cepted accounting principles and practices", as used herein, covers atters such as the following:

- (a) Whether the contractor has in use a cost accounting system suited to the nature of its operations and capable of adequately disclosing the cost of performing the contract in conformity with the terms thereof.
- (b) Whether there is consistency of treatment from period to period of such items as capitalization of fixed assets, depreciation methods, bases for costing materials from stores, etc.
- (c) Whether costs which should be smortized over more than one financial accounting period (contractor's fiscal year) are being so treated.
- (d) Whether significant items susceptible to direct costing are being so bandled.
- (e) Whether indirect costs are grouped into classes suited to the size and nature of the business and are allocated between military comtracts and other work on bases which produce equitable results. The
  contractor's method of distributing indirect costs abould make provision
  for special consideration of any military contract or other project which
  calls for products or services dissimilar in nature to the contractor's
  regular work. Such special consideration may be necessary in order to
  prevent inequities to the Government or to the contractor.

15-102 Individual Items of Cost. For the purposes of this part, it not considered necessary to deal at any length with individual items cost and no attempt has been made to do so, with a few exceptions.

alogal Federal Income and Excess Profit Taxes. These taxes are not properly includable as a part of costs and it will be expected actors will exclude them in all instances.

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- (a) Whether the contractor has in use a cost accounting system suited to the nature of its operations and capable of adequately disclosing the cost of performing the contract in conformity with the terms thereof.
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- (4) Whether significant items susceptible to direct costing are being so handled.
- (e) Whether indirect costs are grouped into classes suited to the size and nature of the business and are allocated between military contracts and other work on bases which produce equitable results. The contractor's method of distributing indirect costs should make provision for special consideration of any military contract or other project which calls for products or services dissimilar in nature to the contractor's regular work. Buck special consideration may be necessary in order to prevent inequities to the Government or to the contractor.

15-100 Individual Items of Cost. For the purposes of this part, it is not considered necessary to deal at any length with individual items of cost and no attempt has been made to do so, with a few exceptions.

15-102.1 Federal Income and Excess Profit Taxes. These taxes are not a sidered properly includable as a part of costs and it will be expected that contractors will exclude them in all instances.

15-100.2 Entertainment Expenses. Entertainment expenses, other than for business conferences and meetings, should be excluded.

15-102. Fines and Penalties. Fines and penalties for violations of law other than fines for minor traffic violations or penalties incurred through following a course of action directed by the contracting officer abould be excluded.

15-103 Tests of Propriety by the Government. Where the occasion
werrants, the Covernment may be expected to test, by sudit or otherwise,
the propriety of the contractor's cost representations. In so doing,
the matters mentioned in the subparagraphs below will receive consideration.

- (a) Whether there is comformity with the stendards outlined in paragraph 15-101 and the trustment indicated for individual items of cost in paragraph 15-102.
- (b) Whether the amounts of cost elements and cost items most the test of reasonableness.
- (c) Whether cost elements meet the test of allocability. By the test of allocability is meant whether considering all of the circumstances surrounding the incurrence of a cost or type of cost, (purpose, intent, otc.) and taking into account any benefits resulting from such incurrence, it would be fair and reasonable to charge a portion thereof to the mili-tery contract.

15-104 Helated Matters. The text of this paragraph does not deal with nost prisciples as such, but the matters discussed have a close relationship to contractors' submissions of cost data and subsequent evaluation thereof by contracting officers. They are accordingly included for the information and convenience of all concerned.

and prospective contractors will be expected to be reasonably responsive to requests for further details concerning any cost elements or items regarding which the contracting officer desires additional information.

15-104.2 Use of Prescribed Formats. Contractors and prospective contractors may be called upon to present cost data being submitted for contract pricing purposes in conformity with any applicable DOD or departmental format.

13-104.3 Access to Records. Where the contracting officer desires
the assistance of an advisory sudit report as a pricing aid (ARPR 3-809)
the contractor or prospective contractor will be expected to parmit the
cognizant military department auditors access to all books, records, work
paper summaries and other papers in its possession which relate either
to historical costs or the preparation of cost estimates.

15-104.4 Certification of Cost Data. Contractors or prospective contractors may be called upon to certify that cost data submitted for purposes of negotiating prices under fixed price contracts has been pre-pared in conformity with paragraphs 15-101 and 15-102 of this part of Section XV, ASPR.

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# SECTION XV CONTRACT COST PRINCIPLAN

# PART 1 - FIRED PRICE CONTRACTS

It's loope of Part. This part sets forth standards and principles for use or guidance, as appropriate, in those cases where cost representations by contractors are to be used in negotiating prices under fixed price type contracts. It is not intended that these standards and principles will be incorporated in such contracts either directly or by reference, insamuch as such incorporation would tend to reduce the flexibility which is so essential a part of pricing negotiations.

15-101 Standards for Preparation of Contractors' Cost Representations.

It will be expected that contractors' cost representations will be prepared in conformity with the standards set forth in the subparagraphs
below.

15-101.1 Appropriate Detail. The total costs presented are to be appropriately detailed according to the cost classifications used in the contractors' or prospective contractors' financial and cost accounting systems.

15-101.2 Identification of Ristorical and Astimated Costs. Ristorical cost data, i.e., data based on costs actually incurred and recorded on the contractor's books, is to be so identified and distinguished from amounts which represent cost estimates.

15-101.3 Conformity with Generally Accepted Accounting Principles and Practices. The cost data presented is to be prepared in conformity with generally accepted accounting principles and practices. Without

15-102.2 Entertainment Expenses. Entertainment expenses, other than for business conferences and meetings, should be excluded.

15-102.3 Pines and Penalties. Fines and penalties for violations of law other than fines for minor traffic violations or penalties incurred through following a course of action directed by the contracting officer should be excluded.

15-103 Tests of Propriety by the Government. Where the occasion varrants, the Government may be expected to test, by audit or otherwise, the propriety of the contractor's cost representations. In so doing, the matters mentioned in the subparagraphs below will receive consideration.

- (a) Whother there is comformity with the standards outlined in paragraph 15-101 and the treatment indicated for individual items of cost in paragraph 15-102.
- (b) Whother the emounts of cost elements and cost items meet the test of reasonableness.
- (c) Whether cost elements meet the test of allocability. By the test of allocability is meent whether considering all of the circumstances surrounding the incurrence of a cost or type of cost, (purpose, intent, etc.) and taking into account any benefits resulting from such incurrence, it would be fair and reasonable to charge a portion thereof to the mili-tary contract.

15-104 Belated Matters. The text of this paregraph does not deal with cost principles as such, but the matters discussed have a close relationship to contractors' submissions of cost data and subsequent evaluation thereof by contracting officers. They are accordingly included for the information and convenience of all concerned.

15-104.1 Further Details as to Oost Elements or Items. Contractors and prospective contractors will be expected to be reasonably responsive to requests for further details concerning may cost elements or items regarding which the contracting officer desires additional information.

15-104.2 Use of Prescribed Formsts. Contractors and prospective contractors may be delled upon to present cost data being submitted for contract pricing purposes in confermity with any applicable DOD or departnental format.

15-104.3 Access to Records. Where the contracting officer desires
the assistance of an advisory mudit report as a pricing mid (AMPR 3-809)
the contractor or prospective contractor will be expected to penuit the
cognizant military department muditors access to all books, records, work
paper summaries and other papers in its possession which relate either
to historical costs or the preparation of cost estimates.

15-104.4 Certification of Cost Date. Contractors or prospective contractors may be called upon to certify that cost date submitted for purposes of negotiating prices under fixed price contracts has been prespected in conformity with paragraphs 15-101 and 15-102 of this part of Section XV, ASPR.

(vi) traveling expenses, to the extent authorized by the contracting

(c) utility services, such as communication, power, gus, and water;

(c) vacation, holiday and severance pay, sick leave and military leave, to the extent required by law or specifically provided for olsowhere in the contract; 15-406

(p) wages and nataries; and

(q) pension and retirement plans in accordance with the interwetation not forth in ASPR as end and group health, arodust and life insurance plans (but see ASPH 15-404 (b), (d), and (w)),

15-404 Framples of Rema of Unaltowable Costs. The following itemof costs are considered unallowable, except as indicated and then only achject to the requirements of ASPR 15-402

(s) advortising (including advortising in trade or technical journals).

except "help wanted" advertising;

(b) central office expenses of the contractor, such as supplies; seguipment, rent or any other expenses incident to its majorenauco and operation, except to the extent authorized by the contracting

(c) commissions and bonuses (under whatever name) in connection

with obtaining or negotiating for a Government contract;

(d) compensation and traveling expenses of any officer or implayed in the central office organization of the contractor, except to the extent authorized by the contracting officer;

(6) contingency reserves;

(f) contributions and donations;

(h) entertainment, except for on-aire recreational activities for the contractor's employees as authorized by the contracting officer.

(i) interest on borrowings (however represented), band discount and

expense, and financial charges;

(i) legal, accounting and consulting fees and related expenses. except to the extent authorized by the contracting officer;

(k) losses on other contracts;

(1) westburships in trade, business and professional organizations;

(m) premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneheinry directly or indirectly;

(n) storage of contract records after completion of contract operations, irrespective of contractual or statutory requirements re-

garding the preservation of records; and

(e) taxes, fees or charges imposed upon, by reason of, or measured by the contractor's fee.

PROCUREMENT REGULATION - \$15-104

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# SECTION XV CONTRACT COST PRINCIPLES

# PART 1 - FIXED PRICE CONTRACTS

13-100 Deope of Part. This part sets forth standards and principles for use or guidance, as appropriate, in those cases where cost representations by contractors are to be used in negotiating prices under fixed price type contracts. It is not intended that these standards and principles will be incorporated in such contracts either directly or by reference, imassuch as such incorporation would tend to reduce the flexibility which is so essential a part of pricing negotiations.

10-101 Standards for Preparation of Contractors' Cost Representations.

It will be expected that contractors' cost representations will be prepared in comformity with the standards set forth in the subparagraphs

alow.

reprintely intailed according to the cost classifications used in the contractors' or prospective contractors' financial and cost accounting

15-101.2 Identification of Historical and Estimated Costs. Historical out data, i.e., data based on costs actually incurred and recorded on the contractor's books, is to be so identified and distinguished from security which represent cost estimates.

and Practices. The cost data presented is to be prepared in conformity with generally accepted accounting principles and practices. Without

#### 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 fixedprice 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 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.
- Pricing, as distinguished from costing, is emphasized.
- 3. The fundamental differences between retrospective and forward pricing has been maintained.
- 4. The principles "shall be used as a guide 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.

#### Latest Suggested Revision

#### Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts and subcontracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

(i) firm fixed-price contracts (ASPR 3-403.1)
(ii) fixed-price contracts with escalation (ASPR 3-403.2)
(iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
(iv) fixed-price incentive contracts (ASPR 3-403.4)

(v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or the compensation are furnish equally reliable guides to fair compensation. The ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement.

(b) Among the different types of fixed-price type contracts, the need for consideration of costs varies considerably indicated below:

- on of costs varies considerably indicated below:

  (i) Retrospective Pricing and outtlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, 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. However, even in these situations, the finally agreed price or settlement may represent 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.
- (ii) Forward Fricing. 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 cost data is often a valuable aid, it will not control negotiation of prices for work to be performed, or a target price under an incentive contract.

15-702 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-701, costs are to be considered in the negotiation of fixed-price type contract, Section XV, Part 2, shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8.

(b) Whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, Section XV, Part 2, will serve as a guide for the resolution of the issue.

(c) In applying Part 2 of this Section XV to fixed-price contracts, contracting officers will: (1) not be required to negotiate agreement on each individual element of officers will: (i) not be required to negotiate agreement on each 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. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.

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#### Issue

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.

## 10 Sept 1957 - 8/21/58 Draft

15-000 Scope of Section. This Section contains general cost principles and standards for use in connection with (1) 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 contractor, for determination of:
  - reimbursable costs under cost-reimbursement type contracts including (A) cost-reimburgement type subcontracts thereunder and the cost-reimburgement portion of time and materials contracts;
  - terminations when the adounts thereof are determined unilaterally by the
  - (C) costs of terminated cost-reimbursement contracts.

As a basis for:

- (A) the dayelopment and submission of cost data and price analyses by contractors and prospective contractors as required in support of negotiated overhead rates, requests for progress payments, and settlement proposals under termination;
- 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:
  - 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 and incentive contract.
  - (iv) As the basis for the resolution of questions of acceptability of individual costs whenever such questions become issues.

#### 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.

#### 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.

#### Government Position

We think that the desirability of reaching advanced understandings on certain controversial items is an important feature 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

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.

#### Current Proposal

We have made no additional changes in the cost principles to accommodate this Industry argument. However, we have suggested that the title of Section XV be changed to "Contract Cost Principles and Procedures."

#### 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."

Latest Suggested Revision

# ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows: ... Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be 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 determinations covered thereby throughout the performance of the related the cost determinations contend the state of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

- pre-contract costs (ASPR 15-204.2 (dd));
- (ii) royalties (ASPR 15-204.2 (jj));
  (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2 (ss)(5));

Examples of others for which such agreements are normally appropriate, though not essential, are:

- (iv) use charged for fully depreciated assets (ASPR 15-204.2 (i)(6)); (v) compensation for personal services (ASPR 15-204.2 (f)); (vt) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii)); (vii) research and development costs (ASPR 15-204.2 (ii)(6)); and (viii) selling and distribution costs (ASPR 15-204.2 (kk)(2))."

#### Issue

2. Recognition of all normal and legitimate

# Issue

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

# 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.

# 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 governin 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 in not all, that we should not say that a cost is not allocable to us.

4. Advanced understandings with respect to certain specific cost elements.

# Industry Position

In general, Industry agrees to the concept of reaching an advanced agreement on the contro-versial cost questions. However, Industry is fearful that advanced agreements will be required in each instance and that the absence of quired 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 advanced to the section of the regulation of the section of the regulation. 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 hesis.

