection says the new rules shall be "the basis for the negotiation of overhead rates." Since an auditor admittedly has no power to negotiate, this seems to give the ultimate decision to the contracting officer or his delegee in overall rate negotiations. Is there, then, to be one group the contractor deals with as to direct costs, and another as to indirect costs, and none as to all costs? If such be the intention, look out for fireworks from the contracting officers!

The new rules contain, for the first time, definitions of "reasonableness" and "allocability." Contractors with whom I have talked find no fault with these, and to have them spelled out with such care is a real achievement of the new rules. Indeed,

many professional accountants believe that the new rules would be excellent had they stopped right there. Do these provisions give us any guide as to the authority to determine applicability? I believe they do - for in Sec. 15-204(a), it is said that

> "Costs shall be allowed to the extent that they are reasonable, allocable and determined to be allowable in view of the other factors set forth in ASPR 15-201.2 and 15-201.5. These criteria apply to all the selected items of cost which follow, notwithstanding that particular guidance is provided in connection with certain specific items for emphasis or clarity."

These words certainly seem to make reasonableness and allocability the ultimate tests, and it would seem that even the most audacious auditor would leave the determination of reasonableness to the contracting party - namely, the contracting officer.

I really believe we shall have no more problems in this area under the new rules than we have had under the old rules, but being new rules, and hence subject to new interpretations, I suspect that some of our old problems may be repeated. I hope, though, that we all can agree that the contracting officer or his delegee should retain the ultimate authority for cost settlements as well as price settlements and other contract terms.

The applicability of the new rules to successive tiers of subcontractors holding cost-reimbursement type subcontracts may prove more troublesome. It is not enough to pass this off by saying that all the new rules say is that the prime will only be paid for payments to subcontractors which recognize the allowances, disallowances and interpretations contained in the new rules. This is a pretty hefty stick, and you can be sure that the prime will be taking every possible step to pass the new rules through, by contract terms, to the cost-reimbursement type subcontractors - but in many cases, he cannot force such acceptance, and even if he does, he often will not be permitted to audit a major company's costs merely because it is a subcontractor. So here we are with the same problem the Air Force is facing in its efforts to have prime contractors get more cost data in pricing subcontracts - some way must be provided for Government audit of subcontracts and for the protection of private data belonging to the sub when cost data is disclosed to the prime. This is easier said than done!

The third area of discussion is about advance understandings. As you know, the new rules list, in Sec. 15-107, eight cost elements as to which defense contractors are urged to make advance agreements which can be embodied in contract terms. Actually, elsewhere in the new rules, advance agreements are urged or required as to at least five additional kinds of costs. The last draft made, as to the eight listed items, an advance agreement mandatory if any such costs were to be allowed, but the new rules are less

stringent and now state: "But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable."

Nevertheless, advance agreements are certainly desirable, and industry representatives have welcomed the forthright recognition of their desirability in the new ASPR provisions. Any contractor which does a lot of cost-reimbursement type contracting with the Government will be sure to seek them and to want promptly to negotiate such agreements - but how will he go about it? This is far from clear, and this is the reason I want to discuss this problem today.

To get the matter sharply into focus, let me list the items about which advance agreements are suggested. As I do so, consider as to each whether separate agreements, contract by contract, are practical - or whether the particular cost factor is one which must - to be feasibly handled - be treated alike in every situation, no matter who the customer is or what the type of contract used. I suggest that some are one, and some are the other, and some are mixed.

The eight items listed in Sec. 15-107 are:

1) Compensation for personal services

This I believe can be handled only on an overall basis

2) Use charge for depreciated assets

This I believe can usually best be handled on a contract-by-contract basis, in the situations where such assets are in fact to be used - but if it is a complete facility, building and equipment, then an overall treatment might be required.

3) Deferred maintenance costs

Except in rare instances, this would normally be spread across an entire plant area's overhead costs, and should, therefore, be treated on an overall basis.

4) Pre-contract costs

Obviously, this should be covered on a contract-by-contract basis, for such costs would not always be incurred, or if they were, should not be borne in any degree by another contract or group of contracts.

5) Research and development costs

The whole concept of Sec. 15-205.35 is predicated upon an overall treatment, even though recovery of development costs may be possible only against Government purchases within a given product line.

6) Royalties

Here, it seems to me, is a mixed situation. If a contractor's obligations to pay royalties extend over all its products, or even

all the products of a single division, then this can be handled on an overall basis. If, however, the royalty obligations are narrower, then recovery should be restricted to the situations where royalties have to be paid, and probably would require a contract-by-contract treatment.

7) Selling and distribution costs

Normally, these can and should be spread over all of a contractor's business and, therefore, can be handled on an overall basis. This is true even in a business which has some Government and some commercial business, for Government selling and distribution costs - other than advertising - are quite different and identifiable from normal commercial sales activities.

8) Travel costs, as related to special or mass personnel movement

This is, again, a situation which could be mixed. Normally it would relate to the specific performance or service requirements of a single contract, and hence would lend itself to contract-by-contract treatment. But how about the move into a completely new and distant laboratory, production facility or test site made by a company to improve its facilities, or to draw upon a new labor market? If this new location

will serve more than one contract, or especially if it will perform both Government and non-Government work, then such costs should be spread across all work on an overall basis.

The five other areas in which advance agreements are suggested or required are:

1) Contingencies (Sec. 15-205.7(ii))

The possible allowability of contingency reserves as a cost is here recognized officially for the first time, but will undoubtedly be approached warily by individual contracting officers. It seems to me, therefore, that this must be handled only on a contract-by-contract basis.

2) Insurance (Sec. 15-205.16(a)3)

This relates to the allowability of losses against a self-insurance program which could have been covered by permissible insurance, only if provided for in the contract. It is impossible in advance to predict either the nature or extent of such losses in any precise way, but reasonable actuarial approaches can be taken in fixing charges to a self-insurance program. These, it seems to me, must be viewed only on an overall basis, and cannot be left to separate allowance on one contract and disallowance on another.

3) Plant reconversion costs (Sec. 15-205.29)

These are stated to be recoverable only "in special circumstances," and hence must only be handled on a contract-by-contract basis.

4) Professional and other services in connection with patent litigation (Sec. 15-205.31(c))

It seems clear that the drafters of the new rules intend this to be negotiated on a contract-by-contract basis, but like royalty costs, situations might arise where equity would require an overall treatment and spreading of such costs. I, therefore, consider this a mixed situation.

5) Rental costs (Sec. 15-205.34(c))

This relates to rental costs fixed in sale and leaseback agreements. These often cover major real estate and facilities, or plant areas alone. Where they do, an overall agreement is the only fair basis for spreading such costs across all the work done in such facilities or plant areas.

In these thirteen situations, then, we have only four that clearly lend themselves to a contract-by-contract negotiation, and six demand overall treatment

if we are to avoid excessively long negotiations of single contracts and the probable inequity of varying conclusions by different contracting officers. The other three are mixed. How and with whom does a contractor negotiate for the overall agreements needed? There is no part of the Department of Defense set up or authorized to conduct such negotiations, nor are there single representatives yet able to speak for all parts of any one of the three Armed Services. The only exception to this statement is the Tri-Service Committee just starting to work on advance agreements covering research and development costs, but even it will only try to cover the largest 50 or 60 defense contractors. Many more than these will need overall agreements covering research and development costs.

We have, therefore, the recognition and promise of advance understandings and agreements, but as to six, and possibly nine cost-elements, no place to get an agreement carrying any assurance that the treatment afforded will be fair, prompt and uniform, except possibly as to research and development costs. This is a situation which I hope will have the attention of each of the Services and of the Department of Defense. In the meantime, however, one device is possible - and even a cure if the various parts of each Service can be brought together into a single, Servicewide negotiation. That is the "basic agreement."

The basic agreement has been used by the Air Force with some contractors

with considerable success, but it has not been widely used elsewhere. For cost-reimbursement type contracts, its usage has even been less. To some extent this reluctance has been the result of unwillingness to come to grips with difficult or controversial problems, or the inability to bring together persons with authority to represent or speak for each part of any one of the Services. There has also been reluctance among some Government lawyers to have contract issues resolved in what they have considered to be a vacuum, apart from the Government's requirements and the contractor's problems relative to a particular procurement. Some have raised questions of adequacy of consideration, or other potential legal obstacles.

Yet here is the only method, now in existence, by which schedules of reimbursible costs, tailored to each contractor's accounting system and containing the advance agreements needed for these ten elements of costs under the new rules, can rather readily be negotiated for incorporation into contracts to be issued after July 1 of this year. I recommend, therefore, that this method be employed by the departments as rapidly as possible, even to the extent of assigning personnel and clothing them with authority to negotiate overall basic agreements as expeditiously as possible. I also suggest again that the objectives gait the action, and that the Government lawyer seek out ways to accomplish the objectives, and not interpose roadblocks.

The final point I want to discuss with you is the concept of cost-sharing,

which is set forth in Sec. 15-205.35(h) pertaining to the allowability of research and development costs. The philosophy back of this appears in the definition of reasonableness, in Sec. 15-201.3, where it is said:

> "The question of the reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to effective competitive restraints."

A preponderance of Government business apparently may create a presumption that competitive restraints are absent.

I can assure you that this is the exception rather than the rule. There are few businesses whose purchases are so sought after and fought for as are the kinds of things the Government buys by negotiated procurement. I can assert categorically that a preponderance of Government business rarely, if ever, frees a company from competitive restraints. Remember that restraints are not imposed merely by having to bid on the price of identical or substantially identical items. Price is only one facet of competition. Others, equally important, are labor rates - fixed by the competition for jobs in the area or industry, technical capabilities - the competition to outdesign someone else, production know-how - the ability to produce faster, or better, or cheaper than someone else. None of these are lessened by having a preponderance of Government business.

But having assumed an absence of competitive restraint, Sec. 15-205.35(h) goes on to say:

"In recognition that cost sharing of the contractor's independent research and development program may provide motivation for more efficient accomplishment of such program, it is desirable in some cases that the Government bear less than an allocable share of the total cost of the program."

Now what does this mean? I can show you by pointing to what the Air Force is doing. Before the new rules were announced, but apparently just after the quoted language was decided upon, the Air Materiel Command at Wright Field on March 24, 1959 issued, over General Graalman's signature, a memorandum to all Commanders of purchasing activities, directing "support of allocable general research costs on a dollar-for-dollar basis ..... when the Government is the principal customer." This position was reaffirmed by General Davis at AMC at a Symposium on Subcontracting held in October 1959, when he indicated that 50% sharing was the average, and that negotiations would be upward or downward closely from that average.

This approach, unless enforced so as to have the Government bear close to its full allocable share of allowable costs, can result in great injustices to individual contractors, but even more important, it may vitiate the real reasons why this new cost allowance was included among the new rules. Let me illustrate what I mean.

Imagine two companies, A and B. Company A's business is 25% with the Government and 75% commercial. Company B's business is just the reverse, 75% with the Government and 25% commercial. Each does a volume per year of $100,000,000 and each devotes 5% of its billings, or $5,000,000 to company-sponsored research programs, the costs of which are allowable under ASPR 15-205.35.

In the case of company A, if cost sharing was based directly on the principle of allocability, 25% of $5,000,000, or $1,250,000 would be allowed against its Government business. The Air Force formula, however, would allow dollar-for-dollar sharing, or $2,500,000 to be borne by the Government.

In the case of company B, allocability would result in 75% of $5,000,000 or $3,750,000 being borne by the Government orders, but by the Air Force formula, only $2,500,000 would be so borne.

This means, of course, that company B would have to spread the other $2,500,000 against $25,000,000 of its annual commercial volume, making this factor a 10% cost of doing a dollar of commercial business. Company A, on the other hand, could spread its other $2,500,000 over $75,000,000 of commercial volume, making its factor only 3-1/3% of the commercial sales dollar. Surely Company A is way ahead of Company B in the competitive maelstrom of commercial business, all because of the over-cautious

and suspicious attitude of the Government toward the very contractor who was willing to give the Government more rather than less of its capabilities and capacities.

Is this deserved, and does it serve the best interests of the Government? Surely not, if the Government really does want its contractors to remain competitively free and independently strong instead of becoming mere agencies of the Government. But there is another vital factor here. Which of the two companies in my example, A or B, is going to slant its corporate-sponsored research program more toward fields which will advance the state of the art helpful to the design and production of missiles or other military devices? Surely not A, for there is no incentive for it to increase its share of Government work, for after all, it wants to serve principally that 75% of commercial customers. Similarly, B will most want to serve its 75% customer - the Government. Therefore, B's program - given equal skill and luck - will be far more productive of new knowledge vital to Government work than will A's program - and this is the very reason the Government was willing to pick up this new tab by the new ASPR rules. Its top officials, not only in the Department of Defense, but also in the Armed Services themselves, knew that industrially-sponsored research must be supported by Government funds and increased if the United States is to have a real chance to stay abreast of Russia's scientific achievements, much less to close a "missile-gap," if such a thing truly exists.

I submit, gentlemen, that the fear of the lack of competition and its step-child, "cost-sharing," must not be allowed to negate the objective to foster and give incentives to more, rather than less, independent research and development by industry.

In summary, and in conclusion, then - these new rules will not yield the same results as the old. In some respects they are more restrictive, both by actual disallowances and by more detailed analyses of costs - while in other respects, they permit greater cost recovery, notably for research and development costs. They contain workable definitions of "reasonableness" and "allocability", even though the former expresses unwarranted concern over the possible absence of competitive restraints. They suffer, as did the old rules, from the fallacy of questioning or disallowing elements of true costs of doing business for real or imagined reasons of public policy or equity, and tend thereby to become an auditor's manual rather than workable policy statements. Nevertheless, they are out and my guess is that they will not be soon changed to any material extent. Therefore, I am more concerned about the practical problems of being ready to live with them and under them by July 1, 1960. I have tried to point out four problem areas in this regard, and how each might be resolved. These are:

1) The elimination of dual accounting systems and getting all cost-reimbursement type contracts and subcontracts under the new rules as soon as can practicably

be done, without the strict balancing off of consideration for the changes to existing contracts.

2) The determination of who has authority for final answers to questions of applicability, and as to interpretation, both as to prime contracts and subcontracts.

3) The use of basic agreements or some other readily available technique to accomplish advance agreements as to those cost elements which can only be equitably negotiated on an overall basis.

4) Prevention of the objectives of the new rules as to research and development cost recovery being vitiated by over-zealous application of the "cost-sharing concept."

There are already many other problems under the new rules, and doubtless still more will develop as they begin to become effective. I hope what I have said, however, will give you some food for thought, and much motivation for prompt action in the four pressing problem areas I have outlined.

Thank you for your kind attention.

SOME PROBLEMS OF NEGOTIATION AND ADMINISTRATION

OF

COST REIMBURSEMENT TYPE CONTRACTS WITH COMMERCIAL ORGANIZATIONS

UNDER

THE NEW "COST PRINCIPLES" PROMULGATED BY THE REVISIONS TO SECTION XV

OF THE

ARMED SERVICES PROCUREMENT REGULATION

ISSUED ON

NOVEMBER 2, 1959

AN ADDRESS

DELIVERED BY ERNEST F. LEATHEM, ASSISTANT TO THE PRESIDENT, RAYTHEON COMPANY

AT A BRIEFING CONFERENCE ON GOVERNMENT CONTRACTS

SPONSORED BY

THE FEDERAL BAR ASSOCIATION AND ITS PHILADELPHIA CHAPTER

IN COOPERATION WITH

THE BUREAU OF NATIONAL AFFAIRS, INC.

AT

THE SHERATON HOTEL, IN PHILADELPHIA, PENNSYLVANIA

ON

FEBRUARY 19, 1960

Mr. Moderator, Fellow Panel Members, Ladies and Gentlemen:

It has been a long time since I have addressed an audience composed primarily of lawyers. For that matter, it has been a long time - almost thirteen years - since I have myself practised law. I am, therefore, rusty both as to the law itself and to any approach slanted solely or primarily toward lawyers. I would be doing you all an injustice were I to attempt to resurrect from the dim past such an approach in talking about the subject - or rather, that part of the subject - which has been assigned to me today. So expect no citations or Latin maxims, and few if any quotations.

Instead let us pick out and discuss just a few - four to be exact - areas in which problems have already been met, or will surely arise, in putting the new ASPR Section XV cost principles into effect under cost-reimbursement type contracts. I say these are just a few, because there are seven subsections under Sec. XV, Part 1, eight in the first four sections of Part 2, and forty-six under Sec. 15-205 alone. I predict that one or more problems will arise under each of these sixty-one within the next eighteen months. It must always be so as long as Government continues in its obstinate refusal to recognize as costs all true costs of conducting a business.

It is not my purpose today, however, to rehash the debates which went on for the eight years during which these new ASPR provisions were under study, preparation,

review and revision. For the time being, at least, these are all water over the dam. Now the new provisions are officially promulgated, and will become mandatorily effective on and after July 1. Nor do I propose to cover, however lightly, all of the principles as stated. Even if time should permit, I would not do it - for no one can wet-nurse you through this complex field. Whether you act for Government agencies, for defense contractors, or as private practitioners, there is no possible substitute for your own careful and painstaking reading and study of the document which spawned this monster, ASPR Revision No. 50 of November 2, 1959. In fact, from now on, I shall assume that you have read it, and not only it, but also the old rules in the present Section XV of ASPR, and even the last draft of the new provisions presented to industry for comment - that dated September 10, 1957. For ease of reference, I shall call these, respectively, the "new rules," the "old rules," and the "last draft."

The first problems I want to discuss are those created by making the new rules effective on July 1, 1960 to all contracts thereafter issued. The exact language used is as follows:

> "This Revision shall be effective at all applicable echelons with respect to contracts issued on or after 1 July 1960, but compliance is authorized upon receipt hereof. Existing cost-reimbursement type contracts may be amended, but only if the amendment will not be to the disadvantage of the Government.

Thus, if a proposed amendment would result in the allowance of greater costs, there must be an equivalent benefit to the Government in the form of improved delivery schedules, increased quantities of work, offsetting reductions in administrative expenses, or the like."

Elsewhere, in the news release issued by the Department of Defense, No. 1233-59 of November 2, 1959, announcing the issuance of the revised cost principles, and in the Question and Answer Sheet which accompanied the news release, it was stated that the "allowability of costs under cost-reimbursement type contracts is not materially changed from the previous regulation," and that "contractors can expect about the same result." Yet it is a fact, just to mention two items, that under certain circumstances, development costs are for the first time allowed as a cost, and the allowability of research costs is extended beyond mere "general research," which is all that the old rules permitted under any circumstances.

Now let us assume that contractor A, holding outstanding CPFF contracts which will extend to July 1, 1962, has never before sought recovery of general research but has in fact company-sponsored programs of applied research and of development which would qualify for cost allowability under the new rules. In order to amend its present contracts to incorporate by reference the new rules, must A match precisely the dollar value of its impending recovery of research and development costs by showing what lesser costs

will be allowed because of the more restrictive nature of the new rules, and if this does not yield enough dollars, then go on to undertake additional work, faster deliveries or other new cost-creating obligations? A strict reading of the quoted language leaves no doubt that this, and only this, is the price to him of an amendment. Thus it has no value to him, and he cannot be expected either to seek it, or to agree to it if proposed to him by a Government negotiator.

And yet, can it possibly be that the Government wants its regular defense contractors to have to keep two sets of overhead rates - one applicable to old contracts issued prior to July 1, 1960, and another applicable to new contracts issued after that date, and to keep these dual accounting systems in being so long as any old contracts continue or are extended? Does it really want to set up barriers as rigid as these, or does it want to get all cost-reimbursement contracts under the new rules, and to have uniformity of treatment, as soon as this practically can be done?

This is where you Government lawyers come into the picture, for if the past repeats itself, you will either volunteer or be called upon to say what is compliance with the quoted language, and to say whether a given set of circumstances does in fact yield "an equivalent benefit to the Government." Here you can receive little help from either the contractor or the contracting officer, for neither will honestly be able to assign a dollar value to savings from single, versus double, bookkeeping, audit, rate

preparation, negotiation and contractual amendment.

It seems proper, therefore, for me to suggest that the purpose may be more important than the words, and that the words should be interpreted and applied to carry out the purpose - and also, that perhaps the best solution of all would be for Commander Malloy and his associates in DOD to rewrite this language to recognize the real, though intangible, benefits to both Government and industry of having one set of rules and not two.

Already, defense contractors are being asked to incorporate by reference the new rules not only into new contracts now being negotiated for issuance prior to July 1, but also into amendments of present contracts occasioned by funding actions, changes in scope, extensions of work time, or other reasons. If the unwary contractor, being anxious to please and with no bargaining position to resist, agrees - is he later going to be met by a legal ruling of failure to provide adequate consideration? This has happened in the past - steps should be taken now to prevent it happening again in the future.

The next problem I want to discuss is the applicability of the new rules. I shall try to stay away from the tempting extension of this discussion to what happens about the various kinds of fixed-price contracts under the provisions of Part 6, and shall let that drop after merely saying that I am inherently suspicious of the use of

the phrase "guidelines for use in the evaluation of costs." But there are going to be problems, even in the applicability of the new rules to cost-reimbursement type contracts.

The new rules say that they "contain general cost principles and procedures for the determination and allowance of costs in connection with the negotiation and administration of cost-reimbursement type contracts," except facilities or construction contracts, and shall be "the basis for determination of reimbursable costs, ... including cost-reimbursement type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts." I am sure that this will be read by the auditors to mean that their findings are absolute, and that this language leaves no latitude for negotiating.

Yet the next subsection says the new rules shall be "the basis for the negotiation of overhead rates." Since an auditor admittedly has no power to negotiate, this seems to give the ultimate decision to the contracting officer or his delegee in overall rate negotiations. Is there, then, to be one group the contractor deals with as to direct costs, and another as to indirect costs, and none as to all costs? If such be the intention, look out for fireworks from the contracting officers!

The new rules contain, for the first time, definitions of "reasonableness" and "allocability." Contractors with whom I have talked find no fault with these, and to have them spelled out with such care is a real achievement of the new rules. Indeed,

many professional accountants believe that the new rules would be excellent had they stopped right there. Do these provisions give us any guide as to the authority to determine applicability? I believe they do - for in Sec. 15-204(a), it is said that

> "Costs shall be allowed to the extent that they are reasonable, allocable and determined to be allowable in view of the other factors set forth in ASPR 15-201.2 and 15-201.5. These criteria apply to all the selected items of cost which follow, notwithstanding that particular guidance is provided in connection with certain specific items for emphasis or clarity."

These words certainly seem to make reasonableness and allocability the ultimate tests, and it would seem that even the most audacious auditor would leave the determination of reasonableness to the contracting party - namely, the contracting officer.

I really believe we shall have no more problems in this area under the new rules than we have had under the old rules, but being new rules, and hence subject to new interpretations, I suspect that some of our old problems may be repeated. I hope, though, that we all can agree that the contracting officer or his delegee should retain the ultimate authority for cost settlements as well as price settlements and other contract terms.

The applicability of the new rules to successive tiers of subcontractors holding cost-reimbursement type subcontracts may prove more troublesome. It is not enough to pass this off by saying that all the new rules say is that the prime will only be paid for payments to subcontractors which recognize the allowances, disallowances and interpretations contained in the new rules. This is a pretty hefty stick, and you can be sure that the prime will be taking every possible step to pass the new rules through, by contract terms, to the cost-reimbursement type subcontractors - but in many cases, he cannot force such acceptance, and even if he does, he often will not be permitted to audit a major company's costs merely because it is a subcontractor. So here we are with the same problem the Air Force is facing in its efforts to have prime contractors get more cost data in pricing subcontracts - some way must be provided for Government audit of subcontracts and for the protection of private data belonging to the sub when cost data is disclosed to the prime. This is easier said than done!

The third area of discussion is about advance understandings. As you know, the new rules list, in Sec. 15-107, eight cost elements as to which defense contractors are urged to make advance agreements which can be embodied in contract terms. Actually, elsewhere in the new rules, advance agreements are urged or required as to at least five additional kinds of costs. The last draft made, as to the eight listed items, an advance agreement mandatory if any such costs were to be allowed, but the new rules are less

stringent and now state: "But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable."

Nevertheless, advance agreements are certainly desirable, and industry representatives have welcomed the forthright recognition of their desirability in the new ASPR provisions. Any contractor which does a lot of cost-reimbursement type contracting with the Government will be sure to seek them and to want promptly to negotiate such agreements - but how will he go about it? This is far from clear, and this is the reason I want to discuss this problem today.

To get the matter sharply into focus, let me list the items about which advance agreements are suggested. As I do so, consider as to each whether separate agreements, contract by contract, are practical - or whether the particular cost factor is one which must - to be feasibly handled - be treated alike in every situation, no matter who the customer is or what the type of contract used. I suggest that some are one, and some are the other, and some are mixed.

The eight items listed in Sec. 15-107 are:

1) Compensation for personal services

This I believe can be handled only on an overall basis

2) Use charge for depreciated assets

This I believe can usually best be handled on a contract-by-contract basis, in the situations where such assets are in fact to be used - but if it is a complete facility, building and equipment, then an overall treatment might be required.

3) Deferred maintenance costs

Except in rare instances, this would normally be spread across an entire plant area's overhead costs, and should, therefore, be treated on an overall basis.

4) Pre-contract costs

Obviously, this should be covered on a contract-by-contract basis, for such costs would not always be incurred, or if they were, should not be borne in any degree by another contract or group of contracts.

5) Research and development costs

The whole concept of Sec. 15-205.35 is predicated upon an overall treatment, even though recovery of development costs may be possible only against Government purchases within a given product line.

6) Royalties

Here, it seems to me, is a mixed situation. If a contractor's obligations to pay royalties extend over all its products, or even

all the products of a single division, then this can be handled on an overall basis. If, however, the royalty obligations are narrower, then recovery should be restricted to the situations where royalties have to be paid, and probably would require a contract-by-contract treatment.

7) Selling and distribution costs

Normally, these can and should be spread over all of a contractor's business and, therefore, can be handled on an overall basis. This is true even in a business which has some Government and some commercial business, for Government selling and distribution costs - other than advertising - are quite different and identifiable from normal commercial sales activities.

8) Travel costs, as related to special or mass personnel movement

This is, again, a situation which could be mixed. Normally it would relate to the specific performance or service requirements of a single contract, and hence would lend itself to contract-by-contract treatment. But how about the move into a completely new and distant laboratory, production facility or test site made by a company to improve its facilities, or to draw upon a new labor market? If this new location

will serve more than one contract, or especially if it will perform both Government and non-Government work, then such costs should be spread across all work on an overall basis.

The five other areas in which advance agreements are suggested or required are:

1) Contingencies (Sec. 15-205.7(ii))

The possible allowability of contingency reserves as a cost is here recognized officially for the first time, but will undoubtedly be approached warily by individual contracting officers. It seems to me, therefore, that this must be handled only on a contract-by-contract basis.

2) Insurance (Sec. 15-205.16(a)3)

This relates to the allowability of losses against a self-insurance program which could have been covered by permissible insurance, only if provided for in the contract. It is impossible in advance to predict either the nature or extent of such losses in any precise way, but reasonable actuarial approaches can be taken in fixing charges to a self-insurance program. These, it seems to me, must be viewed only on an overall basis, and cannot be left to separate allowance on one contract and disallowance on another.

3) Plant reconversion costs (Sec. 15-205.29)

These are stated to be recoverable only "in special circumstances," and hence must only be handled on a contract-by-contract basis.

4) Professional and other services in connection with patent litigation (Sec. 15-205.31(c))

It seems clear that the drafters of the new rules intend this to be negotiated on a contract-by-contract basis, but like royalty costs, situations might arise where equity would require an overall treatment and spreading of such costs. I, therefore, consider this a mixed situation.

5) Rental costs (Sec. 15-205.34(c))

This relates to rental costs fixed in sale and leaseback agreements. These often cover major real estate and facilities, or plant areas alone. Where they do, an overall agreement is the only fair basis for spreading such costs across all the work done in such facilities or plant areas.

In these thirteen situations, then, we have only four that clearly lend themselves to a contract-by-contract negotiation, and six demand overall treatment

if we are to avoid excessively long negotiations of single contracts and the probable inequity of varying conclusions by different contracting officers. The other three are mixed. How and with whom does a contractor negotiate for the overall agreements needed? There is no part of the Department of Defense set up or authorized to conduct such negotiations, nor are there single representatives yet able to speak for all parts of any one of the three Armed Services. The only exception to this statement is the Tri-Service Committee just starting to work on advance agreements covering research and development costs, but even it will only try to cover the largest 50 or 60 defense contractors. Many more than these will need overall agreements covering research and development costs.

We have, therefore, the recognition and promise of advance understandings and agreements, but as to six, and possibly nine cost-elements, no place to get an agreement carrying any assurance that the treatment afforded will be fair, prompt and uniform, except possibly as to research and development costs. This is a situation which I hope will have the attention of each of the Services and of the Department of Defense. In the meantime, however, one device is possible - and even a cure if the various parts of each Service can be brought together into a single, Servicewide negotiation. That is the "basic agreement."

The basic agreement has been used by the Air Force with some contractors

with considerable success, but it has not been widely used elsewhere. For cost-reimbursement type contracts, its usage has even been less. To some extent this reluctance has been the result of unwillingness to come to grips with difficult or controversial problems, or the inability to bring together persons with authority to represent or speak for each part of any one of the Services. There has also been reluctance among some Government lawyers to have contract issues resolved in what they have considered to be a vacuum, apart from the Government's requirements and the contractor's problems relative to a particular procurement. Some have raised questions of adequacy of consideration, or other potential legal obstacles.

Yet here is the only method, now in existence, by which schedules of reimbursible costs, tailored to each contractor's accounting system and containing the advance agreements needed for these ten elements of costs under the new rules, can rather readily be negotiated for incorporation into contracts to be issued after July 1 of this year. I recommend, therefore, that this method be employed by the departments as rapidly as possible, even to the extent of assigning personnel and clothing them with authority to negotiate overall basic agreements as expeditiously as possible. I also suggest again that the objectives gait the action, and that the Government lawyer seek out ways to accomplish the objectives, and not interpose roadblocks.

The final point I want to discuss with you is the concept of cost-sharing,

which is set forth in Sec. 15-205.35(h) pertaining to the allowability of research and development costs. The philosophy back of this appears in the definition of reasonableness, in Sec. 15-201.3, where it is said:

"The question of the reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to effective competitive restraints."

A preponderance of Government business apparently may create a presumption that competitive restraints are absent.

I can assure you that this is the exception rather than the rule. There are few businesses whose purchases are so sought after and fought for as are the kinds of things the Government buys by negotiated procurement. I can assert categorically that a preponderance of Government business rarely, if ever, frees a company from competitive restraints. Remember that restraints are not imposed merely by having to bid on the price of identical or substantially identical items. Price is only one facet of competition. Others, equally important, are labor rates - fixed by the competition for jobs in the area or industry, technical capabilities - the competition to outdesign someone else, production know-how - the ability to produce faster, or better, or cheaper than someone else. None of these are lessened by having a preponderance of Government business.

But having assumed an absence of competitive restraint, Sec. 15-205.35(h) goes on to say:

"In recognition that cost sharing of the contractor's independent research and development program may provide motivation for more efficient accomplishment of such program, it is desirable in some cases that the Government bear less than an allocable share of the total cost of the program."

Now what does this mean? I can show you by pointing to what the Air Force is doing. Before the new rules were announced, but apparently just after the quoted language was decided upon, the Air Materiel Command at Wright Field on March 24, 1959 issued, over General Graalman's signature, a memorandum to all Commanders of purchasing activities, directing "support of allocable general research costs on a dollar-for-dollar basis ..... when the Government is the principal customer." This position was reaffirmed by General Davis at AMC at a Symposium on Subcontracting held in October 1959, when he indicated that 50% sharing was the average, and that negotiations would be upward or downward closely from that average.

This approach, unless enforced so as to have the Government bear close to its full allocable share of allowable costs, can result in great injustices to individual contractors, but even more important, it may vitiate the real reasons why this new cost allowance was included among the new rules. Let me illustrate what I mean.

Imagine two companies, A and B. Company A's business is 25% with the Government and 75% commercial. Company B's business is just the reverse, 75% with the Government and 25% commercial. Each does a volume per year of $100,000,000 and each devotes 5% of its billings, or $5,000,000 to company-sponsored research programs, the costs of which are allowable under ASPR 15-205.35.

In the case of company A, if cost sharing was based directly on the principle of allocability, 25% of $5,000,000, or $1,250,000 would be allowed against its Government business. The Air Force formula, however, would allow dollar-for-dollar sharing, or $2,500,000 to be borne by the Government.