10 Sept 57 or 8/21/58 Draft

# Negotiation Requirement

(b) The extent of allowability of the selected items of cost covered in ASPR 15-204.2 (b) The extent of allowability of the selected items of cost covered in Born 19-204.2 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, 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 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:

(1) 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));

selling and distribution costs (ASPR 15-204.2(kk)(2)); and travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)). (viii) (ix)

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#### Government Position

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.

<u>Current Proposal</u>
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.

#### Latest Suggested Revision

#### COST PRINCIPLE FOR RESEARCH AND DEVELOPMENT

- 1. Basic research, for the purpose of this regulation, is that type of research which 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 affort 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 offorts when their principal aim is the design, development, or test of specific articles offorts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.
- 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 manufacturing and production engineering.

  3. A contractor's independent research and development is that research and development
- which is not sponsored by a contract, grant, or other arrangement.

  4. A contractor's costs of independent research as defined in (1) and (3) above shall be allowable as indirect costs (subject to paragraph (8) below), provided they are allocated to all work of the contractor.
- 5. Cost of contractor's independent development, as defined in paragraphs (2) and (3) above (subject to paragraph (5) below), are allowable to the extent that such development as related to the product lines for which the government has contracts, provided the costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. In cases where a contractor's normal course of business does not involve production work, the cost of independent development is allowable to the extent that such development is related and allocated as an indirect cost to the field of effort of government research and development contracts.
- 6. Independent research and development costs shall include an amount for the absorption of their appropriate share of indirect and administrative costs, unless the contractor, in accordance with its accounting practices consistently applied, treats such costs otherwise.
- 7. 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.
- 8, The reasonableness of expenditures for independent research and development should be determined in light of all pertinent considerations such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures (especially for development) should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the government. Advance agreements as described in ASPR 15-204.1(b), are particularly important in this situation. 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. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (1) review of the contractor's proposed research and development program and agreement to accept the allocable costs of specific research projects; (11) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; and (111) agreement to accept the allocable share of a percentage of the contractor's planned research and development program.

7. Research and Development.

Industry spokesmen argued strenuously and persuasively against our previous draft of this principle. Basically, Industry contended that applied research should be grouped with basic research, and not with development.

#### 10 Sept 1957 - 8/21/58 Draft

15-204.2

(ii) Research and Development Costs.

(1) Research and development costs are divided intwo 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

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 in independent applied research and development are unallowable under research and development contracts. However, in case 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.
- (h) Independent research and developments 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 ment. 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).)

#### Government Position

#### Current Proposal

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.

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.

# Latest Suggested Revision

#### 15-204.2 Listing of 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, <u>provided</u> 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:
  - (ii) help wanted advertising, as set forth in (gg) below, when considered in conjunction with all other recruitment costs;
  - (iii) costs of participation in exhibits sponsored by the Government.
  - for the purpose of developing military applications of products; and advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.
- (2) Except as provided in (iii) and (Iv) above, all advertising which offers products for sale is unallowable.

#### 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."

#### Latest Suggested Revision

# (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, stockbonus 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. In the administration of this principle, it is recommized that not every compensation case need by subjected in detail to the above tests. Such tests need by applied only to those cases in which a general review reveals amounts or types of compensation which appear unreasonable or otherwise out of line. 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: etc."

Advertising Costs.

## Industry Position

While recognizing that some forms of advertising are seldom, if ever, properly allocable to govern-ment 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.

10 Sept 1957 - 8/21/58 Draft

#### 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:

(1) 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

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.

issue

#### Industry Position

6. Compensation for personal services.

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 compen-sation. Industry agrees with this change.

10 Sept 1957 - 8/21/58

# (f) Compensation for Personal Services.

(1) General. a. Compensation for personal services includes all remuneration (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 readered and are not in excess of these costs, which are allowable by the 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:

# HEADQUARTERS UNITED STATES EUROPEAN COMMID OFFSHOR PROCUREMENT POLICY COURDINATING COMMITTEE

SCATT -

APO 124, Hem Tork 21 October 1960

Captain J. P. Falley, SC, GES Staff Director, ASPA Division Office of Procurement Folicy Office of the Assistant Secretary of Lafense Washington 27, D. D.

Deer rate:

Although it has been some little time since we discussed the usefulness of Section XV, ASPR to European contracting officers, at the USENCOM/ASPR Procurement Seminar, I have not forgotten that we were to make a special review of this Section.

In pursuit of this project, each of the component commanders made a review of the Section. The results of these reviews have been discussed at our GSF meetings, and have resulted in the commences that, although the principles and procedures of this Section have limited application for GSF, they are apparently used to the extent possible. It has been agreed that each component commander will encourage maximum use of the "Contract Cost Principles and Procedures", et furth in this Section, throughout his command.

Heither the command reviews nor the subsequent discussions developed recommended changes to this Section which would improve its usefulness for GSP. Should any good ideas be generated in the future, however, they will be forwarded to you.

Wath best regards.

Sincerely.

H. C. DAVISSON COLOREL (66 Chairsen

Et C.C. 6. 1570 Pete-I don't find myself torrive where a with your proposed revision. If is felt that it would be accepine to eiter the sonses or to industry, I might frie in supporting at. Housever, I don't them this change will entiry either and well acquirent only a slightly lower target for both to short at. My specific comments are as faileurs: 1. By removing the direction that contractors submits costs in accordance with Burt 2, it may have the effect of removing one rather ineffective arcument of industry against the statement. However, de a tappayer, I would prefer to see the provision retained since every audit report is going to have to explain in detail the bases for development of the contractor's cost statement instead of mercia dating that it conforme with Sec. it. Min is important not only to the auditor but

Le contractor submit the additional information agarately to the contracting office as well. A 2. Omission from its applies belity to the auditor is underirable, but not too important as I can handle the same thing through an audit Anstruction - merely an added administration 3. Change in (ii) (A) from basis "to "guide" wouldn't bother me too much Two much. it is somewhat in the realure a change without a difference. However, to retrospective vs prospective warrants some efference in terminology. 4. The words in (B) again don't hather me too much because they don't say what you told me this morning -that you would include different elements of cost in forward gricing than your would in retrospective, as a specific suggestion, however, I would like to net the word "general" in the Court line.

extent that overte are a factor.

This I suggest costs to control of the fact that in some negatiations, events may not be a factor.

5. Omission of the grovision for use of the cost frinciples to resolve is some which I would give if there were any seal loan tage. Faving reviewed many ASBCA cases, I think they really need a basis for decision. However I wouldn't exactly gag on this point.

stand or fall on the familiar words of the grior version than to have to support new words which, to me mean the same thing. They may be less acceptable to the GAO type- and also to me more acceptable to industry in.

# SECTION XV

# CONTRACT COST PRINCIPLES AND PROCEDURES

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.

Other Than Educational Institutions. This category includes all costreimbursement type contracts (ASPR 3-404) for supplies, services, or 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). The cost principles and procedures set forth in Part 2 of this Section shall be incorporated by reference in cost-reimbursement supply and research contracts with other than educational institutions as the basis -

(i) for determination of reimburseable costs under such contracts, including cost-reimbursement type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts (ASPR 3-405.1);

- (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
- (iii) for the determination of costs of terminated costreimbursement 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).
- 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 incorporated by reference in cost-reimbursement research contracts with educational institutions as the basis -
  - (i) for determination of reimbursable costs under costreimbursement type contracts, including cost-reimbursement
    type subcontracts thereunder;
  - (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
  - (iii) for the determination of costs of terminated costreimbursement 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 3 is to be used in determining the allowable costs of research and development performed by educational institutions under grants.

Editor's note: When 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 cost-reimbursement type contracts for architect-engineer services 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 incorporated by reference in cost-reimbursement construction contracts as the basis -
  - (i) for determination of reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;
  - (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
  - (iii) 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 settlement of such contracts by determination (ASPR 8-209.7).
  - 15-105 Cost Reimbursement Facilities Contracts. (Reserved)
- 15-106 Use of Cost Principles for Fixed Price Contracts. Part 6 of this Section provides guidance for the use of Parts 2, 3, and 4 where appropriate, in the evaluation of costs in connection with the negotiation of certain fixed-price type contracts and termination settlements:

15-107 Advance Understandings on Particular Cost Items. The extent of allowability of the selected items of cost covered in Parts 2 through 5 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 connection with firms or separate divisions thereof which may not be subject to effective competitive restraints. In order to avoid possible subsequent disallowance or dispute 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 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;
- (ii) use charge for fully depreciated assets;
- (iii) deferred maintenance costs;

- (iv) pre-contract costs;
- (v) research and development costs;
- (vi) royalties;
- (vii) selling and distribution costs; and
- (viii) travel costs, as related to special or mass personnel movement.

Part 2 - Principles and Procedures for Use in Cost Reimbursement Type Supply and Research Contracts with Commercial Organizations

# 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) 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 firms or separate divisions thereof which may not be subject to effective competitive restraints. 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 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.
- 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. Subject to the foregoing, 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 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 which can be identified specifically with a particular cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work.
- (b) This definition shall be applied to all items of cost of significant amount unless the contractor demonstrates that the application of any different 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 one which, because of its incurrence for common or joint objectives, is not readily subject to

treatment as a direct cost. 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. 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 complicate unduly 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 complicate unduly 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 accounting principles, shall generally be acceptable. However, the methods used by the contractor may require re-examination 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. Normally, the base period will be the contractor's fiscal year; however, use of a shorter period may be appropriate in case of (i) contracts whose performance involves only a minor portion of the fiscal year, or (ii) where it is general practice in the industry to use a shorter period. In any event the base period or periods shall be so selected as to avoid inequities in the allocation of costs. 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.

   10 -

- 15-204 Application of Principles and Procedures. (a) Costs shall be allowed 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 and 15-205.
- (b) Costs incurred as reimbursements by a prime contractor to a subcontractor under a cost-reimbursement type subcontract are allowable to the extent that allowance is consistent with the Part of this Section XV which is appropriate to the subcontract involved. Thus, if the subcontract is for supplies, such costs are allowable to the extent that the subcontractor's costs would be allowable if this Part 2 were incorporated in the subcontract; if the subcontract is for construction, such costs are allowable to the extent that the subcontract is costs would be allowable if Part 4 of this Section XV were incorporated in the subcontract.
- (c) Selected items of cost are treated in ASPR 15-205. However, ASPR 15-205 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 15-205 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.

15-205 Selected Costs.

15-205.1 Advertising Costs.

(a) Advertising costs mean the costs 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 the like. The following advertising costs are allowable:

- (i) advertising in trade and technical journals, <u>provided</u> 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;
- (ii) help-wanted advertising, as set forth in ASPR 15-205.33, when considered in conjunction with all other recruitment costs;
- (iii) costs of participation in exhibits --
  - (A) upon invitation of the Government, or
  - (B) which exhibits are for the purpose of disseminating technical information within the contractor's industry; however, such costs are not allowable under this subparagraph (B) if the exhibit offers specific products or services for sale;
- (iv) advertising for the exclusive purpose of obtaining scarce materials, plant, or equipment, or disposing of scrap or surplus materials, in connection with the contract.
- (b) Except as provided above, all other advertising costs are unallowable.
- 15-205.2 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.

15-205.3 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 will be treated as allowable indirect costs, in which event no bidding costs of past accounting periods shall be allowable in the current period to the Government contract. However, if the contractor's established practice is to treat bidding costs by some other method, the results obtained may be accepted only if found to be reasonable and equitable.

# 15-205.4 Bonding Costs.

- (a) 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.
- (b) Costs of bonding required pursuant to the terms of the contract are allowable.
- (c) 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.

# 15-205.5 Civil Defense Costs.

(a) 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.

- (b) Costs of capital assets under (a) above are allowable through depreciation in accordance with ASPR 15-205.9.
- (c) Contributions to local civil defense funds and projects are unallowable.

# 15-205.6 Compensation for Personal Services.

(a) <u>General</u>. (1) 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 contractor performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses (including stock bonuses), incentive awards, employee stock options, employee insurance, fringe benefits, and contributions to pension, annuity, and management employee incentive compensation plans. Except as otherwise specifically provided in this ASPR 15-205.6, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and they are not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

- (2) 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 firms of the same size, in the same industry, or in the same geographic area, for similar services. 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. 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 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.
- (3) Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.
- (4) In addition to the general requirements set forth in (1) through (3) above, certain forms of compensation are subject to further requirements as specified in (b) through (1) below.
- (b) <u>Salaries and Wages</u>. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and are allowable. However, premiums for overtime, extra-pay shifts, and multi-shift work are allowable to the extent approved pursuant to ASPR 12-102.4 or permitted pursuant to ASPR 12-102.5.
- (c) <u>Cash Bonuses and Incentive Compensation</u>. 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

over-all 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 15-107.) Bonuses, awards and incentive compensation when any of them are deferred are allowable to the extent provided in (f) below.

- (d) 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 (c) above (including the incorporation of the principles of paragraph (f) 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 (f)(3) below. (But see ASPR 15-107.)

- (e) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate is unallowable.
- (f) <u>Deferred Compensation</u>. (1) As used herein, deferred compensation includes all remuneration, in whatever form, 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.
- (2) Deferred compensation is allowable to the extent that (i) except for past service pension costs 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 15-107.)
- (3) 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.
- (4) 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.

- (g) 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 ar established policy of the contractor.
  - (h) Severance Pay. See ASPR 15-205.39.
  - (i) Training and Education Expenses. See ASPR 15-205.43.

## 15-205.7 Contingencies.

- (a) 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.
- (b) In historical costing, contingencies are not normally present since such costing deals with costs which have been incurred and recorded on the contractor's books. Accordingly, contingencies are generally unallowable for historical costing purposes. However, in some cases, as for example, terminations, a contingency factor may be recognized which is applicable to a past period to give recognition to minor unsettled factors in the interest of expeditious settlement.
- (c) 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, con
tingencies 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, ASPR 15-205.16, 15-205.20, and 15-205.39).