In the case of company B, allocability would result in 75% of $5,000,000 or $3,750,000 being borne by the Government orders, but by the Air Force formula, only $2,500,000 would be so borne.

This means, of course, that company B would have to spread the other $2,500,000 against $25,000,000 of its annual commercial volume, making this factor a 10% cost of doing a dollar of commercial business. Company A, on the other hand, could spread its other $2,500,000 over $75,000,000 of commercial volume, making its factor only 3-1/3% of the commercial sales dollar. Surely Company A is way ahead of Company B in the competitive maelstrom of commercial business, all because of the over-cautious

and suspicious attitude of the Government toward the very contractor who was willing to give the Government more rather than less of its capabilities and capacities.

Is this deserved, and does it serve the best interests of the Government? Surely not, if the Government really does want its contractors to remain competitively free and independently strong instead of becoming mere agencies of the Government. But there is another vital factor here. Which of the two companies in my example, A or B, is going to slant its corporate-sponsored research program more toward fields which will advance the state of the art helpful to the design and production of missiles or other military devices? Surely not A, for there is no incentive for it to increase its share of Government work, for after all, it wants to serve principally that 75% of commercial customers. Similarly, B will most want to serve its 75% customer - the Government. Therefore, B's program - given equal skill and luck - will be far more productive of new knowledge vital to Government work than will A's program - and this is the very reason the Government was willing to pick up this new tab by the new ASPR rules. Its top officials, not only in the Department of Defense, but also in the Armed Services themselves, knew that industrially-sponsored research must be supported by Government funds and increased if the United States is to have a real chance to stay abreast of Russia's scientific achievements, much less to close a "missile-gap," if such a thing truly exists.

I submit, gentlemen, that the fear of the lack of competition and its step-child, "cost-sharing," must not be allowed to negate the objective to foster and give incentives to more, rather than less, independent research and development by industry.

In summary, and in conclusion, then - these new rules will not yield the same results as the old. In some respects they are more restrictive, both by actual disallowances and by more detailed analyses of costs - while in other respects, they permit greater cost recovery, notably for research and development costs. They contain workable definitions of "reasonableness" and "allocability", even though the former expresses unwarranted concern over the possible absence of competitive restraints. They suffer, as did the old rules, from the fallacy of questioning or disallowing elements of true costs of doing business for real or imagined reasons of public policy or equity, and tend thereby to become an auditor's manual rather than workable policy statements. Nevertheless, they are out and my guess is that they will not be soon changed to any material extent. Therefore, I am more concerned about the practical problems of being ready to live with them and under them by July 1, 1960. I have tried to point out four problem areas in this regard, and how each might be resolved. These are:

1) The elimination of dual accounting systems and getting all cost-reimbursement type contracts and subcontracts under the new rules as soon as can practicably

be done, without the strict balancing off of consideration for the changes to existing contracts.

2) The determination of who has authority for final answers to questions of applicability, and as to interpretation, both as to prime contracts and subcontracts.

3) The use of basic agreements or some other readily available technique to accomplish advance agreements as to those cost elements which can only be equitably negotiated on an overall basis.

4) Prevention of the objectives of the new rules as to research and development cost recovery being vitiated by over-zealous application of the "cost-sharing concept."

There are already many other problems under the new rules, and doubtless still more will develop as they begin to become effective. I hope what I have said, however, will give you some food for thought, and much motivation for prompt action in the four pressing problem areas I have outlined.

Thank you for your kind attention.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

NATIONAL HEADQUARTERS: 1107 19th Street, N.W. · Washington 6, D.C. / REpublic 7-7474

NSIA Bulletin . . . Procurement Information

No. 151-60 17 February 1960

To: All Members, National Security Industrial Association

Subject: Cost Principles - November, 1959 Revision to Section XV, Armed Services Procurement Regulation.

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In November, 1959 there was forwarded to you with Procurement Information Bulletin No. 147-59, a copy of the Department of Defense press release announcing the issuance of revised cost principles for use in defense contracting. This Bulletin is being issued to provide further information on the cost principles.

There is attached a summary, prepared by the Contract Finance Subcommittee, of more important provisions of the revised principles. The summary relates primarily the cost principles as they apply to supply and research contracts with commercial organizations.

As may be expected in a revision of this nature, there are a number of areas in the cost principles that will require further interpretation and discussion by industry and the government. However, the attached summary was not written with the idea of attempting to resolve problems connected with this Revision or to place our own interpretations on given items. Rather, it was prepared for the purpose of summarizing the Revision on as factual a basis as possible and to highlight the areas that may be of particular interest to the NSIA membership.

As a further effort to a better understanding of the cost principles, the Contract Finance Subcommittee is planning to hold a seminar-type meeting in April or May for the benefit of all interested NSIA members. At this meeting, it is proposed that a panel of industry and government personnel will discuss those areas of the cost principles that are of most interest to the membership. Particularly, it is planned to review items that the membership feels need clarification, further interpretation, or revision. In preparation for this, it would be very much appreciated if, after you have completed your review of this Bulletin and the revised cost principles, you would submit a list of suggested items you would like discussed. If at all possible, it is requested that your suggestions be forwarded to the undersigned no later than March 14th, 1960.

(Over)

For those of you who do not already have a copy of the revised cost principles, these may be purchased from the Superintendent of Public Documents, U. S. Government Printing Office, Washington 25, D. C. at a price of $.35. For identification purposes, cite "Revision No. 50, Armed Services Procurement Regulation".

Cordially,

William F. Romig

William F. Romig
Committees Executive

WFR/jtm

Attachment

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

SUMMARY OF CONTRACT COST PRINCIPLES AND PROCEDURES

REVISION NO. 50 TO ARMED SERVICES PROCUREMENT REGULATION

Introduction

On November 2, 1959, Armed Services Procurement Regulation Revision No. 50 was released by the Department of Defense and will replace the existing Section XV in its entirety.

The issuance of this Revision came about as a result of several years of intensive study, negotiation, and compromise among the three Armed Services, and discussion with representative groups from industry.

This new Revision demands thorough study by all contractor personnel engaged in the negotiation and administration of military contracts. The more important changes may be summarized as follows:

1. Individual items of cost, many of which were previously not covered or were only briefly mentioned are now discussed in greater detail as to definition, reasonableness, and allowability. In some cases the treatment of certain items has changed.

2. Applicability of the cost principles has been broadened to include their use as a guide to military personnel in evaluating cost data submitted, when appropriate, in connection with the negotiation of prices under fixed-price contracts.

3. The cost principles contained in Section VIII of ASPR will be eliminated and replaced by the new cost principles, which will be applicable or used as a guide in the negotiation of termination settlements of all contracts, including those awarded through formally advertised bids.

These and other provisions of the new cost principles are discussed in the following paragraphs.

Effective Date

Use of the new cost principles and new termination paragraphs 8-213, 8-301 and 8-302 as set forth in Revision No. 50 are mandatory with respect to contracts issued July 1, 1960 and thereafter but immediate use may be permitted. This means that cost-reimbursement type contracts being currently negotiated may by mutual agreement employ either the cost principles set forth in ASPR through Revision No. 49 or those listed in Revision No. 50. Similarly in the negotiation of fixed-price contracts, mutual agreement may be reached as to the use of the termination clauses contained in the ASPR through Revision No. 49, which would incorporate the cost principles of Section VIII, or the new paragraphs incorporating the new Section No. XV. To prevent misunderstanding, however, specific agreement should be reached in each case.

Existing cost-reimbursement type contracts may be amended to include the latest cost principles but only if such amendment is not to the disadvantage of the government.

Obviously, circumstances permitting the selection and application of one set of cost principles from that of three possibilities will pose problems for an indefinite period of time. Each contractor will need to evaluate the advantages or disadvantages of negotiating for the use of the new principles, or allowing contracts to run out based on existing terms in light of a number of factors. Among these factors are the following:

1. The administrative problems in working with different sets of cost principles, i.e., negotiation of overhead rates, audits, etc.

2. The effect on allowability of costs.

3. A contractor's ability to negotiate on a timely basis those advance understandings which he considers desirable in order to avoid later disagreements.

4. The attitude of subcontractors and prime contractors in accepting a change.

Applicability

The new cost principles represent significant changes from the old principles because, in addition to use in determining reimbursable costs under cost-reimbursement type contracts, including overhead rates thereunder, their applicability has been broadened to include:

> "guidelines for use, when appropriate, in the evaluation of costs in connection with certain negotiated fixed-price type contracts and contracts terminated for the convenience of the Government."

Applicability to cost-reimbursement type contracts

The new Section XV will apply on a contractual basis by virtue of incorporation into the contract for the determination and payment of costs under:

1. Cost contracts
2. Cost sharing contracts
3. Cost-plus-fixed-fee contracts
4. Cost-plus-incentive-fee contracts
5. Facility contracts (now in preparation)

It will be used as the basis of negotiations of overhead rates applicable to cost-reimbursement type contracts and for the determination of costs under terminated cost-reimbursement type contracts when the contractor elects to "voucher out" its costs and for the settlement of such contracts by determination.

Applicability to negotiated fixed-price type contracts

The new Revision will serve as a guide in the negotiation of prices for fixed-price contracts and subcontracts. Included in this category are:

1. Firm fixed-price contracts
2. Fixed-price contracts with escalation
3. Redeterminable fixed-price contracts

4. Fixed-price incentive contracts
5. Non-cost-reimbursable portion of time and material contracts
6. Labor-hour contracts

Contracts awarded by formal advertising are excluded except in the case of terminations for the convenience of the government and possibly when prices require revision because of changes to the contract.

The new Revision makes it clear that "the ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement." and that "cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it." It is also made clear that the policies and procedures of ASPR Section III - Part 8 are governing in the negotiation of fixed-price type contracts.

The need for consideration of costs under varying conditions is also discussed in this Revision. In retrospective pricing and settlements, the Revision states "the treatment of costs is a major factor in arriving at the amount of the price or the settlement." In the area of forward pricing the Revision recognizes that it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Factors such as the technical, production, or financial risk assumed, the complexity of the work, the extent of competitive pricing, and the contractor's record for efficiency, economy, and ingenuity, as well as available cost estimates are emphasized as being important in considering the reasonableness of a proposed price.

Whenever it becomes necessary to obtain specific data on certain cost items, particularly those whose treatment may be dependent upon special circumstances, the Revision states "that contractors are expected to be responsive to reasonable requests for such data."

Applicability to terminations of fixed-price contracts

The new cost principles are to provide guidance in the negotiation of termination settlements for the convenience of the government on fixed-price type contracts. The cost principles formerly set forth in ASPR 8-302 will not be applicable to new procurement after July 1, 1960 and will be replaced by the new cost principles in Section XV.

Applicability to subcontracts

A prime contractor, whose contract binds him to the new Section XV, will be required to justify the allowability of all costs under cost-reimbursement type subcontracts of any tier above the first fixed-price subcontract in accordance with the new Section XV, Part 2 (supply and research subcontracts with commercial organizations), or Part 3 (research subcontracts with educational institutions), or Part 4 (construction subcontracts). In the case of negotiated fixed-price subcontracts, the prime contractor is to use the new cost principles for guidance where an evaluation of costs is required.

Advance Understandings

The new cost principles recognize that criteria for the allowability of the selected items of cost covered in Part 2 apply broadly to many accounting systems in varying contract situations. Since reasonableness and allocability of certain items of cost may be

difficult to determine, contractors are cautioned to seek agreement with the government in advance of incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. However, the absence of such an agreement will not in itself make costs unallowable.

Examples of eight categories of costs are set forth in which advance understandings may be particularly important. However, each contractor will wish to review the entire list of costs in Part 2 as well as these specific examples to determine whether advance understandings are necessary to insure allowability.

With respect to costs that are regularly or customarily incurred, an over-all agreement with the three Services may be necessary to insure equitable and uniform treatment. This is particularly true in the case of indirect costs which may be recovered through the application of negotiated overhead rates. To date no procedure has been established for negotiation by the contractor of over-all advance agreements. However, the new principles do provide that advance agreements may be sought by contracting officers individually or jointly for all defense work of the contractor as appropriate. This provision has already given rise to the promulgation of different clauses by the various agencies in connection with the allowability of research and development costs as well as to the formation of a Tri-Departmental Committee to deal with this matter.

In addition to advance understandings that may be common to all contracts, it may be necessary to negotiate understandings specific to individual contracts such as precontract costs and use charges on fully depreciated assets. Advance understandings between prime and subcontractors should also be agreed upon to assure recovery of costs by both parties.

General Factors Affecting Allowability of Costs

The general factors affecting allowability of costs remain unchanged from the previous version. These are (i) reasonableness, (ii) allocability, (iii) application of those generally accepted accounting principles and practices appropriate to the particular circumstances and (iv) any limitations or exclusions set forth in Part 2 or otherwise included in the contract.

In addition to recital of the general factors, reasonableness and allocability are now defined and basic criteria are set forth for their determination. As a practical matter these criteria are the same as used in the past, although not previously enumerated. These are as follows:

Reasonableness - In determining the reasonableness of a given cost, consideration shall be given to:

(i) whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the contractor's business or the performance of the contract;

(ii) the restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, Federal and State laws and regulations, and contract terms and specifications;

(iii) the action that a prudent business man would take in the circumstances, considering his responsibilities to the owners of the business, his employees, his customers, the government and the public at large; and

(iv) significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs.

Allocability - A cost is allocable to a government contract if it

(i) is incurred specifically for the contract;

(ii) benefits both the contract and other work, or both government work and other work, and can be distributed to them in reasonable proportion to the benefits received; or

(iii) is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown.

The new cost principles also indicate that the reasonableness of costs must be scrutinized with particular care in the case of contractors who may not be subject to effective competition restraints.

It should also be noted that in the listing of specific items of cost additional specific criteria are established for reasonableness and allocability. Contractors should scrutinize these with care in order to determine if their costs meet these criteria.

The new Revision provides also that in ascertaining what constitutes costs "any generally accepted method of determining or estimating costs that is equitable under the circumstances may be used including standard costs properly adjusted for applicable variances." This represents a more favorable recognition by the Department of Defense of the use of standard costs since the old cost principles stated that "the use of normal standard costs (with appropriate adjustments for variances ...) is acceptable in determining amounts of provisional or interim payments, but final allowable costs must represent actual costs."

Direct and Indirect Costs

The new cost principles define direct and indirect costs and criteria relating thereto. As written these represent a practical approach in light of the procedures and practices used by industry.

Selected Items of Cost

Paragraph 15-205 treats in a comprehensive manner 46 selected cost items. Generally, each item is defined and explained and the circumstances and nature regarding its allowability or unallowability are discussed. It is not intended to cover in this paper every element of cost or every situation that might arise in a particular case. Contractors should bear in mind that failure to treat any item of cost in this Section is not intended to imply that it is either allowable or unallowable.

This paragraph is an improvement over the old cost principles to the end that it provides contractors with a better understanding, in most instances, of the Department of Defense's regulations by describing individual items of cost more clearly and in greater detail and by indicating the criteria for judging reasonableness and allocability for certain items. Unfortunately, however, some costs are arbitrarily declared to be unallowable without regard to reasonableness or allocability to government business. Examples of this are contributions and donations. It is primarily for this reason

that industry opposed the use of the new cost principles as guidelines for fixed-price contracts since such use implies that contractors may find it more difficult now to gain acceptance of all costs on the basis of reasonableness and allocability.

It is recommended that contractors compare quite carefully the description of each cost item in this Section with the terminology employed in their present account structure to assure that costs are not being improperly labeled. Failure to do so could result in the disallowance of a good allowable cost because of terminology rather than on the merits of the cost itself.

There follows for your information brief comments on certain cost items in this Section.

Advertising Costs - 15-205.1

This paragraph expands on the old cost principles by defining advertising media in detail and by including as allowable advertising costs (a) the cost of participation in exhibits provided the exhibits do not offer specific products or services for sale and (b) advertising for the exclusive purpose of obtaining scarce items or disposing of scrap or surplus items. It continues to allow the costs of help-wanted advertising and advertising in trade and technical journals. In the case of the latter it eliminates the previous requirement that it be for the purpose of offering financial support. All other advertising costs are stated to be unallowable.

Bidding Costs - 15-205.3

This paragraph indicates that bidding costs of successful and unsuccessful bids are to be treated normally as allowable indirect costs of the current accounting period. If it is the contractor's established practice to treat bidding costs by some other method, the results obtained may be accepted if reasonable and equitable. Contractors may wish to consider obtaining advance agreements if bidding costs are treated in other than the manner indicated.