15-205.8 Contributions and Donations. Contributions and donations are unallowable.

#### 15-205.9 Depreciation.

- (a) 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.
- (b) 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:
  - (1) 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, as amended, 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.
- (c) 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 (a) above, vary with volume of production or use of multi-shift operations.
- (d) 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 (b) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

- (1) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; provided no allowance is made which would duplicate the factors constituting "true depreciation" 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 (e) below); <u>provided</u> the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."
- (e) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for standby purposes.
- (f) 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 reasonable use charge may be agreed upon and allowed. (But see ASPR 15-107.) 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.

15-205.10 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. 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.

15-205.11 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 ASPR 15-205.10 and 15-205.42).

15-205.12 Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for standby purposes, are unallowable. Any costs of excess plant capacity reserved for defense mobilization production which are to be paid for by the Government should be the subject of a separate contract.

15-205.13 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.

15-205.14 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 contractors's facilities. Reasonable losses from the operation of such services are allowable if they are allocated to all activities served. 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.

15-205.15 Fringe Benefits (See ASPR 15-205.6(g))

## 15-205.16 Insurance and Indemnification.

- (a) 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.
- (1) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.
- (2) Costs of other insurance maintained by the contractor in connection with the general conduct of his business are allowable subject to the following limitations:
  - (1) types and extent of coverage shall be in accordance with sound business practice and the rates and premiums shall be reasonable under the circumstances;
  - (11) costs allowed for business interruption or other similar insurance shall be limited to exclude coverage of profit;
  - (iii) costs of insurance or of any provision for a reserve covering the risk of loss or of damage to Government property are allowable only to the extent that the

contractor is liable for such loss or damage and such insurance or reserve does not cover loss or damage which results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers, or other equivalent representatives, who has supervision or direction of (A) all or substantially all of the contractor's business, or (B) all or substantially all of the contractor's operations at any one plant or separate location in which the contract is being performed, or (C) a separate and complete major industrial operation in connection with the performance of the contract.

- (iv) provisions for a reserve under an approved selfinsurance program are allowable to the extent that
  the types of coverage, extent of coverage, and the
  rates and premiums would have been allowed has
  insurance been purchased to cover the risks; and
  costs of insurance on the lives of officers,
  partners, or proprietors are allowable to the
  extent that the insurance represents additional
  compensation (see ASPR 15-205.6).
- (3) 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.
- (b) 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 (a)(3) above.

15-205.17 Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional 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 ASPR 15-205.41. (But see ASPR 15-205.24.)

15-205.18 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.

15-205.19 Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under costsharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable.

#### 15-205.20 Maintenance and Repair Costs.

- (a) 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 15-205.9):
  - (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 15-107.)
- (b) Expenditures for plant and equipment, including rehabilitation thereof, 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.
- 15-205.21 Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with the following, are allowable:
  - (1) 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.

#### 15-205.22 Material Costs.

(a) 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 (concerning correction of defective work, see the provisions of the contract relating to inspection and correction of defective work). These costs are allowable subject, however, to the provisions of (b) through (e) below.

- (b) 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 reasonable circumstances, such lost discounts need not be so credited.
- (c) Reasonable adjustments arising from differences between periodic physical inventories and book inventories may be included in arriving at costs, provided such adjustments relate to the period of performance of the contract.
- (d) When the materials are purchased specifically for an 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 may be used, but the basis of pricing must be disclosed.

(e) Charges for 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.

15-205.23 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.

15-205.24 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.

15-205.25 Overtime, Extra-Pay Shift and Multi-Shift Premiums. Premiums for overtime, extra-pay shifts, and multi-shift work are allowable to the extent approved pursuant to ASPR 12-102.4, or permitted pursuant to ASPR 12-102.5.

15-205.26 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 filling of a patent application where title is conveyed to the Government, are allowable. (See ASPR 15-205.36).

15-205.27 Pension Plans. See ASPR 15-205.6.

15-205.28 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.

15-205.29 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. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent agreed upon before the costs are incurred. Whenever such costs are given consideration, care should be exercised to avoid duplication through allowance as contingencies, as additional profit or fee, or in other contracts.

15-205.30 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 15-107.)

# 15-205.31 Professional Service Costs - Legal, Accounting, Engineering, and Other.

- (a) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (b) and (c) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-205.23.)
- (b) Factors to be considered in determining the allowability of costs in a particular case include:
  - 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 bona fide services: available or rendered.

(c) 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.

15-205.32 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 expital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see ASPR 15-205.9(b) as to basis for depreciation).

15-205.33 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.

## 15-205.34 Rental Costs (Including Sale and Leaseback of Facilities).

(a) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as rental costs of comparable facilities and market conditions in the area, the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

Application of these factors, in situations where rentals are extensively used, may involve among other considerations, comparison of rental costs with the amount which the contractor would have received had it owned the facilities.

- (b) Charges in the nature of rent between plants, divisions, or organizations under common control are allowable 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.
- (c) 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.

## 15-205.35 Research and Development Costs.

(a) Basic research, for the purpose of this Part 2, 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 Part 2, consists of that type of effort which (i) normally follows basic research, but may not be severable from the related basic research, (ii) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and (iii) 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, which are within the definition of the term development as hereinafter provided.

- (b) 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 manufacturing and production engineering.
- (c) A contractor's independent research and development is that research and development which is not sponsored by a contract, grant, or other arrangement.
- (d) A contractor's costs of independent research as defined in(a) and (c) above shall be allowable as indirect costs (subject to paragraph(h) below), provided they are allocated to all work of the contractor).
- (e) Costs of contractor's independent development, as defined in (b) and (c) above (subject to (h) below), are allowable to the extent that such development is related to the product lines for which the Government has contracts, provided the costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. In cases where a contractor's normal course of business does not involve production work, the cost of independent development is allowable to the extent that such development is related and allocated as an indirect cost to the field of effort of Government research and development contracts.
- (f) Independent research and development costs shall include an amount for the absorption of their appropriate share of indirect and administrative costs, unless the contractor, in accordance with its accounting practices consistently applied, treats such costs otherwise.
- (g) 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 except where allowable as precontract costs (see ASPR 15-205.30).

(h) The reasonableness of expenditures for independent research and development should be determined in light of all pertinent consideration such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures (especially for development) should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Advance agreements as described in ASPR 15-107 are particularly important in this situation. 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. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (1) review of the contractor's proposed independent research and development program and agreement to accept the allocable costs of specific projects; (ii) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; (iii) an agreement to accept the allocable share of a percentage of the contractor's planned research and development program.

## 15-205.36 Royalties and Other Costs for Use of Patents.

(a) 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:

- (1) 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.
- (b) 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.:
  - 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.
- (c) 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.
  - (d) See ASPR 15-107, regarding advance understandings.

#### 15-205.37 Selling Costs.

(a) 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.

- (b) Selling costs are allowable to the extent they are reasonable and are allocable to Government business (but see ASPR 15-107 and 15-205.1). 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.
- (c) Notwithstanding (b) 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.

15-205.38 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, care should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

## 15-205.39 Severance Pay.

(a) 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.

- (b) 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.

15-205.40 Special Tooling Costs. The term "special tooling" means all jigs, dies, fixtures, molds, patterns, special taps, special gauges, special test equipment, other special equipment and manufacturing aids, and replacements thereof, acquired or manufactured by the contractor for use in the performance of a contract, which are of such a specialized nature that, without substantial modification or alteration, their use is limited to the production of such supplies or parts thereof, or the

performance of such services, as are peculiar to the needs of the Government. The term does not include: (i) items of tooling or equipment acquired by the contractor prior to the contract, or replacements thereof, whether or not altered or adapted for use in the performance of the contract, (ii) consumable small tools, or (iii) general or special machine tools, or similar capital items. 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 for which acquired.

## 15-205.41 Taxes.

- (a) 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 ASPR 15-205.17);
  - (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.
- (b) Taxes otherwise allowable under (a) above, but upon which a claim of illegality or erroneous assessment exists, 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 or with the concurrence 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.

(c) 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 accured over the period during which the contractor had been reimbursed by the Government for the taxes, interest or penalties.

## 15-205.42 Trade, Business, Technical and Professional Activity Costs.

- (a) <u>Memberships</u>. This category includes costs of memberships in trade, business, technical, and professional organizations. Such costs are allowable.
- (b) <u>Subscriptions</u>. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.
- (c) <u>Meetings and Conferences</u>. 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.

#### 15-205.43 Training and Educational Costs.

- (a) 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 (excluding overtime compensation which might arise therefrom), 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.
- (b) Costs of part-time 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.

- (c) 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.
- (d) 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 ASPR 15-205.20, 15-205.9, and 15-205.34, respectively.
- (e) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships,

are considered contributions and are allowable.

15-205.44 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 directly costed as transportation costs or added to the cost of such items (see (22) 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, shall be treated as a direct cost.

#### 15-205.45 Travel Costs.

- (a) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.
- (b) 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 mathod used does not result in an unreasonable charge.
- (c) Travel costs incurred in the normal course of over-all administration of the business are allowable and shall be treated as indirect costs.
- (d) 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).
- (e) 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 15-107.)

- Part 6 Guidelines for Application in the Negotiation and Administration of Fixed-Price Type Contracts and in the Negotiation of Termination Settlements
- 15-600 Scope of Part. This Part provides guidance for the use of Parts 2, 3, and 4 of this Section XV in the evaluation of costs in pricing of negotiated fixed-price type contracts and subcontracts in those instances where such evaluation is required to establish prices for such contracts and (ii) in the negotiation of termination settlements.
- 15-601 Definition of Fixed-Price Type Contracts. "Fixed-price type" contracts include, for purpose of this Part, the following:
  - (i) firm fixed-price contracts (ASPR 3-403.1)
  - (ii) fixed-price contracts with escalation (ASPR 3-403.2)
  - (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
  - (iv) fixed-price incentive contracts (ASPR 3-403.4)
  - (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)
  - (vi) labor-hour contracts (ASPR 3-405.2)
- 15-602 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The ability to apply standards of business judgment as distinct

from strict accounting principles is at the heart of a negotiated price or settlement.

- (b) Among the different types of fixed-price type contracts, the need for consideration of costs varies considerably as indicated below:
  - (i) Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, 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. However, even in these situations, the finally agreed price or settlement may represent something other than the sum total of acceptable costs plus profit, 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.
  - (ii) Forward Pricing. 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 cost data is often a valuable aid, it will not control negotiation of prices for work to be performed, or a target price under an incentive contract.

- 15-603 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-602, costs are to be considered in the negotiation of fixed-price type contracts, the appropriate Part of this Section XV shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8.
- (b) In retrospective pricing, whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, the appropriate part of this Section XV will serve as a guide for the contracting officer in his conduct of negotiations.

- (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. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.
- (d) In order to permit the proper evaluation of cost data submitted by contractors for use in negotiating prices, it may be necessary to obtain breakdowns or account analyses in respect to some cost items particularly those whose treatment may be dependent upon special circumstances as stated in the principles. Contractors will be expected to be responsive to reasonable requests for data of this kind.

MALLOY

DRAFT 26 June 1959



#### SECTION XV

#### CONTRACT COST PRINCIPLES AND PROCEDURES

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.

Other Than Educational Institutions. This category includes all costreimbursement type contracts (ASPR 3-404) for supplies, services, or 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). The cost principles and procedures set forth in Part 2 of this Section shall be incorporated by reference in cost-reimbursement supply and research contracts with other than educational institutions as the basis -

 (i) for determination of reimburseable costs under such contracts, including cost-reimbursement type, subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts (ASPR 3-405.1);

- (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
- (iii) for the determination of costs of terminated costreimbursement 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).
- 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 incorporated by reference in cost-reimbursement research contracts with educational institutions as the basis -
  - (i) for determination of reimbursable costs under costreimbursement type contracts, including cost-reimbursement
    type subcontracts thereunder;
  - (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
  - (iii) for the determination of costs of terminated costreimbursement 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 3 is to be used in determining the allowable costs of research and development performed by educational institutions under grants.

Editor's note: When 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 cost-reimbursement type contracts for architect-engineer services 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 incorporated by reference in cost-reimbursement construction contracts as the basis -

- for determination of reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;
- (ii) for the negotiation of overhead rates (ASPR Section III, Part 7); and
- (iii) 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 settlement of such contracts by determination (ASPR 8-209.7).
- 15-105 Cost Reimbursement Facilities Contracts. (Reserved)
- 15-106 Use of Cost Principles for Fixed Price Contracts. Part 6 of this Section provides guidance for the use of Parts 2, 3, and 4 where appropriate, in the evaluation of costs in connection with the negotiation of certain fixed-price type contracts and termination settlements.

15-107 Advance Understandings on Particular Cost Items. The extent of allowability of the selected items of cost covered in Parts 2 through 5 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 connection with firms or separate divisions thereof which may not be subject to effective competitive restraints. In order to avoid possible subsequent disallowance or dispute 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 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;
- (ii) use charge for fully depreciated assets;
- (iii) deferred maintenance costs;

DRAFT 26 June 1959

- (iv) pre-contract costs;
- (v) research and development costs;
- (vi) royalties;
- (vii) selling and distribution costs; and
- (viii) travel costs, as related to special or mass personnel movement.

Part 2 - Principles and Procedures for Use in Cost Reimbursement Type Supply and Research Contracts with Commercial Organizations

#### 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) 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 firms or separate divisions thereof which may not be subject to effective competitive restraints. 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 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.
- 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. Subject to the foregoing, 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 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 which can be identified specifically with a particular cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work.
- (b) This definition shall be applied to all items of cost of significant amount unless the contractor demonstrates that the application of any different 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 one which, because of its incurrence for common or joint objectives, is not readily subject to

treatment as a direct cost. 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. 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 complicate unduly 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 complicate unduly 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 accounting principles, shall generally be acceptable. However, the methods used by the contractor may require re-examination 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. Normally, the base period will be the contractor's fiscal year; however, use of a shorter period may be appropriate in case of (i) contracts whose performance involves only a minor portion of the fiscal year, or (ii) where it is general practice in the industry to use a shorter period. In any event the base period or periods shall be so selected as to avoid inequities in the allocation of costs. 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.

   10 -

15-204 Application of Principles and Procedures. (a) Costs shall be allowed 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 and 15-205.

a subcontractor under a cost-reimbursement type subcontract are allowable to the extent that allowance is consistent with the Part of this Section XV which is appropriate to the subcontract involved. Thus, if the subcontract is for supplies, such costs are allowable to the extent that the subcontract tractor's costs would be allowable if this Part 2 were incorporated in the subcontract; if the subcontract is for construction, such costs are allowable to the extent that the subcontract is costs would be allowable if Part 4

of this Section XV were incorporated in the subcontract.

(c) Selected items of cost are treated in ASPR 15-205. However, ASPR 15-205 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 15-205 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.

15-205 Selected Costs.

15-205.1 Advertising Costs.

(a) Advertising costs mean the costs 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 the like. 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;
- (ii) help-wanted advertising, as set forth in ASPR 15-205.33, when considered in conjunction with all other recruitment costs;
- (iii) costs of participation in exhibits --
  - (A) upon invitation of the Government, or
  - (B) which exhibits are for the purpose of disseminating technical information within the contractor's industry; however, such costs are not allowable under this subparagraph (B) if the exhibit offers specific products or services for sale;
- (iv) advertising for the exclusive purpose of obtaining scarce materials, plant, or equipment, or disposing of scrap or surplus materials, in connection with the contract.
- (b) Except as provided above, all other advertising costs are unallowable.
- 15-205.2 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.

15-205.3 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 will be treated as allowable indirect costs, in which event no bidding costs of past accounting periods shall be allowable in the current period to the Government contract. However, if the contractor's established practice is to treat bidding costs by some other method, the results obtained may be accepted only if found to be reasonable and equitable.

#### 15-205.4 Bonding Costs.

- (a) 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.
- (b) Costs of bonding required pursuant to the terms of the contract are allowable.
- (c) 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.

#### 15-205.5 Civil Defense Costs.

(a) 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.

- (b) Costs of capital assets under (a) above are allowable through depreciation in accordance with ASPR 15-205.9.
- (c) Contributions to local civil defense funds and projects are unallowable.

#### 15-205.6 Compensation for Personal Services.

(a) <u>General.</u> (1) 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 contractor performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses (including stock bonuses), incentive awards, employee stock options, employee insurance, fringe benefits, and contributions to pension, annuity, and management employee incentive compensation plans. Except as otherwise specifically provided in this ASPR 15-205.6, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and they are not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

- (2) 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 firms of the same size, in the same industry, or in the same geographic area, for similar services. 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. 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 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.
- (3) Compensation in lieu of salary for services rendered by partners and sole proprietors will be allowed to the extent that it is reasonable and does not constitute a distribution of profits.
- (4) In addition to the general requirements set forth in (1) through (3) above, certain forms of compensation are subject to further requirements as specified in (b) through (i) below.
- (b) <u>Salaries and Wages</u>. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and are allowable. However, premiums for overtime, extra-pay shifts, and multi-shift work are allowable to the extent approved pursuant to ASPR 12-102.4 or permitted pursuant to ASPR 12-102.5.
- (c) <u>Cash Bonuses and Incentive Compensation</u>. 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

over-all 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 15-107.) Bonuses, awards and incentive compensation when any of them are deferred are allowable to the extent provided in (f) below.

- (d) 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 (c) above (including the incorporation of the principles of paragraph (f) 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 (f)(3) below. (But see ASPR 15-107.)

- (e) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate is unallowable.
- (f) <u>Deferred Compensation</u>. (1) As used herein, deferred compensation includes all remuneration, in whatever form, 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.
- (2) Deferred compensation is allowable to the extent that (i) except for past service pension costs, 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 15-107.)
- 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.
- (4) 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.

- (g) <u>Fringe Benefits.</u> 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.
  - (h) Severance Pay. See ASPR 15-205.39.
  - (i) Training and Education Expenses. See ASPR 15-205.48.

## 15-205.7 Contingencies.

- (a) 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.
- (b) In historical costing, contingencies are not normally present since such costing deals with costs which have been incurred and recorded on the contractor's books. Accordingly, contingencies are generally unallowable for historical costing purposes. However, in some cases, as for example, terminations, a contingency factor may be recognized which is applicable to a past period to give recognition to minor unsettled factors in the interest of expeditious settlement.
- (c) 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, ASPR 15-205.16, 15-205.20, and 15-205.39).

15-205.8 Contributions and Donations. Contributions and donations are unallowable.

#### 15-205.9 Depreciation.

- (a) 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.
- (b) 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
  - (11) 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, as amended, 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.
- (c) 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 (a) above, vary with volume of production or use of multi-shift operations.
- (d) 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 (b) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board and allocated rateably over the full five year emergency period;

provided no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, eenstituting "true depreciation", and

1/6

- (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 (e) below); provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."
- (e) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for standby purposes.
- (f) 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 reasonable use charge may be agreed upon and allowed. (But see ASPR 15-107.) 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.

15-205.10 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. 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.

<u>15-205.11</u> 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 ASPR 15-205.10 and 15-205.42).

15-205.12 Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for standby purposes, are unallowable. Any costs of excess plant capacity reserved for defense mobilization production which are to be paid for by the Government should be the subject of a separate contract.

9/28-

15-205.13 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.

15-205.14 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 contractors's facilities. Reasonable losses from the operation of such services are allowable if they are allocated to all activities served. 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.

15-205.15 Fringe Benefits (See ASPR 15-205.6(g))

## 15-205.16 Insurance and Indemnification.

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- (a) Insurance includes (1) 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.
- (1) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.
- (2) Costs of other insurance maintained by the contractor in connection with the general conduct of his business are allowable subject to the following limitations:
  - (1) 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 similar insurance shall be limited to exclude coverage of profit;
  - (iii) costs of insurance or of any provision for a reserve covering the risk of loss or of damage to Government property are allowable only to the extent that the

contractor is liable for such loss or damage and such insurance or reserve does not cover loss or damage which results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers, or other equivalent representatives, who has supervision or direction of (A) all or substantially all of the contractor's business, or (B) all or substantially all of the contractor's operations at any one plant or separate location in which the contract is being performed, or (C) a separate and complete major industrial operation in connection with the performance of the contract;

- (iv) provisions for a reserve under an approved selfinsurance program are allowable to the extent that the types of coverage, extent of coverage, and the rates and premiums would have been allowed has insurance been purchased to cover the risks; and
- costs of insurance on the lives of officers,
  partners, or proprietors are allowable to the
  extent that the insurance represents additional
  compensation (see ASPR 15-205.6).
- (3) 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:

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- 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.
- (b) 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 (a)(3) above.

15-205.17 Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional 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 ASPR 15-205.41. (But see ASPR 15-205.24.)

15-205.18 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.

15-205.19 Losses on Other Contracts. An excess of costs over income under any other contract (including the contractor's contributed portion under costsharing contracts), whether such other contract is of a supply, research and development, or other nature, is unallowable.

- 28 -

#### 15-205.20 Maintenance and Repair Costs.

- (a) 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 15-205.9):
  - (1) 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 15-107.)
- (b) Expenditures for plant and equipment, including rehabilitation thereof, 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.
- 15-205.21 Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with the following, are allowable;
  - (1) 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.

#### 15-205.22 Material Costs.

(a) 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 (concerning correction of defective work, see the provisions of the contract relating to inspection and correction of defective work). These costs are allowable subject, however, to the provisions of (b) through (e) below.

- (b) 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 reasonable circumstances, such lost discounts need not be so credited.
- (c) Reasonable adjustments arising from differences between periodic physical inventories and book inventories may be included in arriving at costs, provided such adjustments relate to the period of performance of the contract.
- (d) When the materials are purchased specifically for an 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 may be used, but the basis of pricing must be disclosed.

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(e) Charges for 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 (1) 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.

15-205.23 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.

15-205.24 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 taking 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.

15-205.25 Overtime, Extra-Pay Shift and Multi-Shift Premiums. Premiums for overtime, extra-pay shifts, and multi-shift work are allowable to the extent approved pursuant to ASPR 12-102.4, or permitted pursuant to ASPR 12-102.5.

15-205.26 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 filling of a patent application where title is conveyed to the Government, are allowable. (See ASPR 15-205.36).

15-205.27 Pension Plans. See ASPR 15-205.6.

15-205.28 Plant Protection Costs. Costs of items such as (1) 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.

15-205.29 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. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent agreed upon before the costs are incurred. Whenever such costs are given consideration, care should be exercised to avoid duplication through allowance as contingencies, as additional profit or fee, or in other contracts.

15-205.30 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 15-107.)

costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

15-205.32 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 ASPR 15-205.9(b) as to basis for depreciation).

15-205.33 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.

15-205.34 Rental Costs (Including Sale and Leaseback of Facilities).

(a) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as rental costs of comparable facilities and market conditions in the area, the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement.

Application of these factors, in situations where rentals are extensively used, may involve among other considerations, comparison of rental costs with the amount which the contractor would have received had it owned the facilities.

# 15-205.31 Professional Service Costs - Legal, Accounting, Engineering, and Other.

- (a) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (b) and (c) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-205.23.)
- (b) 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;
  - (11) 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 bona fide services available or rendered.

(c) 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

- (b) Charges in the nature of rent between plants, divisions, or organizations under common control are allowable 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.
- (c) 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.
- (d) The allowability of rental costs under unexpired leases in connection with terminations is treated in ASPR 15-205.42(e).

#### 15-205.35 Research and Development Costs.

(a) Basic research, for the purpose of this Part 2, 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 Part 2, consists of that type of effort which (i) normally follows basic research, but may not be severable from the related basic research, (ii) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and (iii) 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, which are within the definition of the term development as hereinafter provided.

- (b) 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 manufacturing and production engineering.
- (c) A contractor's independent research and development is that research and development which is not sponsored by a contract, grant, or other arrangement.
- (d) A contractor's costs of independent research as defined in(a) and (c) above shall be allowable as indirect costs (subject to paragraph(h) below), provided they are allocated to all work of the contractor).
- (e) Costs of contractor's independent development, as defined in (b) and (c) above (subject to (h) below), are allowable to the extent that such development is related to the product lines for which the Government has contracts, provided the costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. In cases where a contractor's normal course of business does not involve production work, the cost of independent development is allowable to the extent that such development is related and allocated as an indirect cost to the field of effort of Government research and development contracts.
- (f) Independent research and development costs shall include an amount for the absorption of their appropriate share of indirect and administrative costs, unless the contractor, in accordance with its accounting practices consistently applied, treats such costs otherwise.
- (g) 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 except where allowable as precontract costs (see ASPR 15-205.30).



(h) The reasonableness of expenditures for independent research and development should be determined in light of all pertinent consideration such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures (especially for development) should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Advance agreements as described in ASPR 15-107 are particularly important in this situation. 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. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (1) review of the contractor's proposed independent research and development program and agreement to accept the allocable costs of specific projects; (ii) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; (iii) an agreement to accept the allocable share of a percentage of the contractor's planned research and development program.

## 15-205.36 Royalties and Other Costs for Use of Patents.

(a) 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.
- (b) 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.:
  - 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.
- (c) In any case involving a patent formerly owned by the contractor, the am unt of royalty allowed should not exceed the cost which would have been allowed had the contractor retained title thereto.
  - (d) See ASPR 15-107, regarding advance understandings.

    15-205.37 Selling Costs.
- (a) 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.

- (b) Selling costs are allowable to the extent they are reasonable and are allocable to Government business (but see ASPR 15-107 and 15-205.1). 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.
- (c) Notwithstanding (b) 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.

15-205.38 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, care should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

# 15-205.39 Severance Pay.

(a) 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.

- (b) 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.

15-205.40 Special Tooling Costs. The term "special tooling" means all jigs, dies, fixtures, molds, patterns, special taps, special gauges, special test equipment, other special equipment and manufacturing aids, and replacements thereof, acquired or manufactured by the contractor for use in the performance of a contract, which are of such a specialized nature that, without substantial modification or alteration, their use is limited to the production of such supplies or parts thereof, or the

performance of such services, as are peculiar to the needs of the Government. The term does not include: (1) items of tooling or equipment acquired by the contractor prior to the contract, or replacements thereof, whether or not altered or adapted for use in the performance of the contract, (ii) consumable small tools, or (iii) general or special machine tools, or similar capital items. 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 for which acquired.

# 15-205.41 Taxes.

- (a) 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 ASPR 15-205.17);
  - (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.
- (b) Taxes otherwise allowable under (a) above, but upon which a claim of illegality or erroneous assessment exists, 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 arising out of (b)(i) above or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, 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 or with the concurrence 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 t assure timely direction after prompt request therefor, are also allowable

(c) 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.

- 15-205.42 Termination Costs. Contract terminations generally give rise to the incurrence of costs, or the need for special treatment of costs, which would not have arisen had the contract not been terminated. Cost principles covering these items are set forth below. They are to be used in conjunction with the remainder of this Part in termination situations.
- (a) Common Items. The cost of items reasonably usable on the contractor's other work shall not be allowable unless the contractor submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the contractor, the contracting officer should consider the contractor's plans and orders for current and scheduled production. Contemporaneous purchases of common items by the contractor shall be regarded as evidence that such items are reasonably usable on the contractor's other work. Any acceptance of common items as allocable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.
- (b) <u>Costs Continuing After Termination</u>. If, in a particular case, despite all reasonable efforts by the contractor, certain costs cannot be discontinued immediately after the effective date of termination, such costs are generally allowable within the limitations set forth in this Part, except that any such costs continuing after termination due to the negligent or wilful failure of the contractor to discontinue such costs shall be considered unallowable.
- (c) <u>Initial Costs</u>, including starting load and preparatory costs, are allowable, subject to the following:

- (1) Starting load costs are costs of a non-recurring nature arising in the early stages of production and not fully absorbed because of the termination. Such costs may include the cost of labor and material, and related overhead attributable to such factors as
  - (i) excessive spoilage resulting from inexperienced labor,
  - (ii) idle time and subnormal production occasioned by testing and changing methods of processing,
  - (iii) employee training, and
    - (iv) unfamiliarity or lack of experience with the product, materials, manufacturing processes and techniques.
- (2) Preparatory costs are costs incurred in preparing to perform the terminated contract, including costs of initial plant rearrangement and alterations, management and personnel organization, production planning and similar activities, but excluding special machinery and equipment and starting load costs.
- (3) If initial costs are claimed and have not been segregated on the contractor's books, segregation for settlement purposes shall be made from cost reports and schedules which reflect the high unit cost incu red during the early stages of the contract.
- (4) When the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end items called for by the contract immediately prior to termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.