Compensation for Personal Services - 15-205.6

This paragraph indicates that compensation costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and to the extent that the costs are not in excess of those allowable by the Internal Revenue Code and regulations thereunder. It establishes criteria for determining reasonableness and treats certain forms of compensation in considerable detail. It specifically recommends advance understandings in the case of cash bonuses and incentive compensation, bonuses and incentive compensation paid in stock, and deferred compensation. The cost of options to employees to purchase stock is unallowable.

Because of the detail with which compensation is treated, it would be advisable for contractors to study this paragraph carefully and assure themselves that their compensation policies are consistent with the specific criteria set forth and result in reasonable total compensation for individual employees.

Contingencies - 15-205.7

This paragraph makes contingencies for historical costing purposes generally unallowable except in special cases.

In connection with estimates of future costs, contingencies are either to be included in the estimates of cost or disclosed separately for negotiation of appropriate coverage. The treatment of each item depends upon the degree of accuracy with which the future course of events can be predicted so as to provide equitable results.

Depreciation - 15-205.9

This paragraph is basically consistent with the rules of the old cost principles on depreciation but covers the subject in greater detail. It is recommended that contractors review this Section carefully to see that their depreciation practices are consistent with the criteria set forth.

Sub-paragraph (f) of this Section states that a reasonable use charge may be agreed upon and allowed in the case of fully depreciated assets provided the original depreciation was not recovered substantially against government contracts or subcontracts. An advance understanding is recommended for this item.

It is noted that when contractors elect to use true depreciation, the amount agreed on is to be allocated rateably over the full five-year emergency period, and thereafter contractors are precluded from recovering any unrecovered true depreciation. This deserves careful consideration since in some stances, the determination of true depreciation may not coincide timewise with the start of the five-year emergency period.

Excess Facility Costs - 15-205.12

Contractors should note that costs of maintaining, repairing, and housing idle and excess contractor-owned facilities are allowable only if reasonably necessary for standby purposes. It should also be noted that this paragraph provides that a separate contract should be obtained to cover costs of excess plant capacity reserved for defense mobilization production.

Insurance and Indemnification - 15-205.16

The new Revision provides that the costs of insurance required or approved under the terms of the contract are allowable. Costs of other insurance, in connection with the general conduct of business, are allowable if the types and extent of coverage are in accordance with sound business practice and the premiums are reasonable. Costs of business interruption insurance are allowable to the extent it excludes the coverage of profit. Costs of insurance covering the risk of loss or damage to government property are allowable only to the extent that the contractor is liable for such loss or damage. The cost of reserves for self-insurance programs are allowable provided they do not exceed the equivalent purchased insurance. Since actual losses, which could have been covered by an approved self-insurance program or otherwise, are unallowable, contractors should carefully review their practices and consider the advisability of negotiating advance understandings.

Regarding indemnification, the cost principles state "the government is obligated to indemnify the contractor only to the extent expressly provided for in the contract." For this reason, contractors engaged in missile and other potentially hazardous work should give serious attention to obtaining advance agreements for specific indemnifications over and above the standard provisions of the clauses entitled Insurance - Liability to third Persons (ASPR 7-203.22 and 7-402.26).

Maintenance and Repair Costs - 15-205.20

Both normal and extraordinary maintenance and repair costs are allowable but in the case of extraordinary costs they must be allocated to the periods to which applicable. Advance agreements are recommended if maintenance costs are deferred.

Manufacturing and Production Engineering Costs - 15-205.21

Costs of engineering in connection with current manufacturing processes and current production problems are allowable. Contractors should exercise care in the classification within their accounts of these costs as distinct from general research and development costs.

Material Costs - 15-205.22

Material costs are treated in considerable detail and flexibility is provided to recognize the various practices of contractors.

Specific provision is now included for the allowance of a contractor's inter-organization charges on a price basis, in lieu of cost where "(1) the item is regularly manufactured and sold by the contractor through commercial channels, and (2) it is the contractor's long established practice to price inter-organization transfers at other than cost for commercial work" provided this price does not exceed the price charged to the most favored customer for the same item in like quantity, or the current market price, whichever is lower. Although Section XV does not specifically recommend advance understandings with reference to a contractor's inter-organization transfers at price, contractors may wish to consider the advisability of such understandings.

Overtime, Extra Pay Shift and Multi-Shift Premiums - 15-205.25

These costs are allowable "to the extent approved pursuant to ASPR 12-102.4 or permitted pursuant to ASPR 12-102.5". Contractors should be familiar with these provisions and negotiate for the approvals of overtime, where required, with the cognizant contracting activity. Ad advance understanding may be required to assure recovery of costs.

Plant Reconversion Costs - 15-205.29

The costs of removing government property and related plant restoration and rehabilitation costs caused by the removal are allowable. Advance understandings are required for the allowance of additional costs in special circumstances.

Pre-Contract Costs - 15-205.30

Advance understandings are recommended to achieve allowability of pre-contract costs.

Professional Service Costs - Legal, Accounting, Engineering and Other - 15-205.31

The cost of professional services rendered by other than the contractor's employees are allowable subject to special criteria. However, such costs in connection with organization and reorganization, defense of antitrust suits, and the prosecution of claims against the government are unallowable. Such costs in connection with patent infringement litigation are allowable if provided for in the contract.

Recruiting Costs - 15-205.33

In general, this category recognizes industry practices. However, contractors should review their practices to insure they are consistent with those followed in their industry, since the costs of special benefits offered to prospective employees are unallowable beyond the standard practices in the industry.

Rental Costs (Including Sale and Leaseback of Facilities) - 15-205.34

This category of costs is allowed. However, criteria as to reasonableness are established which require careful review by contractors, particularly those who rent extensively if rental costs exceed costs of ownership. Advance agreements are especially important if sale and leaseback agreements are involved since in the absence of specific contract provisions, rental costs are allowable only to the extent they do not exceed the costs to the contractor had he retained title.

Research and Development Costs - 15-205.35

The contractor's independent "basic" and "applied research" as defined are allowable when allocated to all work of the contractor. The contractor's independent "development" is allowable when allocated to all work of the contractor on related product lines for which the government has contracts. In addition, the costs must be reasonable in amount, should be pursuant to a broad planned program, reasonable in scope, and well managed. Certain other tests must also be met.

In view of all the criteria the contractor is encouraged to negotiate advance understandings based on submission of his planned independent research and development programs. In certain cases the government may support less than an allocable share of the total cost of the programs. In these cases, the bases for agreement include but are not limited to (i) agreement to accept the allocable costs of specific projects, (ii) agreement on a maximum dollar limit on costs, an allocable portion of which will be accepted, (iii) agreements to accept the allocable share of a percentage of the contractor's planned research and development program.

This paragraph represents a substantial change in Defense Department policy brought about by recognition of the need to encourage research and development, in the national interest. In further recognition of the importance of these cost elements and their magnitude, a Tri-Departmental Committee composed of technical as well as procurement representatives has been established to negotiate advance understanding with contractors whose business is on a Tri-Service basis. The activities of this committee will undoubtedly establish precedents of value to guide procuring agencies and contracting officers.

Royalties and Other Costs for Use of Patents - 15-205.36

This paragraph encourages the use of advance understandings. Royalties or other costs for purchase of patents or rights thereto if necessary for proper performance of the contract and applicable to contract products or processes are allowable unless the government has a license or right to free use, or the patent is invalid, unenforceable, or expired. Certain tests are set forth to determine whether the costs are reasonable.

Selling Costs - 15-205.37

This paragraph is also one that encourages specific advance understandings. It defines selling costs and provides for their allowability and appears to exclude product advertising costs.

Severance Pay - 15-205.39

Severance pay is an allowable item of cost, either on an actual or an accrual basis provided such payments are required by law, employment agreement, or other established policy, and provided such costs are reasonable and allocated to all work of the contractor. The cost of abnormal or mass severance payments will be considered on a case by case basis.

Taxes - 15-205.41

Taxes in general are allowable except for Federal income and excess profit taxes, taxes in connection with financing, refinancing, etc., taxes from which exemptions are available and assessments which represent capital improvements on land. Taxes upon which a claim of illegality or erroneous assessment exists are allowable; provided that prior to payment of such taxes: the contractor requests instructions from the contracting officer concerning such taxes and takes all action directed by the contracting officer in determining the legality of the tax or securing a refund. These provisions should be carefully considered, together with the specific tax clauses required elsewhere in ASPR which may be included in contracts. This is particularly so with reference to taxes now being levied by various taxing authorities on government property or its use by the contractor.

Termination Costs - 15-205.42

This paragraph recognizes that terminations give rise to incurrence of costs or the need for special treatment of costs which would not have arisen but for the termination. Such costs and provisions regarding their allowability are set forth and should be carefully reviewed. It should be noted that the new cost principles will apply in the case of terminations to all types of contracts negotiated after July 1, 1960 and to all contracts negotiated prior thereto in which either the new cost principles or the new termination clauses are included. With respect to termination of cost-reimbursement contracts, the new principles present little change from the principles previously established by the termination clauses. However, with respect to fixed-price contracts the new principles are more restrictive, particularly with respect to consideration of allowance of interest on borrowings and certain advertising expenses.

Training and Educational Costs - 15-205.44

Training and educational costs are listed as allowable subject to certain restrictions. This makes it desirable for contractors to evaluate their educational programs to determine whether advance understandings are necessary.

Travel Costs - 15-205.46

Travel costs are allowable; however the importance of advance understandings is stressed with respect to costs of special or mass movements of personnel.

- END -

RAYTHEON COMPANY

WALTHAM 54, MASSACHUSETTS

ERNEST F. LEATHEM
ASSISTANT TO THE PRESIDENT

February 22, 1960

Hon. E. Perkins McGuire
Assistant Secretary of Defense (S&L)
Room 3E810 The Pentagon
Washington 25, D. C.

AsstSecDef(S&L) has seen

Dear Perk,

At Pete Malloy's suggestion, I am sending a copy to you of my remarks delivered at the Federal Bar Association meetings in Philadelphia last Friday, at which I shared the rostrum with Pete.

Cordially,

EFL:K

Enc.

C. W. Snider
Speech for SIA Seminar - May 26, 1960

You have heard the opening remarks by our two previous panel members, Commander Malloy of the Office of Assistant Secretary of Defense, and Mr. Gruenwald of Lockheed Aircraft Co. I am assuming that in addition to the information contained in their opening statements, that you also have a certain familiarity with the subject of the Armed Services Procurement Regulations, entitled, "ASPR Section XV."

You know, then, that under the new Cost Principles Regulations, regardless of whether the contract is of a Cost-Reimbursement-Type or a Negotiated-Fixed-Price-Type, or if the contract has been terminated, it will now be audited under the new provisions of Section XV. With respect to terminated contracts, the major change in auditing under Section XV, instead of the old Section VIII, is that interest which was previously an allowable cost in a termination situation is no longer allowed. Under Cost-Reimbursement-Type Contracts and Negotiated-Fixed-Price Contracts, the new principles provide more specific guidance than in the past and it seems to me that this will result in a reduced recovery by the contractor in many instances.

The subject of research and development costs, representing a contractors independent research and development work which is not sponsored by a contract, has been mentioned briefly and inasmuch as the new regulations provide that prospective contractors may seek agreement with the Government in advance of incurrence of this type of cost, it is undoubtedly advisable to reach an agreement before monies are spent in this area. Actually, as we know, there is an Air Force letter dated March 24, 1959, which provides that as a rule of thumb the Government will accept only 50 percent of independent research and development. I believe therefor, that a contractor may expect to be limited to this percentage - probably as a top figure which will be shared by the Government.

However, the principal fault that I have to find with the Cost Principles is not so much in what is said but rather in how this is administered. As you know, industry worked for a good many years with the Government in trying to iron out the differences that existed in the thinking with respect to the regulations that were ultimately issued. In all probability, it could be stated that the new regulations represent a pretty fair compromise and that the position of the small businessman is pretty much the same as the large company.

Unfortunately, however, the personnel in the Government who wrote these regulations are not the same individuals who administer them and it is in this area that I feel we run into the principal problem when you consider the quantity and quality of the administrative contracting officers, cost analysists, financial officers, production officers, security inspectors, resident inspectors, inspectors of the wages and hours division, officers charged with the responsibility of inspecting stockroom activities, use of Government Furnished Equipment, authorization of personnel, and last but not least, Army, Air Force, Navy, and Maritime Commissioned auditors. Very often much is left to be desired from the standpoint of the small businessman.

Then, too, the small businessman very often does not have in his own organization an individual or individuals who are well qualified to cope with this problem. I am reminded of the story of a small businessman who had been doing an excellent job in industry and who the Defense Department sought out for one of its Cost-Plus development contracts. As in most small business organizations, he had few records, controls and established procedures. The Department of Defense felt they should give him some help and they sent their various bureaus in to assist him. Stock control procedures were installed, progress charts, filing systems, all of the safeguards and controls normally found in Government operations were properly installed. A few months later the Contracting Officer stopped by to see this individual to check on how the contract was coming along and he asked him whether he had gotten the proper help from the various agencies. He answered that they had the systems all installed and said he knew exactly where all the materials were in the plant, that he knew how much it cost to do almost anything and that he had all the graphs and progress charts all up to date. The Contracting Officer then said, "Fine, now how's the work coming along?" to which he replied: "Oh, we've stopped all production, everybody's too busy working on the records!"

Then superimposed upon this whole system is the General Accounting Office which in practice and procedure has made each of the other agencies extremely sensitive as to what it may interpret as contract costs and what policies and procedures of a company may be approved.

I should like to recommend to you the statement of Mr. Charles E. Hastings, President and Chief Engineer of Hastings-Raydist, Inc, Hampton, Virginia, before the Select Committee on Small Business, United States Senate, March 20, 1959. In one paragraph of his statement he says, "The G.A.O. has often been referred to as the 'watchdog of the public purse.' I well recognize, gentlemen, the advantages of such a watchdog; however, when the watchdog turns and bites not only the robber, but the butcher, the milkman, the iceman, the neighbor, the guest and even the child, it cannot truly be said that the watchdog is properly serving the desired purpose. In such cases, the dog is usually destroyed and the owner required to pay the price for the dog's actions. Too vicious a watchdog is frequently more costly than the possible robber."

It may be that Mr. Hastings is a little strong in his recommendations, however, if you consider some of the things that have happened to his company in dealing with the Government, you will perhaps understand his thinking and as a matter of fact to a greater or lesser degree some of the things that have happened to him have probably happened to all of us. I think it is therefor probably worthwhile to list his recommendations:

1. Government contracts with small business should be simple, concise and easily understood, with emphasis placed on performance and achievement (Internal Revenue short form).

2. Small business, to participate effectively in defense projects under Cost-Type contracts, must be exempted from most of the provisions, technical regulations and audits under the present ASPR, specifically Section XV. I would personally recommend that ASPR not apply to small businesses at all.

3. Small business must be protected against illegal and improper actions of Government auditing and administrative officials other than through recourse to costly and time-consuming appeal procedures and the courts. A house-cleaning of the General Accounting Office should be made, limitations placed on its powers, and it should be held more closely accountable to Congress for its action.

4. An independent statistical study should be made to determine the true opinions, attitudes and feelings of the small businessman toward Government contracts and the administrative agencies involved.

5. Legislation should be provided to authorize the awarding of damages, attorney's fees, and interest by the Armed Services Board of Contract Appeals and the courts to small businesses if small businesses are forced to go to these costly ends to obtain what is due them.

6. Small business, if it is to prosper and grow, should be exempted from the Renegotiation Act.

7. That if the Government wants to help small business, the help should be in the form of tangible help which any small businessman can understand and benefit from - i.e. concrete benefits, clearly defined, easily understood and equally applicable to all small businesses.

8. Government contracts with small business should relieve the contractor of most of the onerous, expensive and conflicting audits, regulations and unnecessary administrative controls.

In all probability, the new cost principles are here to stay. In my opinion, the best solution for small business would be the elimination of their application to companies under a certain size. We have a precedent for this in the tax law which provides for a reduced rate on income below $25,000. We also have a case in point in the Renegotiation law that provides for a floor of $1,000,000 of sales, below which it is inapplicable.

I think we should push for this as a solution and at the same time make our feelings known that the regulations are being very poorly administered. In this effort we could well join forces with other representative groups such as A.I.A., N.S.I.A. and E.I.A.