- (5) When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead.
- (6) Initial costs attributable to only one contract shall not be allocated to other contracts.
- (d) Loss of useful value of special tooling, special machinery and equipment is generally allowable, provided -
  - (i) such special tooling, machinery or equipment is not reasonably capable of use in the other work of the contractor;
  - (ii) the interest of the Government is protected by transfer of title or by other means deemed appropriate by the contracting officer; and
  - (iii) the loss of useful value as to any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the special tooling, special machinery and equipment was acquired.
- (e) Rental costs under unexpired leases are generally allowable where clearly shown to have been reasonably necessary for the performance of the terminated contract, less the residual value of such leases, if -
  - (i) the amount of such rental claimed does not exceed

    the reasonable use value of the property leased for

    the period of the contract and such further period as

    may be reasonable; and

(ii) the contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

There also may be included the cost of alterations of such leased property, provided such alterations were necessary for the performance of the contract, and of reasonable restoration required by the provisions of the lease.

- (f) <u>Settlement expenses</u> including the following are generally allowable:
  - (1) accounting, legal, clerical, and similar costs reasonably necessary for -
    - (i) the preparation and presentation to contracting officers of settlement claims and supporting data with respect to the terminated portion of the contract, and
    - (ii) the termination and settlement of subcontracts; and
  - (2) reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract.
- (g) Subcontractor claims, including the allocable portion of claims which are sommon to the contract and to other work of the contractor are generally illowable.

### 15-205.43 Trade, Business, Technical and Professional Activity Costs.

- (a) <u>Memberships</u>. This category includes costs of memberships in trade, business, technical, and professional organizations. Such costs are allowable.
- (b) <u>Subscriptions</u>. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

(c) <u>Meetings and Conferences</u>. 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.

# 15-205.44 Training and Educational Costs.

- (a) 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 (excluding overtime compensation which might arise therefrom), 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.
- (b) Costs of part-time 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.

- (c) 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.
- (d) 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 ASPR 15-205.20, 15-205.9, and 15-205.34, respectively.
- (e) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions and are unallowable.
- 15-205.45 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 directly costed as

transportation costs or added to the cost of such items (see (22) 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, shall be treated as a direct cost.

# 15-205.46 Travel Costs.

- (a) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.
- (b) 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.
- (c) Travel costs incurred in the normal course of over-all administration of the business are allowable and shall be treated as indirect costs.
- (d) 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).
- (e) 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 15-107).

- Part 6 Guidelines for Application in the Negotiation and Administration of Fixed-Price Type Contracts and in the Negotiation of Termination Settlements
- 15-600 Scope of Part. This Part provides guidance for the use of Parts 2, 3 and 4 of this Section XV (i) in the evaluation of costs in pricing of negotiated fixed-price type contracts and subcontracts in those instances where such evaluation is required to establish prices for such contracts and (ii) in the negotiation of termination settlements.
- <u>15-601</u> <u>Definition of Fixed-Price Type Contracts</u>. "Fixed-price type" contracts include, for purpose of this Part, the following:
  - (i) firm fixed-price contracts (ASPR 3-403.1)
  - (ii) fixed-price contracts with escalation (ASPR 3-403.2)
  - (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
    - (iv) fixed-price incentive contracts (ASPR 3-403.4)
    - (v) non-cost-reimburgable portion of time and materials contracts (ASPR 3-405.1)
    - (vi) labor-hour contracts (ASPR 3-405.2)
- 15-6 2 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The ability to apply

standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price of settlement.

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- (b) Among the different types of fixed-price type contracts, the need for consideration of costs varies considerably as indicated below:
  - (i) Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, 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. However, even in these situations, the finally agreed price or settlement may represent something other than the sum total of acceptable costs plus profit, 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.
  - (ii) Forward Pricing. The extent to which costs influence forward pricing waries 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 cost data is often a valuable aid, it will not control negotiation of prices for work to be performed, or a target price under an incentive contract.

- 15-603 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-602, costs are to be considered in the negotiation of fixed-price type contracts, the appropriate Part of this Section XV shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8, and in the case of negotiated termination settlements Section VIII, Part 3.
- (b) In retrospective pricing, whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, the appropriate part of this Section XV will serve as a guide for the contracting officer in his conduct of negotiations.

- (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. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.
- (d) In order to permit the proper evaluation of cost data submitted by contractors for use in negotiating prices, it may be necessary to obtain breakdowns or account analyses in respect to some cost items particularly those whose treatment may be dependent upon special circumstances as stated in the principles. Contractors will be expected to be responsive to reasonable requests for data of this kind.

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### PROPOSALS TO CONFORM ASPR SECTION VIII TO ASPR SECTION XV

### Deletions:

### Table of Contents

8-213 Cost Principles Applicable to the Settlement of Certain Terminated Research and Development Contracts .

8-302 Statement of Principles for Consideration of Costs

Pages 820, 821 Part 2

8-213 Cost Principles Applicable to the Settlement of Certain
Terminated Research and Development Contracts.

(To be replaced by new material)

## Part 3

Pages 823 through 831

8-302 Statement of Principles for Consideration of Costs
(To be replaced by reference to new 8-213)

#### Additions:

#### Table of Contents

8-213 Cost Principles Applicable to the Settlement of
Terminated Contracts

8-302 Cost Principles Applicable to the Settlement of
Terminated Contracts

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#### Part 2

- 8-213 Cost Principles Applicable to the Settlement of Terminated
  Contracts. In the consideration of costs incident to the
  negotiation of termination settlements, the cost principles
  and procedures in the applicable Part of ASPR, Section XV,
  shall be used as a guide in conjunction with those set
  forth below:
  - (i) Common Items. The cost of items reasonably usable on the contractor's other work shall. not be considered acceptable unless the contractor submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the contractor, the contracting officer should consider the contractor's plans and orders for current and scheduled production. Contemporaneous purchases of common items by the contractor shall be regarded as evidence that such items are reasonably usable on the contractor's otherwork. Any acceptance of common items as allocable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

- (ii) Costs continuing after termination. If in a particular case, despite all reasonable efforts by the contractor, certain costs cannot be discontinued immediately after the effective date of termination, such costs are generally acceptable within the limitations set forth in ASPR XV, and this paragraph 8-213, except that any such costs continuing after termination due to the negligent or wilful failure of the contractor shall be considered unacceptable.
- (iii) <u>Initial Costs</u>, including starting load and preparatory costs, are generally acceptable.
- (A) Starting load costs are costs of a non-recurring nature arising in the early stages of production and not fully absorbed because of the termination. Such costs may include the cost of labor and material, and related overhead attributable to such factors as (I) excessive spoilage resulting from inexperienced labor, (II) idle time and subnormal production occasioned by testing and changing methods of processing, (III) employee training, and (IV) unfamiliarity or lack of experience with the product, materials, manufacturing processes and techniques.

- (B) Preparatory costs are costs incurred in preparing to perform the terminated contract, including costs of initial plant rearrangement and alterations, management and personnel organization, production planning and similar activities, but excluding special machinery and equipment and starting load costs.
- (C) If initial costs are claimed and have not been segregated on the contractor's books, segregation for settlement purposes shall be made from cost reports and schedules which reflect the high unit cost incurred during the early stages of the contract.
- (D) When the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end items called for by the contract immediately prior to termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.
- (E) When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead.
- (F) Initial costs attributable to only one contract shall not be apportioned to other contracts.

- (iv) Loss of useful value of special tooling, special machinery and equipment is generally acceptable: provided (A) such special tooling, machinery or equipment is not reasonably of use in the other work of the contractor; (B) the interest of the Government is protected by transfer of title or by other means deemed appropriate by the contracting officer; and (C) the loss of useful value as to any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the special tooling, special machinery and equipment was acquired.
- (v) Rental costs under unexpired leases are generally acceptable where clearly shown to have been reasonably necessary for the performance of the terminated contract, less the residual value of such leases, if:
- (A) the amount of such rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable, and

(B) the contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

There also may be included the cost of alterations of such leased property, provided such alterations were necessary for the performance of the contract, and of reasonable restoration required by the provisions of the lease.

- (vi) <u>Settlement expenses</u> including the following are generally acceptable:
- (A) accounting, legal, clerical, and similar costs reasonably necessary for (I) the preparation and presentation to contracting officers of settlement claims and supporting data with respect to the terminated portion of the contract, and (II) the termination and settlement of subcontracts; and
- (B) reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract.
- (vii) Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor are generally acceptable.

### Part 3

8-302 <u>Cost Principles Applicable to the Settlement of</u>
Terminated Contracts. See ASRR 8-213.

# Reference Changes

- 8-303(a) Page 831 Line 4 change parenthetical reference 8-302(b) (27) to 8-213 (vi).
- 8-304(b) (iii) Page 832 Line 3 change parenthetical reference 8-302(b) (13) to 8-213 (iii).
- 8-503.5 Page 841 Line 5 change paranthetical reference 8-302a (1)(a)(ii) to 8-213 (i).
- 8-701 Clause par(f) Page 862 Line 3 change reference 8-302 to 8-213.
- 8-703 Clause par(f) Page 872 Line 3 change reference 8-302 to 8-213.

### PROPOSALS TO CONFORM ASPR SECTION VIII TO ASPR SECTION XV

### Deletions:

# Table of Contents

8-213 Cost Principles Applicable to the Settlement of Certain

Terminated Research and Development Contracts.

8-302 Statement of Principles for Consideration of Costs.

# Part 2

### Pages 820, 821

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Terminated Research and Development Contracts.

(To be replaced by new material.)

#### Part 3

### Pages 823 through 831

8-302 Statement of Principles for Consideration of Costs.

(To be replaced by reference to new 8-213,)

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Contracts.

8-302 Cost Principles Applicable to the Settlement of Terminated

Contracts.

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  and procedures in the applicable Part of ASPR, Section XV,
  shall be used as a guide in conjunction with those set
  forth below:
  - (i) Common Items. The cost of items reasonably usable on the contractor's other work shall not be considered acceptable unless the contractor submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the contractor, the contracting officer should consider the contractor's plans and orders for current and scheduled production. Contemporaneous purchases of common items by the contractor shall be regarded as evidence that such items are reasonably usable on the contractor's other work. Any acceptance of common items as allocable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

- (ii) Costs Continuing After Termination. If in a particular case, despite all reasonable efforts by the contractor, certain costs cannot be discontinued immediately after the effective date of termination, such costs are generally acceptable within the limitations set forth in ASPR XV, and this paragraph 8-213, except that any such costs continuing after termination due to the negligent or wilful failure of the contractor shall be considered unacceptable.
- (iii) <u>Initial Costs</u>, including starting load and preparatory costs, are generally acceptable.
- (A) Starting load costs are costs of a nonrecurring nature arising in the early stages of production and not fully absorbed because of the termination.
  Such costs may include the cost of labor and material,
  and related overhead attributable to such factors as (I)
  excessive spoilage resulting from inexperienced labor,
  (II) idle time and subnormal production occasioned by
  testing and changing methods of processing, (III) employee
  training, and (IV) unfamiliarity or lack of experience with
  the product, materials, manufacturing processes and techniques.
- (B) Preparatory costs are costs incurred in preparing to perform the terminated contract, including costs

of initial plant rearrangement and alterations, management and personnel organization, production planning and similar activities, but excluding special machinery and equipment and starting load costs.

- (C) If initial costs are claimed and have not been segregated on the contractor's books, segregation for settlement purposes shall be made from cost reports and schedules which reflect the high unit cost incurred during the early stages of the contract.
- (D) When the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end items called for by the contract immediately prior to termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.
- (E) When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead.
- (F) Initial costs attributable to only one contract shall not be apportioned to other contracts.
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  machinery and equipment is generally acceptable:

  provided (A) such special tooling, machinery or

  equipment is not reasonably capable of use in the

other work of the contractor; (B) the interest of the Government is protected by transfer of title or by other means deemed appropriate by the contracting officer; and (C) the loss of useful value as to any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the special tooling, special machinery and equipment was acquired.

- (v) Rental costs under unexpired leases are generally acceptable where clearly shown to have been reasonably necessary for the performance of the terminated contract, less the residual value of such leases, if:
- (A) the amount of such rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable, and
- (B) the contractor makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease.

There also may be included the cost of alterations of such leased property, provided such alterations

were necessary for the performance of the contract, and of reasonable restoration required by the provisions of the lease.

- (vi) <u>Settlement expenses</u> including the following are generally acceptable:
- (A) accounting, legal, clerical, and similar costs reasonably necessary for (I) the preparation and presentation to contracting officers of settlement claims and supporting data with respect to the terminated portion of the contract, and (II) the termination and settlement of subcontracts; and
- (B) reasonable costs for the storage, transportation, protection, and disposition of property acquired or produced for the contract.
- (vii) Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor are generally acceptable.

### Part 3

8-302 Cost Principles Applicable to the Settlement of Terminated
Contracts. See ASPR 8-213.

# Reference Changes

8-303(a) Page 831 - Line 4 change parenthetical reference 8-302(b) (27) to 8-213 (vi).

8-304(b)(iii) Page 832 - Line 3 change parenthetical reference 8-302(b) (13) to 8-213 (iii).

8-503.5 Page 841 - Line 5 change parenthetical reference 8-302a (1)(a)(ii) to 8-213 (i).

8-701 Clause par(f) - Page 862 - Line 3 change reference 8-302 to 8-213.

8-703 Clause par(f) - Page 872 - Line 3 change reference 8-302 to 8-213.

#### CONTRACT COST PRINCIPLES

### Part 4--Construction Contracts

Definition of Construction Contract. The term "construction contract" as used in this Part means any contract for the construction, alteration or repair of buildings, bridges, roads, or other kinds of real property. It does not include a contract for the manufacturing, producing, furnishing, construction, alteration, repair, processing or assembling of vessels, aircraft, or other kinds of personal property, regardless of the terms of any such contract as to payment or title.

of a cost-reimbursement type contract for construction or for architectengineer services related to construction is the sum of the allowable
costs incident to the performance of the contract, less applicable income
and other credits. The tests used in determining the allowability of costs
also include (i) reasonableness and (ii) any limitations as to types or
amounts of cost items set forth in this Part 4 of Section 2V or otherwise
included in the contract. Failure to mention any item of cost in this
Part is not intended to imply that it is either allowable or not allowable.
Income and other credits arising out of operations under the contract,
where the related cost was reimbursed or accepted as an allowable cost,
will be credited to the Government.

- 15-403 Examples of Items of Allowable Costs. Subject to the requirements of paragraph 15-402 with respect to the general basis for determining allowability of costs, the following items of cost are considered allowable within the limitations indicated:
  - (a) bonds and insurance, including self-insurance, to the extent authorized by the contracting officer;
  - (b) camp operations (but see paragraph 15-404 (h));
  - (c) freight, transportation, and material handling;
  - (d) land and structures, temporary use thereof;
  - (e) materials and supplies, including inspection, storage, salvage, and other usual expenses incident to the procurement and use thereof;
  - (f) patents, purchased designs, and royalty payments, to the extent authorized by the contracting officer;
  - (g) plant and equipment, purchase or rental thereof;
  - (h) recruiting of personnel (including "help wanted" advertising);
  - (1) restoration and cleanup of site and facilities, as directed by the contracting officer;
  - (j) structures and facilities of a temporary nature;
  - (k) subcontracts;
  - (1) taxes, fees or charges, except those imposed upon, by reason of, or measured by the contractor's fee;

- (m) traveling expenses, to the extent authorized by the contracting officer;
- (n) utility services, such as communication, power, gas, and water;
- (o) vacation, holiday and severance pay, sick leave and military leave, to the extent required by law or specifically provided for elsewhere in the contract;
- (p) wages and salaries; and
- (q) pension and retirement plans in accordance with the interpretation set forth in ASPR 15-406 and group health, accident and life insurance plans (but see ASPR 15-404 (b), (d), and (m)).

15-404 Examples of Items of Unallowable Costs. The following items of costs are considered unallowable, except as indicated and then only subject to the requirements of ASPR 15-402:

- (a) advertising (including advertising in trade or technical journals), except "help wanted" advertising;
- (b) central office expenses of the contractor, such as supplies, equipment, rent, or any other expenses incident to its maintenance and operation, except to the extent authorized by the contracting officer;
- (c) commissions and bonuses (under whatever name) in connection with obtaining or negotiating for a Government contract;
- (d) compensation and traveling expenses of any officer or

employee in the central office organization of the contractor, except to the extent authorized by the contracting officer;

- (e) contingency reserves;
- (f) contributions and donations;
- (g) dividend payments;
- (h) entertainment, except for on-site recreational activities for the contractor's employees as authorized by the contracting officer;
- (1) interest on borrowings (however represented), bond discount and expense, and financial charges;
- (j) legal, accounting and consulting fees and related expenses, except to the extent authorized by the contracting officer;
- (k) losses on other contracts;
- (1) memberships in trade, business and professional organizations;
- (m) premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneficiary directly or indirectly;
- (n) storage of contract records after completion of contract operations, irrespective of contractual or statutory requirements regarding the preservation of records; and
- (o) taxes, fees or charges imposed upon, by reason of, or measured by the contractor's fee.

- 15-405 Examples of Subjects Requiring Special Considerations. 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 specific
    identification of the types thereof and the period involved;
  - (b) Government-furnished property, general nature and extent;
  - (c) indirect cost basis (i) actual, (ii) negotiated rate or amount, 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 nature;
  - (k) plant facilities fully depreciated or amortized on the contractor's books of account or acquired without cost (possible compensation for utilization in the form of a use or rental charge);
  - (1) rearrangement or relocation of facilities or plant sites;
  - (m) research programs of a general nature;

- (n) security measures of a special nature;
- (o) sharing of cost of research projects of the type which an educational or other nonprofit institution might undertake 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.
- 15-406 Cost Interpretation of Pension and Retirement Plans (See ASPR 15-403 (q))
- (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 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 rethrement plans are based on profits, providing that provisions of the Enternal Revenue Code and regulations of the Bureau of Internal Revenue have been met, the amount allowable for apportionment to contracts in any one year so All 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 mansomable expectation that, upon completion of the contracts, the services of practically with the result that contract we will benefit from contractors made on behalf of these employees, because such performed 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.

DRAFT 12 March 1959

#### CONTRACT COST PRINCIPLES AND PROCEDURES

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 the evaluation of costs in negotiated fixed-price type contracts and in contracts terminated for the convenience of the Government.

Part 1 - Applicability in Cost-Type Supply and Research Contracts with Organizations Other Than Educational Institutions

15-101 Scope of Part. This Part prescribes the use of contract cost principles and procedures, set forth in Part 2 of this Section, in contracting and procedures, with organizations other than educational institutions under cost-reimbursement type contracts (including cost-reimbursement type subcontracts thereunder) and, to the extent hereinafter provided, in the termination of such contracts for the convenience of the Covernment.

## 15-101.1 Prescribed Use. Part 2 is prescribed for use:

(i) as a 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, and the cost-reimbursement portion of time-and-materials contracts (ASPR 3-405.1);

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- (ii) as the basis for the minution of hegotiated overhead rates (ASPR, Section III, Part 7), and
- (iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts in which the contractor elects to "voucher-out" his costs (ASPR, Section VIII, Part 4), and for settlement of such contracts by determination (ASPR 8-209.7).

DRAFT 12 March 1959

Part 2 - Principles and Procedures for Use in Cost-Type
7 Supply and Research Contracts and Embroatracts
with Commercial Organizations

15-200 Scope of Part. This Part contains principles and procedures for use in cost-reimbursement type supply and research contracts and subcontracts with organizations other than (i) educational institutions, (ii) for construction and for architect-engineering services related to construction.

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.

<u>15-201.3</u> <u>Definition of Reasonableness</u>. 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 prependerance 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 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;

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;

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- (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 estermined 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. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work.
- (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

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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 definition of the cost of the desired and adjusted the training 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 inturn 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

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.

- 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.
- 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 yetro-with companies of zapanate 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 contracting officers individually/or jointly for all defense work of the contractor. as may be appropriate. Any such agreement should be incorporated in costreimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost

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 re-examination 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

# 15-209 - Indirect Conts

(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. Normally the base period will be the contractor's fiscal year, however, use of a shorter period may be appropriate in case of (i) contracts whose performance involves only a minor portion of the fiscal year; or (ii) where it is general practice in the industry to use a shorter period. In any event the base period or periods shall be so selected as to avoid inequities in the allocation of costs. 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.

determinations covered thereby throughout the performance of the related contract. 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. However, the nature of certain costs is such that advance agreements are particularly important, such as:

- (i) pre-contract costs (ASPR 15-204.2 (dd));
- (ii) royalties (ASPR 15-204.2 (jj));
- (iii) travel costs, as related to special or mass personnel movement (ASPR 15-204.2 (ss)(5));

Examples of others for which such agreements are important in order to avoid future misunderstandings are:

- (v) compensation for personal services (ASPR 15-204.2 (f));
- (vi) deferred maintenance costs (ASPR 15-204.2 (t)(1)(ii));
- (vii) research and development costs (ASPR 15-204.2 (ii)(6)); and
- (viii) selling and distribution costs (ASPR 15-204.2 (kk)(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.

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15-20 Selected Costs.

(1) Advertising Costs.

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;
- (ii) help-wanted advertising, as set forth in <del>(gg)</del> below, when considered in conjunction with all other recruitment costs;

(iii) costs of participation in exhibits upon invitation of the Government

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205 15-20 Selected Costs.

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  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;
- (ii) help-wanted advertising, as set forth in (gg) below, when considered in conjunction with all

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industry, provided, such ourse are not ultimable more this subgarageon (B) if the participation is for the purpose of offering specific products

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or services for sele;

Commercial (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.

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; nowever, the contractor's established practice be to treat bidding costs by some other secognized method. Regardless of the method used, the results obtained may be accepted may if found to be reasonable and equitable.

# (4) (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.

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

(c)(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.

# (5) (Civil Defense Costs

(a) (I) 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.

(b) (2) Costs of capital assets under (1) above are allowable through depreciation in accordance with (4) below.

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(f) Compensation for Personal Services.

(a) (1) General. 2. 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-honus and incentive compensation of minagement appropries. 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.

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. 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. 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.

(3) . 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.

set forth in a through c above, certain forms of compensation are subject to further requirements as specified in (2) through (13) below.

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 below.

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 over-all 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

DRAFT 12 March 1959

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 15-107.)

15-204.1(b).) Bonuses, awards and incentive compensation when any of them are deferred are allowable to the extent provided in (6) below.

- (d) (1) 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)e below. (But see ASPR 15-204.1(b).)

- (e) (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 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.

Deferred compensation is allowable to the extent that (i) except for past service pension costs 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).)

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.
- 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.

(3) Fringe Benefits. See (5).

Overtime, Extra-Pay Shift and Multi-shift Premiums.

Training and Education Expenses. See (qq).

Insurance and Indemnification. See (p).

# (7) (c) 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.

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In historical costing, contingencies are not normally present since such costing deals with costs which have been incurred and recorded on the contractor's books. Accordingly, contingencies are generally unallowable for historical costing purposes. However, in some cases, as for example, terminations, a contingency factor may be recognized which is applicable to a past period to give recognition to minor unsettled factors in the interest of expeditious settlement.

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 (nm) below).

(a) Contributions and Donations. Contributions and donations are unallowable.

# (a) Depreciation.

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.

(1)(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, and including --
  - (A) the straight line method;
  - (B) the declining balance method, using a rate not

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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.

(d) 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

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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 15-20+.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 moral, and employee performance, are allowable. Such costs shall be equitably allocated to all work of the contractor. Income

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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.

- 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)).
- (1) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediatel, prometive 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.
- 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 15-20 1(b).) Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for

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the benefit of the employees at the site or sites of contract performance)

accurring 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.

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.

(a) (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.

(1) Costs of insurance required or approved, and maintained, pursuant to the contract, are allowable.

(2) 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 SIMILIR insurance shall be limited to exclude coverage of profit; interest, and any other items of cost unallowable

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### under this Part;

- (iii) costs of insurance or of any contributions to any reserve

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  property are allowable only to the extent that the Govern—

  ment 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).
- (3) 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) above.

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Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional 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 (co) below. (But see (x).)

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 (1)):

ASFR 15-204 2(1)):

- (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 15-20-1(b).)

(12) Expenditures for plant and equipment which, according to generally

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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.

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.

(b)(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

DRAFT 12 March 1959

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.

physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided such adjustments (1) do not include "write-downs" or "write-ups" of values and (11) relate to the period of performance of the contract.

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.

tween 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.

- 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 above).
- 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. Overtime, extrapay 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.
- (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 (2) above.

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(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.

- 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. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent mutually agreed upon before the costs are incurred. Whenever such costs are given consideration, care should be exercised to avoid duplication through allowance as contingencies, as additional profit or fee, or in other contracts.
- (dd) <u>Brecontract Costs</u>. 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 15-201-1(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;

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- (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 how fide services rendered.

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.

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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 (1) (2) above as to basis for depreciation).

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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 market conditions in the area, 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 along with other considerations comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

(1) (2) Charges in the nature of rent between plants, divisions, or organizations under common control are mallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation,

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taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

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.

## (35) (11) Research and Development Costs.

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 remarkin, consists of that type of effort which (i) normally follows basic research, but may not be severable from the related basic research, (ii) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and (iii) 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, which are within the definition of the term development as hereinafter provided.

(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 manufacturing and production engineering.

A contractor's independent research and development is that research and development which is not sponsored by a contract, grant, or other arrangement.

A contractor's costs of independent research as defined in (1) and (3) above shall be allowable as indirect costs (subject to paragraph (8) below), provided they are allocated to all work of the contractor.

(e) (5) Cost of contractor's independent development, as defined in paragraphs (2) and (3) above (subject to paragraph (8) below), are allowable to the extent that such development is related to the product lines for which the government has contracts, provided the costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. In cases where a contractor's normal course of business does not involve production work, the cost of independent development is allowable to the extent that such development is related and allocated as an indirect cost to the field of effort of government research and development contracts.

(4) (6) Independent research and development costs shall include an amount for the absorption of their appropriate share of indirect and administrative costs, unless the contractor, in accordance with its accounting practices consistently applied, treats such costs otherwise.

(4) 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 specific where allowable the day where the costs (see the state of the costs) where

(1) (8) The reasonableness of expenditures for independent research

27 HPR11,959 and development should be determined in light of all pertinent considerations such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures (especially for development) should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the government. Advance agreements as described in ASPR 15-20-1(to) are particularly important in this situation. In recognition that cost charing 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. Under these circumstances, the following are among the approaches which may be used as the basis for INDEPENDENT agreement: (i) review of the contractor's proposed research and development program and agreement to accept the allocable costs of specific projects; (11) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; and (iii) agreement to accept the allocable share of a percentage of the contractor's planned research and development program.