1) Poor administration
2) No C.P. for companies under certain size.

I. P. Grunwald
Speech for SIA Seminar - May 26, 1960

This panel discussion on "Cost Principles" is timely in some respects. However, we are also at a disadvantage because, as of this date, we have not had any experience in operating under the new ASPR release, No. 50. Some of the reservations that I, and perhaps others of you in industry, hold with respect to this document is the manner in which it will be administered by the Armed Services. With all due respect to one of my colleagues on this panel, Commander Malloy, I would like, with his permission, to quote from his speech of February 19, 1960, at Philadelphia, Pennsylvania:

"We have many cases that go to the Armed Services Board of Contract Appeals which involve the factor of costs. The Board will have use for these new principles, particularly in the area of fixed-price type contracts. For the past several years, the Board has had no guidelines whatsoever in this area and, hence, it created its own rules and precedents. I believe that many of these precedents will be upset in the future."

I also believe that many of these precedents will be upset. Perhaps it is wishful thinking but I hope that we are wrong and that prior decisions can be used as guidelines for determining allowable costs. The Board's decisions were made after careful review of the facts, giving due consideration to the rights of the Government and the contractor. If we must accept the new Cost Principles as a means of upsetting prior precedents -- then we must assume that the revised Cost Principles were developed as a means of disallowing more of a contractor's legitimate and necessary business expense. I hope and believe that the Commander did not intend his statement to carry this inference, but that the new Cost Principles are more specific and thereby will clarify areas in the so-called gray zone.

One of the areas in which there no doubt will be much controversy is the so-called "Cost Items Recommended for Advance Understanding." Section 15-107 defines this as special or unusual costs in categories where reasonableness or allocability are difficult to determine. Sections 15-201.3 and 15-201.4 in turn define reasonableness and allocability. I will not attempt at this time to evaluate or discuss the pros and cons of these definitions except to point out that they appear to follow and restate the old principle of Treasury Decision 5000, i.e., "Is the cost necessary for and incidental to the performance of the contract?" Administration of a contractor's costs under these principles is difficult at its best, and opens the way for a wide divergence of opinion which may result in many directives or regulations. With your permission, I would like to review with you one such case already in existence.

One of the cost items recommended for advance understanding is "Research and Development." Section 15-205.35 defines Research and Development which industry has basically accepted. However, the corditions of reasonableness and allocability are contrary to industry practice, contrary to a free enterprise system, detrimental to a healthy and expanding industry so essential to the protection and growth of our country. Costs of a contractor's Independent Research and Development must be recovered as overhead through the sales of its products. In terms of Government contracting, the costs should therefore be allowable in determining the sales price. The Cost Principles, however, state that cost sharing may motivate for more efficient accomplishment and, therefore, in some cases, the Government bear less than an allocable share of the total cost.

As an administrative procedure, over one year ago the Air Force issued a letter which stated that procurement personnel should establish support of allocable

general research costs on a dollar-for-dollar sharing with the company, or maximum limit of support when the Government is the principal customer. Percentages of sharing other than 50-50 may be appropriate in particular cases. This policy assumes that one-half of the costs should be taken from the company's profits and the other half allocated through overhead to all of the contractor's business -- military and commercial. The portion taken from profits assumes that it is an investment by the contractor in future products or future business. It takes funds from the stockholders or owners of the business the same as using funds for buildings and equipment. But here the philosophy parts. Even under investments for buildings and equipment, the contractor recovers costs through depreciation allocable to all the work performed. But not R&D -- these costs are the contractors, never to become allowable under present or future business. There, of course, can be little disagreement as to the goal or objective of the Government, which is to obtain the maximum development of knowledge and technology as well as to obtain the best application thereof in appropriate channels in consideration for the monies expended.

Another class of expenses to which I would like to invite your attention is the cost item that is more restrictive under the new Cost Principles. Your past experience, industry practices, or Board of Contract Appeals decisions may or may not be the basis for guidelines in making a determination as to allowability. As an example of this class of expense, I call your attention to Section 15-205.34, Rental Costs (Including Sale and Leaseback of Facilities), paragraph (c), which states:

"Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed the amount which the contractor would have received had it retained legal title to the facilities."

The manner in which this principle is administered could result in substantial cost disallowances. It may be appropriate to apply this principle to new sale and leaseback transactions but it should not apply to lease contracts entered into in good faith by a contractor prior to the issuance of the new Cost Principles. Sale and leaseback has been an accepted industry practice. There are Board of Contract Appeals decisions that have upheld this practice. If the costs under this type of agreement have been allowable in the past, they should be allowable in the future. Any other treatment or basis of disallowance is, by administrative decision, making the new Cost Principles retroactive. Such a procedure would not in my opinion be fair and reasonable because the contractor cannot change his lease agreement to meet the administrative decision. The test of reasonableness should apply to both the Government and contractor.

The last item that I would like to call to your attention is the application of the Cost Principles to certain fixed-price type contracts. It will directly affect the subcontractor as well as the prime contractor. Prime contractors will, of necessity, be required to train personnel in the application of the Cost Principles to subcontract negotiation. The subcontractor in turn will, no doubt, be required to maintain more detailed records in support of its costs.

I sincerely hope that I have not appeared to be critical for I did not intend to do so. A great amount of effort has been expended over the past several years by very competent personnel from the Government and industry in developing the revised Cost Principles. Compromises were made by both sides. The acid test is yet to be applied and the success of this document depends to a great extent upon its administration.

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by: Melvin P. Jones, Manager, Contract Analysis Dept., Collins Radio Company, Cedar Rapids, Iowa

Introduced by: Chester Hay, Comptroller, Motorola - Phoenix.

At: Monthly meeting of Phoenix, Arizona, Chapter of National Association of Accountants, January 12, 1961.

Thank you, Chet, for the very kind words. National Vice President Stillwagen, President Speers, Members and Guests of the Phoenix Chapter of NAA. It is a real pleasure for us to leave the snow-covered hills of Iowa behind and journey to your beautiful city of Phoenix in the middle of the winter. I understand you have two main ambitions out here in Arizona -- one, to make Phoenix the largest city in the world (you're well on your way as it jumped from 99th to 29th in size of U.S. cities from 1950 to 1960, with the largest percentage growth of any major city in the U.S. in that 10-year period); and two, to elect a native son as Republican President of the U.S. (rumor has it that two other states have the same ambition). Should a poll be taken of the more or less conservative accountants comprising the membership of NAA, I would hazard a guess that your man would win going away!

However, I'm not out here to make a political speech or discuss climate but rather to address you on a subject which I think is vital today in the era of the cold war and the continuing need for private industry to provide the Defense Department of our government with the tools it needs to keep ahead of Russia in the desperate battle for survival. (In effect, the Defense Contract stands between us and Communism.) My subject is entitled, "Accounting for Government Contracts, Section XV of the Armed Services Procurement Regulation as revised July 1, 1960."

Before I get deeper into the subject, may I ask if there are any government auditors, contracting officers or military personnel in the audience? (Ask for show of hands). You see, I have two speeches ready, depending on who is in the audience!

Seriously, I want to make it clear that the opinions about to be expressed on this more or less controversial subject are my own and do not necessarily represent those of my company, Collins Radio Company.

My subject tonight is rather specialized in nature, and therefore I'm sure there are many of you in the audience who are not too familiar with all the details and ramifications of accounting for government contracts. On the other hand, I'm certain there are among you experts much more familiar with the subject than am I. Nevertheless, to be fair to the entire membership, let me begin by outlining in fairly simple terms what we really mean by accounting for government contracts, and then follow up later on the intricate details of Section XV, ASPR.

ASPR means Armed Services Procurement Regulation. These are the basic regulations which cover the handling of government contracts placed by the Defense Department

with [illegible] prime contract, so that any of you [illegible] on a defense contract, [illegible] down the line, and affected by these regulations. Don't forget that the Department of Defense is the biggest business in the world today; its contracts have a terrific impact on gross national product; and sooner or later it enters the life of almost every business in America, however large or small. My topic is Section XV but let us examine briefly the topics covered by the other sections to give you a broad idea of the entire area of government defense procurement:

Section I	General Provisions
Section II	Procurement by Formal Advertising
Section III	Procurement by Negotiation
Section IV	Special Types and Methods of Procurement
Section V	Interdepartmental & Coordinated Procurement
Section VI	Foreign Purchases
Section VII	Contract Clauses & Forms
Section VIII	Termination of Contracts
Section IX	Patents & Copyrights
Section X	Bonds & Insurance
Section XI	Federal, State & Local Taxes
Section XII	Labor
Section XIII	Government Property
Section XIV	Inspection & Acceptance
Section XV	Contract Cost Principles
Section XVI	Procurement Forms
Section XVII	Extraordinary Contractual Actions to Facilitate the National Defense

In addition to these basic Armed Service Procurement Regulations, each Service follows up with implementations of their own, known as AFPI (Air Force Procurement Instruction), -- Air Force people say ASPR follows AFPI! -- NPD (Navy Procurement Directive), and APP (Army Procurement Procedure). The individual Service interpretations sometimes differ greatly so a contractor must be ready to live with 3 different sets of rules, depending on which Service is his customer. One of industry's biggest gripes is the lack of uniform implementation by the various Services of the basic ASPR especially at the field level. However, that is a subject of its own, so tonight we'll stick with the basic ASPR Section XV without going into details of how the 3 services interpret it.

As an aside at this point, I would like to point out that industry does and must constantly review how the various ASPR sections are working out in actual practice. Various industry organizations, such as the Electronic Industries Association, the National Security Industrial Association, the Aerospace Industries Association, the Automobile Manufacturers Association, the National Association of Manufacturers, the U.S. Chamber of Commerce, and the Machinery & Allied Products Institute, appoint committees of industry specialists to keep watch on the different fields of government procurement. The government also favors this mutually beneficial approach, and joint industry-government meetings are often held, at which industry's recommendations for changes in the basic ASPR are reviewed. There is an over-all ASPR Committee headed by Capt. Malloy which reviews and approves or disapproves all recommended changes to the basic ASPR as recommended by the ASPR Sub-Committees covering each Section of ASPR. These ASPR Sub-Committees are composed of members from all the Military Services. It is the ASPR Committee and Sub-Committees that industry must deal with in recommending changes to ASPR. I am particularly familiar with these endeavors (as Chairman of the EIA Termination Committee) in the termination field where I have seen a number of industry recommendations actually incorporated in

Section VIII, ASPR. Not tooting my own horn but the working relationship of the Industry and Government in the Termination field is considered exemplary with the result that more has been accomplished in this area to the mutual benefit of both sides than in any other area of defense contracting. Presently we are jointly preparing a simplified Termination guide primarily for use of small subs who don't know how to handle a Termination and are confused by ASPR Section VIII. Industry needs the help of all of you engaged in defense contracting. If you have any ideas or complaints, don't hesitate to bring them to the attention of the appropriate industry association.

Before tackling exactly what is in the new Section XV and its impact on defense industry, I believe you would find it interesting to learn some of the history behind the so-called new Section XV, which went into effect last July 1.

Prior to that date, the old Section XV covered cost principles applicable to Cost-type (CPFF, etc.) contracts only. Price redetermination contracts weren't covered specifically by any Section although the old Section XV was used as a guide by Government personnel. Termination cost principles were a separate set contained in Section VIII, ASPR. Cost principles for forward pricing, quotations, establishing negotiated or firm fixed prices, etc., did not exist, as such actions were generally accomplished by negotiation.

For a long time the government has been attempting to issue a comprehensive set of cost principles which would put all costing actions under the same rules. Industry has strongly opposed such an idea on the grounds that different type contracts and costs (cost reimbursement v.s. fixed price) do not lend themselves to a single set of principles; also, that negotiated fixed price contracts are priced largely on a competitive basis. However, because of pressure by GAO and Congress, the Department of Defense, through Revision No. 50 on November 2, 1959, issued the New Section XV Contract Cost Principles and Procedures to be mandatorily effective as of July 1, 1960.

Thanks to concentrated action by industry which culminated in a joint Defense-Industry conference on October 15, 1958, prior to the issuance of the new Section XV, the new cost principles are more flexible than the government had originally intended. For instance, although they continue to serve as the contractual basis for the payment of costs under cost-reimbursement type contracts, they will serve only as a guide in the negotiation of prices or settlements in all other defense contracting. Also, "Reasonableness" is the major test applied by the new Section XV in measuring the allowability or nonallowability of costs.

Nevertheless, government auditors all over the country have turned to the new principles with relish and are attempting to apply them across the board as though they were mandatory. The result is a trend toward "formula pricing." One big reason for this is the present cost-cutting drives being pushed by all the Services; another one is the adverse GAO publicity over the past few years covering the so-called horror cases where contractors have on occasions not passed on to the government certain cost savings. Of course, never publicized are the many, many cases where a contractor is given a clean bill of health by the GAO. But that is another subject, so let us return to the one at hand.

Before getting into the new cost principles themselves, I think it would be a good idea to briefly review the types of contracts and pricing actions which may be affected. Remember that CPFF and Production Contracts are 2 different animals. The cost-reimbursement type contract, whose costs are strictly

governed by the Section XV cost principles, is commonly known as a CPFF, CPIF or Cost Sharing. In the case of the CPFF Contract, which usually covers development of a new type equipment, an estimated cost plus a fixed fee is established. The fee remains fixed even though costs may be more or less. The fee may be increased, of course, if a change of scope can be established. CPIF means cost plus incentive fee, where the contractor gets a greater fee if costs are under target and a lesser fee if they are over. Cost sharing is where the contractor and the government share the costs with no fee involved. Cost-reimbursement contracts may be of a construction nature, with educational institutions, or with commercial organizations such as contractors.

The new Section XV cost principles are to be used as a guide on the following type contracts and pricing actions:

(1) Firm or negotiated fixed price contracts where once the price is negotiated it is never changed.

(2) Redeterminable and incentive type contracts where an original or target price is set and then redetermined at some future date into a final price. Both actions are now subject to Section XV cost principles as a guide.

(3) Terminations. Every government contract contains a termination for convenience of Government clause. In event of termination, most costs are recoverable, with Section XV instead of the old Section VIII cost principles as a guide.

(4) Fixed-price contracts with escalation; non-cost-reimbursable portion of time and materials contracts; and labor-hour contracts.

In other words, we now have government auditors checking almost everything we do, including quotes, setting of prices on firm fixed price contracts, redeterminations, terminations, etc.

Now, after all these preliminary statements, let us turn to the much publicized new Section XV, ASPR, and see just what it does say and how it effects defense contracting. Before considering the individual elements of cost which are or are not allowable, we should review some of the generalizations in the new Section XV:

(1) Advance understandings on particular cost items.

In order to avoid possible subsequent disallowance or dispute based on unreasonableness or nonallocability, it is important (says the government) that prospective contractors, particularly those whose work is predominantly with the government, seek agreement with the government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Examples of such instances are: Compensation for personal services; use charge for fully depreciated assets; deferred maintenance costs; pre-contract costs; and R & D Costs. Let me give you a word of warning. Do not get advance agreements in areas where you are having no trouble. Also, don't sell your rights down the river just to get an advance agreement with, say, a local auditor.

(2) General factors affecting allowability of costs.

Factors to be considered in determining the allowability of individual

items of costs include (i) reasonableness, (ii) allocability, (iii) application of those generally accepted accounting principles and practices appropriate to the particular circumstances, and (iv) Any limitations or exclusions set forth in Sec. XV or otherwise included in the contract as to types or amounts of cost items. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. A cost is allocable if it is assignable or chargeable to a particular cost objective, such as a contract, product, product line, process, or class of customer or activity, in accordance with the relative benefits received or other equitable relationship. Unfortunately for industry, if a cost is listed as unallowable in Section XV, tests of reasonableness, allocability and generally accepted accounting principles do not apply.

(3) Direct and Indirect Costs.

A direct cost is any cost which can be identified specifically with a particular cost objective. As an aside, the government accepts direct costing if results are fair to Government. Direct costing, however, is difficult to use under Government Contracts where costs are usually deferred and amortized. An indirect cost is one which, because of its incurrence for common or joint objectives, is not readily subject to treatment as a direct cost.

The above explanations are from the broad-brush viewpoint but it is necessary to consider them in order to understand Section XV, because we are now ready to consider the various individual elements of cost which in the eyes of the government are or are not allowable. Before listing such costs, Section XV says: "Section 15 does not cover every element of cost and every situation that might arise in a particular case. Failure to treat any item of cost in Section 15 is not intended to imply that it is either allowable or unallowable." This means that any peculiar costs you may have not specifically covered by Section 15 have to be negotiated based on the broader principles of reasonableness, allocability and application of generally accepted accounting principles. One other observation might be in order at this time -- the contractor who mixes government and commercial work in one plant, with a consequent mixture of costs, will probably encounter more difficulty with the new cost principles than the contractor who keeps his defense work isolated in one location.

We are now ready to consider the individual cost items and their treatment in Section XV, paragraph 205. They are in alphabetical order and we'll cover them in that order with stress on the more controversial and important areas.

ADVERTISING

Our first topic is near the top of the list as one of the most controversial of all. It is the general opinion of industry that the new Section XV makes recovery of advertising costs more difficult than the old Section XV, and certainly much more difficult under a termination than was true under the old Section VIII, where advertising was allowable if reasonable and allocable. Under the new Section XV the following advertising costs are allowable:

Advertising in trade & technical journals provided such advertising does not offer specific products or services for sale.

Help-wanted advertising.

Costs of participation in exhibits upon invitation of the Gov't. or for purpose of disseminating technical information within the contractor's industry providing specific products or services aren't offered for sale.

Advertising for purpose of obtaining scarce materials, plant or equipment; or disposing of scrap or surplus materials, in connection with the contract.

Although government auditors are prone to disallow almost all advertising today, defense contractors should not give in without a battle as it is definitely an area for negotiation. The framers of the new Section XV recognize that Advertising is causing considerable trouble in negotiations, and they are investigating the matter which will probably result in elaborating on the current language. Over the years advertising has been a sore spot in the costing of defense work. Although military people know it is useful, and often necessary, advertising by defense contractors is politically vulnerable. Defense officials have never found a way to explain the contribution that institutional advertising makes to the stability of our production system, or to the public's understanding of national defense problems.

Advertising in trade and technical journals is the biggest bone of contention. A clear cut definition of what constitutes a trade and technical journal has never been released. The prohibition of advertising copy which offers specific products or services for sale also is in an ambiguous area -- for instances, what if such products are offered solely or substantially to the government.

In the absence of authoritative, definitive interpretations, defense contractors are placed in the position of negotiating individually with various Government procurement and audit representatives. In my opinion defense contractors whose advertising expenditures are substantial should seek reimbursement for every dollar of advertising expense which has not been declared unallowable in a clear cut manner by a regulation, supporting his case by reasonableness, allocability, and the fact that it is the over-all intent of Section XV to negotiate a fair price -- not to allow or disallow individual items of cost. Advertising beamed strictly at commercial products, of course, could not be supported under a government contract. The gist of the two positions is that the Government sees Advertising as Selling Expense -- Industry as a means to keep its name before the public, including Government agencies.

BAD DEBTS

Unallowable as before on the theory that bad debts are inapplicable to government sales.

BIDDING COSTS

Spelled out as Proposal Costs in the old Section XV, this is another problem area in the new principles. Companies who previously charged independent research into bidding expense are being forced to change their methods as it no longer can be buried there. Also, some firms are running into trouble because of heavy charges under bidding expense for unsolicited technical proposals. Bidding costs basically are acceptable if reasonable and equitable.

BONDING COSTS

Generally allowable.

CIVIL DEFENSE COSTS

Allowable except for contributions to civil defense funds and projects.

COMPENSATION FOR PERSONAL SERVICES

Generally allowable. However, important qualifications are placed on such things as executives salaries, cash and stock incentives and bonuses, and deferred compensation. If you are having trouble in this area, an advance understanding may be desirable. Stock options are unallowable. The new Section XV goes to much greater length than the old Section XV in outlining what is covered by compensation for personal services.

CONTINGENCIES

The new Section XV is more liberal than the old Section XV in that it specifies that contingencies which are foreseeable within reasonable limits of accuracy are allowable in estimating costs; all other contingencies are unallowable.

CONTRIBUTIONS & DONATIONS

Continue unallowable. This is a real sore spot with industry. We maintain that support of charitable, scientific and educational institutions is a normal and necessary cost of doing business in a community and, as such, is allocable to Government business to the extent that it is reasonable. For years industry has fought to get contributions and donations accepted as an allowable cost on government contracts. At one time it had succeeded through all the procurement labyrinths of the Pentagon, only to have the idea vetoed by a Secretary of Defense who felt that what was good for General Motors was not good for the government. We will have to wait and see how the man from Ford reacts! We will continue to fight this battle. However, for the time being contributions and donations are unallowable costs on every phase of government procurement.

DEPRECIATION

Generally allowable if handled in accordance with procedures approved by the Internal Revenue Code of 1954, as amended, and if applied on a consistent and reasonable basis. However, depreciation on idle or excess facilities is not allowable unless such facilities are necessary for standby purposes. If an asset has been fully depreciated, a reasonable use charge will be allowed if a substantial portion of the amount previously depreciated was not against Government contracts or subcontracts. The use of a replacement value basis is not allowed since it involves a process of valuation.

EMPLOYEE MORALE, HEALTH, AND WELFARE COSTS AND CREDITS

Allowable providing income generated from these activities is credited to the costs.

ENTERTAINMENT COSTS

Strictly unallowable, unless for benefit of employees or in connection with technical business meetings and conferences. As an interesting sidelight, when the new Section XV was first released, this particular paragraph said "but see 15-205.42." Section 15-205.42 happens to cover Termination Costs. At the time the new Section XV was released, my Electronic Industries Association termination committee made a detailed study comparing the new Section XV cost principles with the old Section VIII cost principles. We could see no reason for the reference to termination costs under entertainment, so we contacted

certain people in the Pentagon and asked them if this meant that entertainment costs were allowable under a termination! We got a quick answer on that one -- it was a clerical error and the reference should have been to section 15-205.43, covering Trade, Business, Technical and Professional Costs; the new Section XV has now been corrected to show the proper reference, so at least industry can say in one instance they were instrumental in changing the new Section XV! We discovered it one day before Mr. Bannerman, DOD Director of Procurement Policy.

EXCESS FACILITY COSTS

Unallowable, except those reasonably necessary for standby purposes.

FINES AND PENALTIES

Unallowable, except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the Contracting Officer.

FOOD SERVICE AND DORMITORY COSTS AND CREDITS

Allowable providing profits are included as credits. Company cafeteria is an example.

FRINGE BENEFITS

Items such as pay for vacations, employee insurance, etc., generally allowable.

INSURANCE AND INDEMNIFICATION

Generally allowable but with important limitations. If you have any problems in this area, suggest you read the new Section XV carefully and have an understanding with the Contracting Officer.

INTEREST AND OTHER FINANCIAL COSTS

Unallowable, as it was under the old Section XV. However, under old Section VIII Interest Expense was allowable under a termination, which is the major change as far as termination is concerned. Over the years industry has argued that Interest Expense should be allowed as the cost of money, for whatever purpose and however evidenced, is an essential cost of doing business, government or commercial. The government position is that the allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and, therefore, would provide an incentive for borrowing for the performance of government contracts even where cash requirements could be met out of available capital. Industry will continue to push for allowance of such a basic cost as interest; however, it will be a long hard road.

LABOR RELATIONS COSTS

Allowable.

LOSSES ON OTHER CONTRACTS

Unallowable.

MAINTENANCE AND REPAIR COSTS

Generally allowable.

MANUFACTURING AND PRODUCTION ENGINEERING COSTS

Generally allowable.

MATERIAL COSTS

Generally allowable. The big problem in this area is material sold or transferred between plants, divisions or organizations. Competitive prices, profit on profit, inventory pricing, etc., all enter the picture.

ORGANIZATION COSTS

Unallowable. Cover such things as fees in connection with reorganization of a business or raising capital.

OTHER BUSINESS EXPENSES

Allowable. Include such items as registry and transfer charges, costs of directors and shareholders meetings, etc.

OVERTIME, EXTRA-PAY, SHIFT, AND MULTISHIFT PREMIUMS

Generally allowable. Overtime requires prior approval.

PATENT COSTS

Allowable if title is conveyed to the government. Will discuss further under royalties.

PENSION PLANS

Generally allowable but subject to close scrutiny. If Internal Revenue has approved Plan, there is no question.

PLANT PROTECTION COSTS

Allowable.

PLANT RECONVERSION COSTS

Generally unallowable. However, the cost of removing government property, and other additional costs may be acceptable if agreed upon in advance.

PRECONTRACT COSTS

Allowable to extent they would have been allowable if incurred after the date of the contract. An anticipatory cost clause is a good idea in this area.

PROFESSIONAL SERVICE COSTS -- LEGAL, ACCOUNTING, ENGINEERING AND OTHER

Generally allowable, except in connection with organization and reorganization, defense of anti-trust suits, and prosecution of claims against the government, or patent infringement litigation.

PROFITS AND LOSSES ON DISPOSITION OF PLANT, EQUIPMENT, OR OTHER CAPITAL ASSETS

Unallowable.

RECRUITING COSTS

Allowable within the standard practices of the industry. From the government standpoint, this is another problem area. Congress is constantly keeping the heat on DOD to make sure that excessive recruiting costs are not allowed. A recent DOD survey shows that recruiting costs of Defense contractors are substantially higher than those of non-defense contractors. The result may be that CPFF contractors are given too much leeway to engage in a race for technical talent at government expense. Industry, of course, maintains that recruiting is a necessary expense to advance the state of the art, and that it could not turn out the complicated missiles and planes demanded by the government without recruiting talented personnel.

RENTAL COSTS (INCLUDING SALE AND LEASEBACK OF FACILITIES)

Generally allowable. However, the portion relating to sale and leaseback of facilities not previously covered in the old Section XV, is causing trouble. The new Section XV says: "Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed the amount which the contractor would have received had he retained legal title to the facilities." This immediately becomes a hard figure to prove and an area for negotiation. For instance, does the new Section XV apply to sale and leaseback agreements entered into prior to July 1, 1960, the costs of which are reflected in contracts issued after that date? This could be an area where an advance agreement would be necessary.

RESEARCH AND DEVELOPMENT COSTS

Without a doubt this is the most controversial and difficult area in the entire new set of cost principles, both from an industry and government standpoint. The regulation is flexible enough that each contractor is being looked upon more or less as an individual case, with the result being separate agreements between contractors and government as to how much of the contractor's Research and Development program the government will pay. Two important new general features are incorporated in this revised principle -- (1) Necessity for advance agreements; and (2) The theory of cost sharing -- in other words, industry picking up a portion of the tab for Research and Development Expense.

DOD Instruction 4105.52 established the Armed Services Research Specialists Committee to review individual contractor's Research and Development Expense and to determine what portion the government should bear. This Committee goes into action only upon request of a particular military department for review of independent Research and Development programs of defense contractors. If one of the military services has already been assigned "negotiation cognizance" over your firm, the chances are you will continue to deal with that Service in negotiating your Research and Development Expense rate. It is the intent of the government to review this area yearly. To date there has been wide divergence in how various individual contractors have fared in the Research and Development area. As I mentioned above, there is no hard and fast rule of exactly how much the government will allow. Thus, it is up to each company to sell its own case. The DOD position is that they are dealing with each case on its merits, which was the intent of the drafters of this particular cost principle. It also is the government's intent to consider the reasonableness test first, and then cost-sharing. How this may work out in actual practice is another matter. Before getting further into the subject, let us examine the new Section XV interpretation

of just what Research and Development Expense is and to what extent it may be allowable. Three categories of Research and Development Expense are spelled out --

(1) Basic Research -- That which is directed toward the increase of knowledge in science.

(2) Applied Research -- That which is directed toward the practical application of science.

(3) Development -- The systematic use of scientific knowledge directed toward the production of or improvement in useful materials, devices, methods or processes, exclusive of design manufacturing and production engineering.

Under Section XV, Basic Research shall be allowable as indirect costs (if reasonable) provided they are allocated to all work of the contractor -- production contracts, development contracts, and commercial work. Applied research, which is in the never-never land between basic research and development, will be treated as basic research only if its principal aim is not the design, development, or test of specific articles or services to be offered for sale. Otherwise, applied research falls in the development category. Under Development Expense, costs are allowable to the extent that such development is related to the product lines for which the Government has contracts. Development Expense, which probably comprises on the average around 90% of a contractor's Research and Development Expense, is thus allocable only to Government production contracts and is the big bone of contention under the cost-sharing premise. Formerly, Research and Development was allowable under CPFF if specified in contract; allowable if allocable under Termination; no set rule on Firm Fixed Price or Redeterminable Contracts.

In the era of the cold war and survival, Research and Development efforts are our very life-blood. The industry position is that the government should pay its full share of such expense or industry may be discouraged or unable to participate fully in the Research and Development area, from which the weapons of tomorrow will rise. On the other hand, industry does not expect the government to pick up the tab 100% where commercial products are involved. The result is that Research and Development Expense is strictly an area for negotiation on an individual company basis. The new Section XV is ambiguous enough to leave a wide opening as to what Research and Development Expense is and is not allowable under government contracts. You cannot tie into what the government is allowing some other firm because each one is being handled differently. My final comment is -- good luck to all of you in negotiating an agreement on your Research and Development Expense.

ROYALTIES AND OTHER COSTS FOR USE OF PATENTS

Generally allowable with important exceptions. Such things as government right to free use of patent, an unenforceable or expired patent, royalties arrived at as a result of less than arm's length bargaining, etc., enter the picture.

SELLING COSTS

Allowable if reasonable and allocable to government business. In a firm which mixes government and commercial sales in one location, the question always arises about the proper allocation of selling costs. Salesman's commissions are allowable only if paid to bona fide employees or agencies maintained by the contractor for the purpose of securing business, which is an improvement over the old Section XV, where commissions and bonuses (under whatever name) were non-allowable.

SERVICE AND WARRANTY COSTS

Not covered by the old Section XV, these costs are now generally allowable. A problem area is how to recover such costs occurring after a contract is delivered.

SEVERANCE PAY

Allowable but with important conditions attached. Each case is examined separately.

SPECIAL TOOLING COSTS

Generally allowable if allocable to government work.

TAXES

Generally allowable, except for:

(i) Federal income and excess profits taxes.
(ii) Taxes in connection with financing, refinancing or refunding operations.
(iii) Taxes from which exemptions are available to the contractor.
(iv) Special assessments on land which represent capital improvements.

There are so many taxes today that it is a wise idea to get advance approval from the Contracting Officer when in doubt because of the legal ramifications.

TERMINATION COSTS

As mentioned before, termination cost principles formerly were contained in Section VIII; now the new Section XV cost principles govern. Section VIII remains in effect covering termination regulations except cost principles. However, in placing termination under the over-all Section XV, it was necessary to pinpoint specific costs which are peculiar to termination only. The EIA and NSIA termination committees worked closely with the government ASPR committee prior to the release of Section XV to make sure it covered these peculiar termination costs. The result is section 15-205.42 which covers the following matters:

(1) Cost of common items reasonably usable in other work is not allowable.
(2) Certain Costs continuing after termination may be allowable.
(3) Initial costs, including starting load and Preparatory costs, are allowable.
(4) Loss of useful value of special tooling, special machinery and equipment is generally allowable.
(5) Rental costs under unexpired leases are generally allowable.
(6) Settlement expenses (preparing claim, settling subs, storage, etc.) are allowable.
(7) Subcontractor claims are allowable.

TRADE, BUSINESS, TECHNICAL AND PROFESSIONAL ACTIVITY COSTS

Generally allowable, including memberships, subscriptions, and technical meetings and conferences.

TRAINING AND EDUCATIONAL COSTS

Generally allowable, except grants to educational or training institutions, which are considered contributions and unallowable.

TRANSPORTATION COSTS

Allowable.

TRAVEL COSTS

Generally allowable. Again, we have a problem area from the government's standpoint. The Military Departments feel that more precision is needed in the area of per diem, travel and moving expenses, and would like to prescribe guidelines similar to those applicable to Civil Service employees, to prevent abuses by industry. However, those in control at DOD prefer to let these items stay general and to curb any abuses which may develop under the concept of "reasonableness". Industry certainly favors the latter approach, as per diem, travel and moving expenses are in a competitive category between firms. Naturally industry does not favor paying more than is necessary for such items, but at the same time it must meet competition in these fields.

So far we have talked in generalities about government contracts and the cost principles which govern them. Certainly we can't completely pass over the actual role of the accountant in defense contracting.