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:

(1) 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;
- (11) 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.

tractor, the amount of royalty allowed should not exceed the cost which would have been allowed had the contractor retained title thereto.

(d) (5) See ASPR 15-204-1(b).

(37)
Selling Costs.

27 April 1959

(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.

Allocated 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.

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, care should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

### (39) (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 (1) law, (11) employer-employee agreement, (111) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (1v) 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
- (11) 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.

(mm) 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.

- ments. 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:
  - (1) Federal income and excess profits taxes;
  - (ii) taxes in connection with financing, refinancing or refunding operations (see (4));
  - (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

Draft 12 March 1959

exemption outweighs the corresponding benefits accruing to the Government; and

- (iv) special assessments on land which represent capital improvements.
- 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.

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.
- (a) (1) <u>Memberships</u>. This category includes costs of memberships in trade, business, technical, and professional organizations. Such costs are allowable.
- (h) (2) Subscriptions. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.
- (2) 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.
  - (44) 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
  - (1) salaries of the director of training and staff when the training program is conducted by the contractor; or
  - (11) tuition and fees when the training is in an institution not operated by the contractor;

are allowable.

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Draft 12 March 1959

(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:

- (1) 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.

(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

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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 (\*\*), (\*\*), 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).
- 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 directly costed as transportation costs or added to the cost of such items (see (\*\*) 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.
- 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.

Draft 12 March 1959

- (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).
- 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 15-20+1-(b).)

Draft 12 March 1959

Part > Guidelines for Application in the Negotiation and Administration of Fixed-Price Type Supply and Research Contracts with Organizations Other Than Educational Institutions and in the Negotiation of Termination Settlements for the Convenience of the Government

15-500 Scope of Part. This Part provides guidance for the use of Part 2 of this Section (i) in the evaluation of costs in pricing of negotiated fixed-price type supply and research contracts and subcontracts with organizations other than educational institutions, in those instances where such evaluation is required to establish prices for such contracts and (ii) in the negotiation of termination settlements, for the convenience of the Coverence of the Coverence

15-50r Definition of Fixed-Price Type Contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (11) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) mon-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)
- (vi) labor-hour contracts (ASPR 3-405.2)

15-502 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts.

Accordingly, the policies and procedures of ASPR Section III, Part 8, are

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governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement.

- (b) Among the different types of fixed-price type contracts, the need for consideration of costs varies considerably as indicated below:
  - (1) Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, 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. However, even in these situations, the finally agreed price or settlement may represent something other than the sum total of acceptable costs plus profit, 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.

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(ii) Forward Pricing. The extent to which costs influence forward pricing varies greatly from case to case. 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 mot possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while cost data is often a valuable aid, it will not control negotiation of prices for work to be performed, or a target price under an incentive contract.

15-503 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-505, costs are to be considered in the negotiation of fixed-price type contracts, Section XV, Part 2, shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other

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Draft 12 March 1959

pertiment considerations as set forth more fully in ASPR Section III,
Part 8.

(b) Whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, Section XV, Part 2, will serve as a guide for the resolution of the issue.

(c) In applying Part 2 of this Section XV to fixed-price contracts, contracting officers will: (i) not be required to negotiate agreement on each 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. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiate.

however, that a order to permit the proper evaluation of cost data submitted by contractors for use in negotiating prices, it may be necessary to obtain breakdowns or account analyses in respect to some cost items particularly those whose treatment may be dependent upon special circumstances as stated in the principles. Contractors will be expected to be responsive to reasonable requests for data of this kind.

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#### Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts and subcontracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts.

\*\*Fixed-price type\*\* contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
  - (iv) fixed-price incentive contracts (ASPR 3-403.4)
  - (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)

15-701 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts. Cost and accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it.

Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The ability to apply standards of business judgment as distinct from strict accounting principles is at the heart of a negotiated price or settlement.

- (b) Among the different types of fixed-price type contracts, the need for consideration of costs varies considerably as indicated below:
  - firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, or negotiation of a settlement agreement under a contract terminated for convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. However, even in these situations, the finally agreed price or settlement may represent 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.
  - (ii) Forward Pricing. 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 cost data is often a valuable aid, 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.

- 15-702 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-701, costs are to be considered in the negotiation of fixed-price type contract, Section XV, Part 2, shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8.
- (b) Whenever an occasion arises in which acceptability of a specific item of cost becomes an issue, Section XV, Part 2, will serve as a guide for the resolution of the issue.
- (c) In applying Part 2 of this Section XV to fixed-price contracts, contracting officers will: (i) not be required to negotiate agreement on each 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. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.

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# SECTION XV CONTRACT COST PRINCIPLES 8 Dec 58

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 as follows:

- (a) It shall be used as a contractual basis, by incorporation by reference in the contract, for determination of:
  - Reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;
  - (2) Reimbursable costs under the cost-reimbursement part of time and materials contracts; and
  - (3) Costs of terminated contracts of the type set forth in (1) and (2) above.
- (b) It shall be used in fixed-price type contracts as general guidance in the negotiation of fair and reasonable prices rather than as a prescribed basis for determining such prices. In this respect, the policies and procedures set forth in ASPR Section III, Part 8, are governing and shall be followed. The degree of use of the principles in Part 2 in fixed-price type contracts is dependent (1) on the

and redeterminable contracts are basically of the fixed-price type, the fact that a specific item of cost is set forth as "unallowable" in Part 2 shall not preclude special consideration of such an item when requested by the contractor on the basis that it contributes to the performance of the contract. This paragraph (3) is equally applicable to terminations of incentive and redeterminable contracts.

(c) Costs under terminations of firm fixed-price type contracts, advertised or negotiated shall be governed by Part 2, subject to the special provisions pertaining to terminations as follows:

#### Part 7 - Fixed-Price Type Contracts

15-700 Scope of Part. This Part sets forth the guidelines to be used for the evaluation of costs in negotiated fixed-price type contracts, including terminations thereof, in those instances where such evaluation is required to establish prices for such contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

- (i) firm fixed-price contracts (ASPR 3-403.1)
- (ii) fixed-price contracts with escalation (ASPR 3-403.2)
- (iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)
- (iv) fixed-price incentive contracts (ASPR 3-403.4)
- (v) non-cost-reimbursable portion of time and materials contracts (ASPR 3-405.1)
- 15-701 Basic Considerations. (a) Under fixed-price type contracts, prices, not separate elements of cost plus profit, are to be negotiated. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts.
- (b) As recognized in ASPR Section III, Part 8, there are within the fixed-price type category of contracts certain situations, and, incentive and redeterminable contracts, in which costs are a significant factor in the negotiation of prices. In such situations, costs must be submitted by contractors, evaluated by the Government, and used as

appropriate in negotiating fair and reasonable prices. However, since the basic objective, even in these situations, is the negotiation of a price rather than the determination of allowable and unallowable costs, the use of cost principles must be flexible.

15-702 Cost Principles and Their Use. (a) When, pursuant to
AMPR 15-701, costs are to be considered in fixed-price type contracts,

Section XV, Part 2, shall be used to provide general guidance in the consideration of cost data in conjunction with other pertinent considerations as set forth more fully in ASPR Section III, Part 8, required to establish a fair and reasonable price.

(b) In using Part 2 of this Section XV for general guidance, contracting officers are not necessairly required to specifically evaluate each individual item of cost (as is required for cost-reimbursement type contracts) in establishing a price; nor shall they be required, in substantiating or justifying a negotiated price, to explain the treatment accorded each such item of cost. Notwithstanding the above, contracting officers are required to fully substantiate and justify any negotiated price in accordance with the pricing techniques set forth in ASTR 3-808.

#### SECTION XV CONTRACT COST PRINCIPLES

#### 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 as follows:

- (a) It shall be used as a contractual basis, by incorporation by reference in the contract, for determination of:
  - Reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;
  - (2) Reimbursable costs under the cost-reimbursement part of time and materials contracts; and
  - (3) Costs of terminated contracts of the type set forth in (1) and (2) above.
- (b) It shall be used in fixed-price type contracts as general guidance in the negotiation of fair and reasonable prices rather than as a prescribed basis for determining such prices. In this respect, the policies and procedures set forth in ASPR Section III, Part 8, are governing and shall be followed. The degree of use of the principles in Part 2 in fixed-price type contracts is dependent (i) on the

circumstances of the procurement and (ii) the form of fixed-price type contract, as follows:

- (1) In formally advertised contracts, Part 2 is inapplicable.
- (2) In straight fixed-price type negotiated contracts, where, according to ASPR 3-808.3, cost analysis is required, Part 2 is to be used primarily as a means of determining the necessity for certain costs, and their reasonableness and allocability, rather than as a primary basis for arriving at a price. Formula type pricing, i.e., costs plus profit equals price, is improper and shall not be used. Costs are but one of many factors to be used in the negotiation of straight fixed-price type contracts.
- (3) Part 2 is not prescribed, by contract, for use in fixed-price incentive and redeterminable contracts.

  Nevertheless, because of the major significance of costs in the establishment of prices under these types of contracts, the use of Part 2 in determining allowability of such costs must, of necessity, be generally patterned after its use under cost-reimbursement type contracts. However, since incentive and redeterminable contracts are basically of the fixed-

price type, the fact that a specific item of cost is set forth as "unallowable" in Part 2 shall not, except as set forth in (4) below, preclude special consideration of such an item when requested by the contractor on the basis that it contributes to the performance of the contract. This paragraph (3) is equally applicable to terminations of incentive and redeterminable contracts.

- (4) Notwithstanding (2) and (3) above, certain items of costs are inappropriate for inclusion in Government contracts as allowable items of cost, regardless of the type of contract. Therefore, to the extent cost analysis is required in fixed-price type contracts, the rules of non-allowability, set forth in Part 2 as to the following items, shall be applied precisely as required for cost-reimbursement type contracts:
  - a. Federal Income and Excess Profit Taxes.
  - b. Entertainment expenses.
  - c. Fines and Penalties.
- (c) Costs under terminations of straight fixed-price type contracts, advertised or negotiated shall be governed by Part 2, subject to the special provisions pertaining thereto set forth in ASPR Section XV, Part 5. (THIS WILL REQUIRE PICKING UP FROM SECTION VIII APPLICABLE PROVISIONS PERTAINING TO TERMINATIONS OF STRAIGHT FIXED-PRICE TYPE CONTRACTS).

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#### 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, the cost-reimbursement portion of time and materials contracts and costs of terminated cost-reimbursement contracts.
- as to unallowability have been dictated by a variety of reasons, including the administrative difficulty of controlling certain expenditures. Accordingly, nothing in this Part 2 shall be construed as preventing the submission by contractors of requests for special consideration of any expenses for which the contractor would not otherwise be reimbursed. Such requests shall be in addition to and shall be specifically excluded from the development and submission of cost data.

  In determining the fee to be paid, contracting officers are authorized where they consider it appropriate to do so to include a factor which will give recognition to any legitimate contractor expenses when such expenses are reasonable under the circumstances of particular procurements.

(iii) Under fixed price type contracts the objective is the negotiation of a mutually satisfactory price or settlement rather than the determination of allowability or unallowability of individual cost items. Accordingly, under such fixed price type contracts, the principles in this part are intended to afford general guidance only to (a) contractors in the preparation and submission of cost representations,
(b) auditors in the rendition of advisory audit reports, and (c) contracting officers in their considerations of cost data incident to the negotiation of contract prices.

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.

#### 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,

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circumstances of the procurement and (ii) the form of fixed-price type contract, as follows:

- (1) In formally advertised contracts and in those negotiated contracts awarded on the basis of initial competitive proposals in accordance with ASPR 3-805 (b), Part 2 is inapplicable.
- (2) Under fixed-price type negotiated contracts, including incentive and redeterminable contracts, where, according to ASPR 3-808.3, cost analysis is required, Part 2 is to be used primarily as an aid in determining the reasonableness and allocability of certain costs, rather than as a primary basis for arriving at a price. Formula type pricing, i.e., costs plus profit equals price, is improper and shall not be used. Costs are but one of many factors to be used in the negotiation of fixed-price type contracts.

- (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 architectengineering 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.

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.
- able 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 15-2070

## 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 reasonable-ness 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 (ASFR 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 (ASAR 15-20h.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, <u>provided</u>
  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) <u>Bad Debts</u>. 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) <u>Bidding Costs</u>. 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) <u>General.</u> <u>a.</u> 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.

- <u>b.</u> 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 <u>a</u> through <u>c</u> above, certain forms of compensation are subject to further requirements as specified in (2) through (11) below.

Draft 10 September 57 Revised 10/1/57

- (2) <u>Salaries and Wages</u>. 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) <u>Cash Bonuses and Awards</u>. 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

sec 15-204, 1(f)(7)

Draft 10 September 57 Revised 10/1/57

sharing plans are divided into two types, namely, immediate payment plans and deforred 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 prosisions 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) <u>Deferred Compensation</u>. <u>a</u>. 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.
- <u>b</u>. Deferred compensation, including profit sharing plan costs allowable under (6) above, is allowable to the extent that (i) it is for serces 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).)

- o. 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 (0).
  - (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

Draft 10 September 1957

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, employeremployee 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)).
- (1) 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,

(c) 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, lolied days, sick leave, military leave, employee insurance and supplemental employment benefits plans, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor.

### (p) Insurance and Indomnification.

- (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.
- $\underline{b}_{\circ}$  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;

Draft 10 September 1957

- (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).
- 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-

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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) belows

- (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 interorganization 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 Fremiums.

(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.
- (co) 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) <u>Precontract Costs</u>. 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 includes
    - (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 cwn 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.

- 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 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 uch 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 meintenance; 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 circuted 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

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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 is 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 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 accorded 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) <u>Memberships</u>. 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 emcluments) 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).)