Management wants to know (and has to know) how it is making out on individual contracts or subcontracts. It is the accountant's job to provide and interpret such figures. He is a member of the team. A Government Accounting Dept., then, should know how individual contracts and subcontracts are making out financially to provide backing information for future bidding, for price redeterminations, for profit analysis, etc. Costs are usually deferred and amortized against deliveries. Most important of all, the accountant in this field should be on the negotiating team which actually settles the final price with the government, with other prime contractors, and with subcontractors. It is a fascinating field as you are actually creating figures, not balancing them, and you are dealing with people, not just books. Actually, the field of government contract accounting has been largely neglected in college curricula and accounting books and publications. This is probably due to the fact that each firm takes an individual approach to the subject and there is no set pattern to handle the confusing complexities that arise; also to the fact that only the larger defense firms need a separate government accounting department. The fact remains that sooner or later most firms get involved in a Government Contract. "Accounting Guide for Defense Contracts, 3rd Edition", by Paul M. Trueger is the best book on the subject. NSIA through Harbridge House and the Graduate School of George Washington University have sponsored courses in general government procurement.

Also, strictly from an accounting standpoint, let me show you the effect on profit of disallowal of certain costs as spelled out in Section XV, ASPR:

		Cost per books	Cost disallowed		Cost Allowed
Prime Cost		$100,000	$ 5,000		$95,000
G&A Expense	10%	10,000	2,400	8%	7,600
R&D Expense	5%	5,000	2,625	2.5%	2,375
Total Cost		$115,000	$10,025		$104,975
Profit		(25)			10,000
Total S.P.		$114,975			$114,975

While the above case may be slightly exaggerated, it points up the fact that the costs disallowed by the government are true costs of doing business and result in a loss of profit. Thus, a contractor's commercial work is unduly burdened with non-allowable Government cost and his incentive to perform Government work is lessened. Because of today's situation, where every bid and every item of cost is being examined, we maintain that renegotiation is obsolete and should be allowed to expire in 1962. Speaking of renegotiation, please do not confuse it with redetermination, as so many people do -- renegotiation is the over-all look the government takes at your government business for the year to determine if you made too much profit; redetermination is the establishment of a final price on an individual contract which is subject to price revision. Renegotiation on incentive contracts is particularly unfair -- on the one hand you are encouraged to get increased profits by cutting costs; on the other hand such profits are taken away from you.

In closing, I'd like to leave you with 3 observations on the subject:

(1) The new Section XV has not really been in operation long enough for a true test. In fact, some large contractors did not go under the new principles until 1 January 1961 in order to tie them into the fiscal year, based on an agreement with the Defense Department. Remember that it is effective only on contracts dated on or after July 1, 1960 (unless existing cost-type reimbursement contracts have been specifically amended to incorporate the new principles). The result is that we may have several sets of cost principles in existence for a long time on contracts awarded prior to July 1, 1960, but which may run for several years -- New Section XV; Old Section XV; and Old Section VIII. However, the DOD is investigating the possibility of cutting all contractors over to the new cost principles on all contracts in 6 months or so. Above all, do not let government auditors and contracting officers at this time invoke the new Section XV on contracts which because of their date still belong under the old principles.

(2) It is not the intent of the framers of the new Section XV that all prices be decided by audit reports or by rigid cost principles, or that "formula pricing" take over. Let me quote from Section 15-603(c): "In applying this Section XV to fixed-price contracts, contracting officers will: (i) not be expected to negotiate agreement on every individual element of cost; and (ii) be expected to use their judgment as to the degree of detail in which they consider the individual elements of cost in arriving at their evaluation of total cost, where such evaluation is appropriate." I realize that today the audit report has become more and more the bible. However, industry must fight back and must continue to insist on negotiated prices which consider more than just individual elements of cost.

(3) For any of you who are really interested in this subject, I highly recommend you attend a joint government-industry Seminar on "Department of Defense Procurement under the Revised Contract Cost Principles and Procedures" sponsored by the National Security Industry Association, and to be held at the Sheraton-Park Hotel, Washington, D.C., on Jan. 24 and 25. A full house is expected so you should get your reservations into NSIA immediately. I have further details for anybody interested.

Gentlemen, it has been a real pleasure to talk to you on this fascinating and important subject in the field of defense contract accounting. I would be most happy to attempt to answer any questions you may have. Thank you for your kind attention.

END

EPJ:bw

THE MORE IMPORTANT CHANGES IN THE REVISED COST PRINCIPLES

An Address

by

Ernest F. Leathem

at

The National Security Industrial Association Seminar

On Department of Defense Procurement

Under the Revised Contract Cost Principles and Procedures

The Sheraton-Park Hotel

Washington, D. C.

January 24, 1961

Mr. Chairman, Distinguished Fellow-Participants
in this Seminar, Ladies and Gentlemen:

Revision 50 to the Armed Services Procurement Regulation was spawned after almost eight years of debate and largely abortive efforts to reconcile fundamental differences between industry representatives and a succession of government procurement officials. It brought forth four pages of index and twenty-six pages of closely printed text, entitled "Principles and Procedures For Use In Cost-Reimbursement Type Supply and Research Contracts With Commercial Organizations". It was first issued on November 2, 1959, and was made mandatorily effective as to all new contracts to which it is applicable, which were executed on or after July 1, 1960. Hence it has been available to the public for almost fifteen months and in force officially almost seven months. There is, then, surely no point in merely listing the differences between the provisions of this document and of its simpler, shorter predecessor. Most of you will probably have read and reread these so-called "principles" several times or, if you have not, you can and should.

No one, however precise or eloquent, can be a substitute for your own careful study and consideration of the intricacies and complexities of this most important subject.

However, even the most ardent advocates of these cost principles would, I believe, concede that even after this lapse of time, they are not being applied wholly, or in some of the areas which were most intended to be changed, and that ways to make them understood and effective still remain to be found. I hope, therefore, that it may be worthwhile this morning to try to focus our attention on some of these major problem areas, and leave to some of the more detailed later discussions consideration of particular differences between old and new.

Before going on, however, let me digress long enough to give you a very few statistics which should so amaze you, if you are not already aware of them, that you should have no difficulty in staying awake until I am through. Purchases of goods and services by the Armed Services are somewhat in ex

billion per year, and are expected to increase by at least ten

within the next two years. According to our next speaker (in a speech he made in Philadelphia almost a year ago), and included in a significant analysis of procurement submitted by the Defense Department last year to the Senate Armed Forces Committee, between 60% and 65% of all such purchases are being made under either incentive, price-redeterminable or cost-reimbursement type contracts. All such types of contracts are subject to the new cost principles ennunciated in the new Section XV of ASPR. Thus some $15 to $17 billion dollars of orders are or will be affected.

Now it is also generally conceded that the application of these new principles cause the partial or total disallowance of costs actually and necessarily incurred by defense contractors. I am personally convinced that the average of such disallowances for most major prime contractors will approach two percent of selling prices - and for many companies, exceed this figure. So if there are 2% disallowances on $15 to $17 billion of sales, defense contractors are being expected to absorb against their profits or, if there are none, out of their other resources, between $300 and $350 million of unrecoverable costs every year. Of course, to the extent such contractors have profits in

excess of these amounts, Uncle Sam absorbs 52% of these costs, after all, by letting them be allowable tax deductions. The remaining 48%, or some $150 million, is still a very large amount of money - and one with which any profit and cost conscious business management should be most concerned.

There is, therefore, more incentive today than there has ever been before for management and its controllers to segregate and identify these disallowable costs, and to minimise their amount in any practical and feasible way. Do not, however, expect to be able to eliminate them entirely, for with few if any exceptions, they are the kinds of costs which to some extent inevitably must be incurred and paid in conducting any corporate enterprise. The other side of a campaign to minimize disallowables is to be willing to accept and to fight for the issuance of more firm fixed-price contracts, for these cost principles do not apply to them except in the case of change order pricing, termination settlements or a few other special circumstances. Many government officials wanted these cost principles to apply to all kinds of negotiated contracts, and the exclusion of firm fixed-price contracts came only in the last drafting. A vestige of this remains - look at Section 15-603 where discussion is had of how these

cost principles shall be "used as a guide in the evaluation of cost data required to establish a fair and reasonable price" whenever "costs are to be considered in the negotiation of fixed-price type contracts." Nonetheless, the only way to eliminate or minimise some of your costs becoming part of the statistics I have quoted is to get more firm fixed-price contracts and, whenever possible, minimise the incurrence of unallowable costs.

Now let us return to the new Section XV itself. As you know, it is composed of two parts - one labelled "Basic Considerations," and the other "Selected Costs". The basic considerations include, for the first time, definitions of "reasonableness" and of "allocability". I have heard no contractor find any serious fault with these, and to have them spelled out with such care is, as I have often said before, a real and significant achievement of the new rules. In fact, several professional accountants, as well as corporate controllers and treasurers, have told me that they think the new rules would be excellent, and practical and completely workable, had they stopped right there. Certainly they would be more equitable, for the disallowances all come in the sections

on "Selected Costs", and in most cases the disallowances of certain kinds of costs are directed without regard to either their reasonableness or their allocability, under these very same definitions. On the other hand, if costs are allowed under the section on Selected Costs, they must also meet the tests of these definitions of reasonableness and allocability - but paradoxically, no one objects to that.

These definitions have one other highly beneficial effect, however, for they, coupled with Sec. 15-204 on "Application of Principles and Procedures," resolve what might otherwise have been an anomalous and dangerous division of authority between auditors and contracting officers in matters of cost determinations. Let me illustrate:

The new principles say that they "contain general principles and procedures for the determination and allowance of costs," and shall be "the basis for determination of reimbursable costs." Government auditors, if this were the only language used, could find justification for asserting that their findings under the cost principles are absolute, and leave no latitude for

negotiating. Some of them would like this very much! The next subsection, however, says that the new principles shall be "the basis for the negotiating of overhead rates." Since an auditor has no power to negotiate, this obviously leaves the resolution of indirect costs to the contracting officer or his delegated negotiator. Surely, though, it is not intended that auditors have the final say as to direct costs, and contracting officers as to indirect costs, and none as to all costs!

This is where the subjective determination of reasonableness, and the objective determination of allocability under the new definitions, come to the rescue of the contracting officer. These are findings which only a contracting officer can make, and often only after negotiation with the contractor. Let no one say, then, that the new cost principles supplant the contracting officer and put the auditor in his place - for they do not and there is no such intention embraced within them, even though they admittedly enlarge the scope and importance of audits.

Probably one of the most significant aspects of the new principles is their requirement or request for advance understandings on certain particular

cost items. Section 15-107 lists eight of these, but elsewhere in the part on "Selected Costs," advance agreements are suggested as to at least five additional kinds of costs. Earlier drafts would have made advance agreements mandatory before any of the designated kinds of costs would have been allowed, but the final regulation is less arbitrary and stringent, for it says, "But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable."

Industry representatives have welcomed the forthright recognition of the desirability of advance agreements in the new ASPR. The more agreements that can be reached, in advance of negotiating particular contracts, on matters common to all contracts calling for cost determinations, the better - for then protracted negotiations leading to long delays, and differing interpretations by different contracting agencies, will be avoided. Also, the legitimate variances in accounting methods can, through advance agreements, be recognized and, when necessary, reconciled.

But where can willing and anxious contractors turn to negotiate such advance agreements? As to one cost element - the allowance of research and

development costs, they got a fairly prompt, unique and - in the main - satisfactory answer. At least the big major defense contractors did. A special committee was created early in 1960, composed of both scientific and procurement officials from each of the three Services, and major contractors have been invited to submit and negotiate proposals for advance agreements as to the allowance of research costs, and as to both the allowance of development costs and the "product lines" to which they are to be allocated. Some of these are for only annual periods, and some extend over several years into the future. The work of this committee has been intense, thoughtful and patient - it has resolved differences not only between government and private companies, but also between scientist and purchaser, and between the different Services themselves. This is not to say everyone, on either side, has come away completely satisfied with the negotiated results, but a major step forward has been accomplished. The unfortunate part of it is that the committee's time does not permit it to negotiate such agreements with everyone, large and small, prime and sub - and hence many contractors still have no place to go to get advance agreements on these two elements of costs.

As to the other kinds of costs about which advance agreements are urged, some by their very nature can only be negotiated on a contract-by-contract basis. These are use charges for fully depreciated assets (unless one is dealing with an entire facility usable for performing several contracts), pre-contract costs, royalties payable under a single contract (as opposed to an obligation to pay royalties on all a company's or division's products), travel costs, contingencies (under Sec. 15-205.7), plant reconversion costs (under Sec. 15-205.29), and professional services in connection with patent litigation (under Sec. 15-205.31). As to these, each company and its government contracting representatives must be aware of and alert to the need for advance agreements - and be sure to get them as a part of original contract negotiations.

As to all the others, however, they are kinds of costs which by their very nature can only be negotiated fairly on an overall, company-wide basis, applicable to all contracts. These cost elements are compensation for personal services, deferred maintenance costs, bread royalty obligations, selling and distribution costs, travel costs when plant relocations occur, insurance (under Sec. 15-205.16), and rental costs fixed in sale and leaseback agreements

(under Sec. 15-205.34). You can readily see that these are all costs which must be spread across multiple activities, and rarely, if ever, can be clearly allocated to a single contract without great injustice to the contractor's other business and outrage to doctrines of sound accounting.

The Services, and the Department of Defense, therefore, must find a practical and fair and speedy way for reaching advance agreements with contractors on all these cost elements, if the praiseworthy objective of advance agreements is to be implemented. Various major contractors have tried a variety of approaches as to one or more of these cost elements, but it seems to me that in this American system of ours, no rule or procedure of government is sound unless it can be efficiently carried out with all concerns, large and small. If the government wants the benefits, it should create and maintain the means to negotiate them.

One device is available, though it has been sparingly used. That is the so-called basic agreement, in which - apart from any particular purchase - are set forth in advance contract provisions - some mandatory and some optional -

which can be incorporated completely or by reference when particular purchase orders or contracts are issued. The trouble with these is that they have never been tried, by each of the Services, and rarely as to tough or controversial issues. To use basic agreements to provide the means for advance agreements on cost elements will require, on the part of both parties, a willingness to extend only a partially tested technique to a new problem, to learn and correct its imperfections as experience is gained, and an aggressive determination to find ways to make them work. Technical roadblocks should not be needlessly interposed which would prevent or deter or delay attaining the objectives.

I sincerely hope that some of the panelists from the military Services, before this seminar is over, will tell us how they propose to get advance agreements on these elements of cost!

The second part of the new ASPR, as titled "Selected Costs", contains forty-six subsections, each dealing with the allowability or unallowability of particular kinds of cost elements. Twenty-six items are completely allowable,

ten are flatly disallowed, and ten more are only partially allowable. Those allowed in whole or in part are, as I have said before, also subject to the tests of reasonableness and allocability. There are few, if any, normal costs of doing business not mentioned in one way or another within these forty-six subsections - hence the effect of their issuance is to insert an auditor's manual within ASPR, although ASPR is primarily intended to be a policy document. It can be argued, with vigor on each side, that such an inclusion should or should not have been made - but that is not the point in my bringing up this matter. What I want to call your attention to is the fact that ASPR's provisions are usually incorporated by reference into contracts, and hence when a contractor executes a contract, these ASPR provisions become contractual terms, protected and enforcible under the common law of contracts, wholly apart from the power of government executive agencies to issue and enforce reasonable rules and regulations. The authority of ASPR also extends over the procurement regulations, rules or instructions of each of the Armed Services, whose individual supplementations or implementations must not contravene or limit ASPR's application. The result, therefore, of including such specific rules in ASPR is to make them

binding administrative orders upon government negotiators and contracting officers - as well as auditors - and contractual or otherwise legal commitments of the contractor.

Not so had these items been left for inclusion in the manuals of the various audit agencies of each of the three Armed Services. Then they would have been procedural instructions only, unilaterally binding upon government auditors but not enforcible in law or by contract against contractors who do not agree with them or who had not accepted the obligation to be bound by them.

Hence if it is in fact impossible for a prospective contractor to accept and live under these rules, it had better recognize and deal with this fact before becoming contractually committed. There is, as you all know, a procedure for obtaining variances in ASPR provisions - usually cumbersome, time-consuming, slow and inherently dangerous to good relations with particular contractual agencies - but it is there to apply for if it is absolutely essential.

This broad and pervading authority of these ASPR provisions has one other important significance often overlooked by both government and industrial

representatives. When the treatment of a particular cost element has been negotiated - such as the formula for allowance of development costs and the delimitation of the "product line" or other base against which recovery is to be applied - then not only are the contracting office and the contractor bound - but also the government auditors are bound. They cannot refuse, capriciously or otherwise, to apply the formula negotiated, even though they personally may not agree with it or believe that it should have been handled in another way.

Similarly, the insertion of these provisions in ASPR act to restrict the independent authority of audit agencies to issue audit manuals, instructions or procedures for the direction and guidance internally of their own auditors and outlying offices. They, too, must recognise that such documents cannot vary or contravene the provisions of ASPR - they can only implement them or, within limits, supplement them. In other words, ASPR here imposes the same character of restrictions upon auditors as it does elsewhere upon the procurement offices of each of the Services. This is the reason why the Controller of the Defense Department, and his staff, have such a continuing interest in the fixing of cost principles and procedures.

There are, throughout this new ASPR, expressions or implications of several governmental philosophies about procurement with which most government contractors sharply disagree. I will not attempt to discuss each of them, for to do so could stretch this talk through the rest of the morning - whereas I am sure most of you are glad that my time is already almost up. Some specific items, such as the governmental attitude toward advertising or entertainment expenses, or contributions, will probably be mentioned by subsequent speakers - but two more general, and related, concepts I must mention again - for they are significant, and represent in these ASPRs a culmination of attitudes too long allowed to grow unchallenged.

The first of these is the idea that when there is no price competition, there are no limits upon the contractor's greed and his anxiety to satiate it. This is neatly expressed in Sec. 15-201.3 where it is said:

> "The question of reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to competitive restraints."

A preponderance of government business apparently can create the presumption that competitive restraints are absent - this was very bluntly evident in earlier drafts of this ASPR, and is not wholly lacking from the final product. Some elements of Congress quite evidently believe that no real competition exists in the absence of advertised public bidding.

The facts are that there are few businesses whose purchases are so sought after and fought for as are the kinds of things the government buys by negotiated procurement. A preponderance of government business rarely, if ever, frees a company of competitive restraints. Such restraints are not imposed only by price competition - for price is but one facet of competition. Others, equally important, are labor rates, which are fixed by the competition for jobs in an area or within an industry; technical capabilities - the competition to outdesign someone else; production know-how and tooling - the competition to be able to produce faster, or better, or cheaper than other companies. None of these elements of competition can safely be lessened by having a preponderance of government business.

The second is the idea that a useful and valid technique to overcome the assumed absence of competitive restraints is to request or demand "cost-sharing". Where the cost being talked about is a direct cost, then a demand for cost sharing is a direct attack upon a contractor's right to a fair and reasonable profit. In cost-reimbursement type contracts, profit return is already so low - especially after taxes - that a new name has to be found to cut it down still more. If the cost is an indirect cost, then the requirement for cost-sharing not only cuts down the contractor's profit once - but partially a second time - all in the same deal. Indirect costs, by their nature, must be allocated over a broad base - usually by a percentage formula. Remember that this formula must meet the overall test of allocability set up elsewhere in these cost principles. To the extent a contractor has non-government business, and its allocation formula requires that business to bear its share of the indirect cost, then there has already been cost sharing in favor of the government. To demand further sharing is to have your cake and to eat it too!

Cost sharing, therefore, in either case does not increase the motivations toward good performance - it only increases the necessity to cut corners recklessly to try to recoup more deserved profits which have gone down the drain.

It is fair to ask, also, what grounds the Department of Defense or Armed Services have to assume an absence of high motivation, especially among those companies which do little if any work for anyone except the government. To them, the interests of their best, or only, customer are paramount. For government spokesmen to point to a few cases - less than 100 out of many thousands - where some prime or subcontractor made a profit on a particular contract which seemed too high to the General Accounting Office or to a partisan Congressional Committee, is no justification - for in almost every one of those cases, there was either a legitimate mistake made, or an unrecognized breakdown of communications, or a basic contractual right accepted by the government. In no single case reported was a major government contractor even accused - much less found guilty - of improper motivation. To anyone who has lived in the environment of our competitive free enterprise system, and

who believes deeply in the long-range wisdom of its choice by the American people, and who knows first-hand of its power to create the highest motives of ethical conduct in management, and who has seen time and again the self-sacrifice and patriotism of America's defense industrials, it is just incomprehensible that men of goodwill in government can believe that such artificial stimulants as "cost-sharing" can improve relations between industry and government.

All of us believe that it is morally and ethically wrong, and not to the interests of our country, for defense industry to make or retain exorbitantly high profits from defense contracting. Let us all also believe, with equal fervor and conviction, that it is also morally and ethically wrong, and not to the interests of our country, to make defense industry a second-class industrial citizen, depressed in profits allowed to a point below fair and usual industrial rates of return, and deprived of charging to the government its fair share of all true costs. If the proponents of the latter were as vocal, and as successful, as the proponents of the former, then we would and could have a much shorter,

less complex and more equitable set of Cost Principles than we find in the new ASPR, Section XV if, indeed, we would need any at all!

Thank you, ladies and gentlemen, for your kind attention.

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As to all the others, however, they are kinds of costs which by their very nature can only be negotiated fairly on an overall, company-wide basis, applicable to all contracts. These cost elements are compensation for personal services, deferred maintenance costs, broad royalty obligations, selling and distribution costs, travel costs when plant relocations occur, insurance (under Sec. 15-205.16), and rental costs fixed in sale and leaseback agreements

(under Sec. 15-205.34). You can readily see that these are all costs which must be spread across multiple activities, and rarely, if ever, can be clearly allocated to a single contract without great injustice to the contractor's other business and outrage to doctrines of sound accounting.

The Services, and the Department of Defense, therefore, must find a practical and fair and speedy way for reaching advance agreements with contractors on all these cost elements, if the praiseworthy objective of advance agreements is to be implemented. Various major contractors have tried a variety of approaches as to one or more of these cost elements, but it seems to me that in this American system of ours, no rule or procedure of government is sound unless it can be efficiently carried out with all concerns, large and small. If the government wants the benefits, it should create and maintain the means to negotiate them.

One device is available, though it has been sparingly used. That is the so-called basic agreement, in which - apart from any particular purchase - are set forth in advance contract provisions - some mandatory and some optional -

which can be incorporated completely or by reference when particular purchase orders or contracts are issued. The trouble with these is that they have never been tried, by each of the Services, and rarely as to tough or controversial issues. To use basic agreements to provide the means for advance agreements on cost elements will require, on the part of both parties, a willingness to extend only a partially tested technique to a new problem, to learn and correct its imperfections as experience is gained, and an aggressive determination to find ways to make them work. Technical roadblocks should not be needlessly interposed which would prevent or deter or delay attaining the objectives.

I sincerely hope that some of the panelists from the military Services, before this seminar is over, will tell us how they propose to get advance agreements on these elements of cost!

The second part of the new ASPR, as titled "Selected Costs", contains forty-six subsections, each dealing with the allowability or unallowability of particular kinds of cost elements. Twenty-six items are completely allowable,

ten are flatly disallowed, and ten more are only partially allowable. Those allowed in whole or in part are, as I have said before, also subject to the tests of reasonableness and allocability. There are few, if any, normal costs of doing business not mentioned in one way or another within these forty-six subsections - hence the effect of their issuance is to insert an auditor's manual within ASPR, although ASPR is primarily intended to be a policy document. It can be argued, with vigor on each side, that such an inclusion should or should not have been made - but that is not the point in my bringing up this matter. What I want to call your attention to is the fact that ASPR's provisions are usually incorporated by reference into contracts, and hence when a contractor executes a contract, these ASPR provisions become contractual terms, protected and enforcible under the common law of contracts, wholly apart from the power of government executive agencies to issue and enforce reasonable rules and regulations. The authority of ASPR also extends over the procurement regulations, rules or instructions of each of the Armed Services, whose individual supplementations or implementations must not contravene or limit ASPR's application. The result, therefore, of including such specific rules in ASPR is to make them

binding administrative orders upon government negotiators and contracting officers - as well as auditors - and contractual or otherwise legal commitments of the contractor.

Not so had these items been left for inclusion in the manuals of the various audit agencies of each of the three Armed Services. Then they would have been procedural instructions only, unilaterally binding upon government auditors but not enforcible in law or by contract against contractors who do not agree with them or who had not accepted the obligation to be bound by them.

Hence if it is in fact impossible for a prospective contractor to accept and live under these rules, it had better recognize and deal with this fact before becoming contractually committed. There is, as you all know, a procedure for obtaining variances in ASPR provisions - usually cumbersome, time-consuming, slow and inherently dangerous to good relations with particular contractual agencies - but it is there to apply for if it is absolutely essential.

This broad and pervading authority of these ASPR provisions has one other important significance often overlooked by both government and industrial

representatives. When the treatment of a particular cost element has been negotiated - such as the formula for allowance of development costs and the delimitation of the "product line" or other base against which recovery is to be applied - then not only are the contracting office and the contractor bound - but also the government auditors are bound. They cannot refuse, capriciously or otherwise, to apply the formula negotiated, even though they personally may not agree with it or believe that it should have been handled in another way.

Similarly, the insertion of these provisions in ASPR act to restrict the independent authority of audit agencies to issue audit manuals, instructions or procedures for the direction and guidance internally of their own auditors and outlying offices. They, too, must recognize that such documents cannot vary or contravene the provisions of ASPR - they can only implement them or, within limits, supplement them. In other words, ASPR here imposes the same character of restrictions upon auditors as it does elsewhere upon the procurement offices of each of the Services. This is the reason why the Controller of the Defense Department, and his staff, have such a continuing interest in the fixing of cost principles and procedures.

There are, throughout this new ASPR, expressions or implications of several governmental philosophies about procurement with which most government contractors sharply disagree. I will not attempt to discuss each of them, for to do so could stretch this talk through the rest of the morning - whereas I am sure most of you are glad that my time is already almost up. Some specific items, such as the governmental attitude toward advertising or entertainment expenses, or contributions, will probably be mentioned by subsequent speakers - but two more general, and related, concepts I must mention again - for they are significant, and represent in these ASPRs a culmination of attitudes too long allowed to grow unchallenged.

The first of these is the idea that when there is no price competition, there are no limits upon the contractor's greed and his anxiety to satiate it. This is neatly expressed in Sec. 15-201.3 where it is said:

> "The question of reasonableness of specific costs must be scrutinized with particular care in connection with firms or separate divisions thereof which may not be subject to competitive restraints."

A preponderance of government business apparently can create the presumption that competitive restraints are absent - this was very bluntly evident in earlier drafts of this ASPR, and is not wholly lacking from the final product. Some elements of Congress quite evidently believe that no real competition exists in the absence of advertised public bidding.

The facts are that there are few businesses whose purchases are so sought after and fought for as are the kinds of things the government buys by negotiated procurement. A preponderance of government busine ss rarely, if ever, frees a company of competitive restraints. Such restraints are not imposed only by price competition - for price is but one facet of competition. Others, equally important, are labor rates, which are fixed by the competition for jobs in an area or within an industry; technical capabilities - the competition to outdesign someone else; production know-how and tooling - the competition to be able to produce faster, or better, or cheaper than other companies. None of these elements of competition can safely be lessened by having a preponderance of government business.

The second is the idea that a useful and valid technique to overcome the assumed absence of competitive restraints is to request or demand "cost-sharing". Where the cost being talked about is a direct cost, then a demand for cost sharing is a direct attack upon a contractor's right to a fair and reasonable profit. In cost-reimbursement type contracts, profit return is already so low - especially after taxes - that a new name has to be found to cut it down still more. If the cost is an indirect cost, then the requirement for cost-sharing not only cuts down the contractor's profit once - but partially a second time - all in the same deal! Indirect costs, by their nature, must be allocated over a broad base - usually by a percentage formula. Remember that this formula must meet the overall test of allocability set up elsewhere in these cost principles. To the extent a contractor has non-government business, and its allocation formula requires that business to bear its share of the indirect cost, then there has already been cost sharing in favor of the government. To demand further sharing is to have your cake and to eat it too!

Cost sharing, therefore, in either case does not increase the motivations toward good performance - it only increases the necessity to cut corners recklessly to try to recoup more deserved profits which have gone down the drain.

It is fair to ask, also, what grounds the Department of Defense or Armed Services have to assume an absence of high motivation, especially among those companies which do little if any work for anyone except the government. To them, the interests of their best, or only, customer are paramount. For government spokesmen to point to a few cases - less than 100 out of many thousands - where some prime or subcontractor made a profit on a particular contract which seemed too high to the General Accounting Office or to a partisan Congressional Committee, is no justification - for in almost every one of these cases, there was either a legitimate mistake made, or an unrecognized breakdown of communications, or a basic contractual right accepted by the government. In no single case reported was a major government contractor even accused - much less found guilty - of improper motivation. To anyone who has lived in the environment of our competitive free enterprise system, and

who believes deeply in the long-range wisdom of its choice by the American people, and who knows first-hand of its power to create the highest motives of ethical conduct in management, and who has seen time and again the self-sacrifice and patriotism of America's defense industrials, it is just incomprehensible that men of goodwill in government can believe that such artificial stimulants as "cost-sharing" can improve relations between industry and government.

All of us believe that it is morally and ethically wrong, and not to the interests of our country, for defense industry to make or retain exorbitantly high profits from defense contracting. Let us all also believe, with equal fervor and conviction, that it is also morally and ethically wrong, and not to the interests of our country, to make defense industry a second-class industrial citizen, depressed in profits allowed to a point below fair and usual industrial rates of return, and deprived of charging to the government its fair share of all true costs. If the proponents of the latter were as vocal, and as successful, as the proponents of the former, then we would and could have a much shorter,

less complex and more equitable set of Cost Principles than we find in the new ASPR, Section XV if, indeed, we would need any at all!

Thank you, ladies and gentlemen, for your kind attention.

Outline of Address

By

Alex A. Landesco, Jr.
Administrator, Corporate Government Contract Policy
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At The

FBA Briefing Conference
Philadelphia, Pa.

on

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I. INDUSTRY'S VIEW ON COST PRINCIPLES

A. To be specific or not to be specific. Industry originally preferred and argued for the broad concept and use of test for reasonableness to establish allowability of costs.

B. Now changing views for two reasons:

1. General excellence of Section XV as written.
2. Variety of interpretations and implementations of non-specific portions of Section XV.

II. CURRENT EXPERIENCE UNDER SECTION XV

Problems are of two main types:

A. Those occasioned by Section XV as written:

1. R&D recovery.
2. Sale and leaseback arrangements.
3. Marketing and bidding.
4. Advance understandings.

B. Those occasioned by variety of interpretations and implementations.

1. Incentive of operating levels to further their own interests as opposed to the general good.

a) Trend toward variety of implementations re allocation now that allowability is specifically covered by Section XV.
b) New Part 5 being written to set up allocation ground rules for facilities contracts. Different overhead treatment for different types of contracts.
c) AEC, FAA, etc., etc. New views on Home Office expense, Marketing and R&D costs. Must bear direct relationship to specific contract.

d) All contrary to Section XV - 201.4 which defines allocable cost as one which is necessary to over-all operation of a business, although a direct relationship to any particular cost objective cannot be shown.

2. Standard accepted methods of spreading overhead never meant to be scientifically accurate, but rather economically expedient and appropriate.

3. Government operating levels now attempting to find and justify means of spreading overhead which will tend to produce lower costs for the government not necessarily more accurately, reasonably or scientifically spread.

III. USE OF COST PRINCIPLES AND RELATIONSHIP TO PROFIT & FEE LEVELS

A. If present interpretation and implementation of Cost Principles is to be used as a means of cutting government expenditures, taking pot shots at long established methods of expense allocation not the solution for two fundamental reasons:

1. It neither reduces unreasonable expense nor induces the contractor to do so. It merely causes more costs to fall in the cracks and reduces the contractor's incentives.

2. It doesn't set up a goal for the contractor upon reaching which he can be sure of recovering all his allowable costs.

Would be better to set up expense ceilings to determine how much of an allowable cost is reasonable.

B. Tremendous need for consistency of interpretation and implementation to insure full recovery of allowable costs.

IV. ADEQUACY OF PRESENT PROFIT AND FEE LEVELS

A. Levels are down because of:

1. Nature of work being performed. More R&D and less production.
2. Type of contracts being negotiated. More CPFF and less F.P.

B. Definite need for increased incentives.

1. Through elimination of profit and fee plateaus.
2. Insured recovery of allowable and reasonable costs.