# UNDERLYING CONSIDERATIONS IN THE DEVELOPMENT OF

#### A COMPREHENSIVE SET OF CONTRACT COST PRINCIPLES

#### OBJECTIVE:

To adopt a uniform set of contract cost principles, applicable alike to cost determinations and cost estimates in those situations in which costs are a factor in pricing.

#### DEFINITION AND USE:

A listing and definition of individual elements of cost and statement of conditions of allowability or unallowability thereof applicable to all situations in which costs are useful, as follows:

a. For incorporation by reference to cover reimbursement in cost-type contracts and in the determination of formula termination settlements, and

b. For use by --

- (1) Contractors in providing pricing, repricing, and termination settlement proposals;
- (2) Audit agencies in their advisory capacity of providing accounting information;
- (3) Contracting officers in any evaluation of cost information whenever such information becomes a significant factor in pricing or termination settlements.

#### CONSIDERATIONS:

- a. Cost treatment should be equalized between the several types of contracts so that one type of contract will be neither less nor more attractive to a contractor or to the Government, by reason only of the cost treatment. Thus, the selection of contract type can be based upon the merits of the negotiation, i.e., the conditions surrounding the required product or services and the extent of any contingencies covering risks, rather than external influences arising out of cost treatment.
- b. Risk in the form of a contingency principle ought to be recognized in those instances in which there is risk exposure.
- c. The objective ought to be fairness and equity in the development of "one" set of cost principles. We should not deny or restrict allowability of a cost, otherwise fair, because determination of reasonableness, in some instances, may be difficult.
- d. We should seek to allow legitimate costs of doing business to the extent that such allowance is reasonable and is allocable to the contract in question. This conclusion requires adoption of a definition of "reasonable" and "allocable" and an application of these definitions in the elements of cost.

e. Uniformity of cost treatment and cost result are important objectives. However, they should not be achieved by arbitrary formulae in terms of allowability and by unnecessary imposition of accounting methods and techniques.

#### CONTRACT COST PRINCIPLES

15-000 Scope of Section. This section contains cost principles and standbe applied in the determination of historical costs; the preparation and presentation of cost estimates by contractors; and the review, audit and evaluation of cost data in contract negotiation and administration.

#### Part 1 - Applicability

15-101 Scope of Part. This Part prescribes the circumstances under which cost principles shall be used and the nature of that use in different situations in which costs, or an evaluation of costs, are a factor in the negotiation and administration of negotiated contracts and subcontracts.

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- 15-101.1 Comprehensive Use. Part 2 is prescribed for use, generally, by contractors in providing pricing, repricing and termination settlement proposals; by audit agencies in their advisory capacity of providing accounting information; and by contracting officers in the evaluation of cost information whenever such information becomes a factor in pricing or termination settlements. Specifically, the nature of the use shall be as follows:
- (a) General Uses. Part 2 shall be used (i) as the contractual basis for cost allowances in cost-reimbursement types of contracts (including cost-reimbursement type subcontracts thereunder and the cost-reimbursement portion of time and materials contracts); (ii) as the contractual basis for the settlement of terminated contracts when settlement is made by determination of the contracting officer pursuant to ASPR 8-309; (iii) in the settlement of terminated cost-reimbursement contracts when the contractor elects to "voucher out" costs pursuant to ASPR 8-509; (iv) by prospective contractors and contractors in the submission of cost and price analyses in support of pricing, repricing, negotiated overhead and settlement proposals under termination; and (v) as the basis for audit reports. In connection with (i), (ii) and (iii), Part 2 will be incorporated by reference in the contracts in order that the principles may be made binding upon the Government and upon the contractor.
- (b) Use in Retrospective Pricing and Settlements. In arriving at fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation, as in final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, negotiation of final negotiated overhead rates pursuant to ASPR, Part 7, Section III, or in negotiated settlements of contracts terminated for the convenience of the Government, 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 such transactions, the treatment of costs is a major factor in arriving at the amount of the price or settlement. Negotiation is usually limited to that portion of the price or settlement amount which consists of the resolution of costs not specifically treated in the cost principles, disputed questions as to reasonableness of costs, settlement of anticipated close-out expenses and frequently profits. The finally agreed price or,

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settlement represents something more than the sum total of allowable costs; it reflects a final resolution of all issues in the negotiation process. It must be recognized that, in negotiation of a price or settlement, the parties agree on a final price acceptable to each, which price does not necessarily reflect agreement on the evaluation of each element of cost thereof.

(c) Use in Forward Pricing. To the extent that costs are a factor in forward pricing, these principles apply to the development and evaluation of cost data. The extent to which costs influence forward pricing varies greatly depending upon the circumstances of each negotiation. Thus, while Part 2 will be used to evaluate cost data, it will not control the negotiation of prices for work to be performed in the future, as in firm fixed-price negotiations, intermediate price revision negotiations covering, in whole or important part, work which is yet to be performed, or in target price negotiations under incentive contracts. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates varies depending upon the circumstances of each negotiation. The Covernment negotiator must be aware of all of the factors which might have an effect on his judgment as to the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, complexity of work, competitive pricing, contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. However, in the negotiation, he must be free to bargain so that he can arrive at a total price which equitably distributes the risks as between the contractor and the Government and provides incentives for efficiency and cost reduction. 'In arriving at such a price through bargaining, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Such prices may be reached without discussion of cost factors and will not require negotiated resolution of questions of the acceptability of individual elements of costs. Nevertheless, when the question of acceptability becomes an issue, Part 2 will serve as a guide in the resolution of the issue.

15-101.2 Definition of "Allowable" and "Allowed" in Relation to Negotiation of Prices, Termination Settlements and Overhead Rates. The words "allowable," "allowed," and the like, used in Part 2, and as applicable to the negotiation of prices, termination settlements and overhead rates, mean that the cost principles contained herein will be considered by the contracting officer to the extent appropriate as a basis for the evaluation of the cost factor. It does not mean that the negotiation is to be undertaken and pricing is to be predicated upon mechanical rules or mathematical formulae.

Part 2 - General Principles and Standards for Cost Consideration

15-200 Scope of Part. This Part contains general principles for the evaluation or determination of cost in supply, service, and research and development contracts and subcontracts with commercial organizations.

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# 15-201 Basic Considerations.

- 15-201.1 Composition of Total Cost. Total cost includes the allowable direct and indirect costs allocable to the contract, incurred or to be incurred, less any allocable credits.
- 15-201.2 Definition of Allocable Cost. An allocable cost is one which is assignable or chargeable to a contract, product, product line, process, or class of customer or activity in accordance with the relative benefits generated or other basis of relationship. Thus, a cost allocable to a Government contract is one which:
  - (a) was incurred specifically for the contract, or
- (b) benefits both the contract and other work or Government and other work and can be distributed to them in reasonable proportion to the benefits received, or
- (c) is necessary to the over-all operation of the business, although a direct relationship to any particular product or process cannot be shown.
- (d) does not involve transactions related to the capital of the business, or is not otherwise excluded by this Section or other specific contractual provisions.
- 15-201.3 Factors Determining Allowability of Cost. Factors to be considered in determining the allowability of individual items of cost include (i) reasonableness, (ii) application of those generally accepted accounting principles and practices appropriate to the particular circumstance, (iii) exclusion of particular items of cost as a matter of public policy as specifically set forth in this section, and (iv) significant deviations from the established practices of the contractor which would substantially increase allowable cost.
- 15-201.4 Definition of Reasonableness. A cost is reasonable if, by its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. Hence, the question of the reasonableness of specific costs must be scrutinized with particular care in connection with companies or separate divisions thereof which are doing the preponderance of their business with the Government and which, therefore, are not subject to competitive restraints. What is reasonable depends upon a variety of considerations and circumstances involving both nature and amount of the cost in a specific case.

In forming an opinion concerning the reasonableness of a given cost or expenditure, consideration should be given to:

- (a) Whether the cost is of a type generally recognized as ordinary and necessary for the conduct of the business and the performance of the contract.
- (b) 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.
- (c) The action that a prudent business man would take in the circumstances. This consideration should include his responsibilities to the owners of the business, to employees, customers, the Government, and the public at large.

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15-201.5 Credits. Any income, rebate, allowance or other credit relating to any allowable cost earned or expected to be earned during the period of contract performance shall be credited to the Government either as a cost reduction or by cash refund, as appropriate.

### 15-202 Direct Costs.

- (a) Direct costs are those incurred or to be incurred solely for the benefit of a single cost objective. 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 through overhead allocation.
- (b) This definition must 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.
- (c) Classification of an item as a direct cost is not determined by its incorporation in the end product as material or labor. A direct cost is any cost incurred or to be incurred for a single cost objective; e.g., contract or other work regardless of the nature of the item.

#### 15-203 Indirect Costs.

- (a) Indirect costs are those incurred or to be incurred for more than one cost objective and those minor direct cost items considered to be indirect costs for reasons of practicality. Thus, after direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs remain to be allocated to the several classes of work.
- (b) Indirect costs shall be accumulated by logical cost groupings which are in turn distributed to the cost objectives. The groupings should be determined so as to permit a distribution weighted in accordance with the

reason for incurring the cost and the benefit accruing to the cost objectives to which distributed. 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 expense group. The number and composition of the groupings is affected by practical considerations. This principle is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results are achieved through less precise methods.

- (c) The individual cost groupings shall be distributed to the several 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 so constructed as to weight the allocation of the grouping to the cost objective in proportion to the reasons for incurring the costs and the benefits accuring. The principle for selection stated in this paragraph is not to be applied so rigidly as to unduly complicate the allocation where substantially the same results can be 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 as are applicable in the circumstances. The contractor's established practices, if in accord with these generally accepted accounting principles as are applicable in the circumstance, shall be acceptable. However, changed circumstances may require a reexamination of the methods used by the contractor, especially 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) The 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 shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but in no event longer than one year.

<sup>15-204.1</sup> General. Applications of the above basic cost principles and standards to certain selected items of cost are set forth below. These applications govern, whether the particular item of cost is treated by

the contractor as direct cost or as indirect cost. The cost principles in Part 2 hereof do not cover every element of cost nor every situation that might arise in a particular case. Failure to mention any item of cost in Part 2 is not intended to imply that it is either allowable or not allowable. They will be accorded that treatment which by analogy approximates the philosophy reflected in Part 2. Uncovered elements which are significantly large in relation to the estimated cost of performance and which are not susceptible for treatment by analogy will be subject to recommendation of higher authority.

# 15-204.2 Listing of 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: To the extent the costs are allowable:
  - 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 recruitment costs;

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(iv) advertising for the purpose of developing subcontracting sources; for the proportionale

institutional advertising; i.e., advertising which does not offer specific products for sale, but which places the contractor's name before the public in order to maintain the contractor's well-being as a commercial entity.

- (2) In connection with this element, special care must be exercised in determining reasonableness. Reasonableness should be appraised in light of:
  - (1) the pattern of past advertising programs;

- (ii) the presence or absence of competitive restraints;
- (iii) the contractor's need for such advertising; i.e., since institutional advertising is designed primarily to maintain the contractor's well-being as a commercial entity, contractors whose principal customer is the Government have relatively less need for institutional advertising, and substantial expenditures for this type of advertising by such contractors would be unreasonable.
- (3) Except as provided in (iii) and (iv) above, all advertising which offers products for sale is unallowable.
- (b) <u>Bad Debts</u>. 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 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 by reason of the act or default of the contractor. They arise also in instances where the contractor requires the assurance in connection with the performance of the contract. Included are such bonds as bid, performance, payment, advance payment, infringement and fidelity.
- (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 anthorities are allowable when allocated to all work of the contractor.

(2) Costs of capital assets acquired for civil defense purposes shall be depreciated in accordance with (i) Depreciation below.

(3) Contributions to local civil defense funds and to local civil defense projects are covered in (h).

# (f) Compensation for Personal Services.

- (1) 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. Subject to specific limitations set forth herein, such costs are allowable to the extent that the total compensation of individual employees, in whatever form paid, is reasonable for the services rendered.
  - amount paid or accrued, in whatever form, is commensurate with the contractor's established policy which 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 paid to owners of closely-held corporations, to partners and sole proprietors, to members of their immediate families, or to persons who have a commitment to acquire a substantial financial interest in such enterprise, will be particularly scrutinized to determine whether the compensation is reasonable in amount and actually is for personal services rather than a distribution of profits. 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. Compensation disallowed as a deductible expense for Federal income tax purposes, because it is unreasonable in amount, is not allowable.
  - (3) Compensation for services rendered in lieu of salary to partners and sole proprietors will be allowed to the extent that it is

reasonable and does not constitute a distribution of profits, even through such allowances are not deductible expenses for Federal income tax purposes.

(4) In addition to the general requirements set forth in (1) through (3) above, the following apply to specific forms of compen-Partisallowanie. sation:

Salaries and Wages. Includes gross compensation paid to employees in the form of cash, products, or services, and may include payroll taxes, workmen's compensation insurance, and the cost of supplemental unemployment benefit plans. Deferred wages and salaries are allowable to the extent authorized in (v) below.

(ii) Cash Bonuses and Incentive Compensation. bonuses to employees and incentive compensation based on production, cost reduction, or efficient management or performance, suggestion awards, and safety awards, including compensation dependent upon or measured by profits, 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 consistently followed by the contractor which constitutes in effect an implicit agreement on the part of the contractor to make such payment. Deferred bonuses and incentive compensation are allowable to the extent authorized in (v) below.

- (iii) Bonuses and Incentive Compensation Paid in Stock. Bonus and incentive compensation, as defined in (ii) above, paid in the stock of the contractor or of an affiliate, are allowable to the extent set forth in (ii) above (including the incorporation of the principles of paragraph (v) for deferred bonuses and incentive compensation), subject to the following additional requirements:
  - (A) Valuation placed on the stock shall be the fair market value, determined upon the most objective basis available.
  - (B) Accruals for stock prior to acquisition by the employees will be subject to adjustment according to the possibilities that the employees will not acquire such stock and that the accruals

Contract Cost Principles

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will be forfeited. Such costs otherwise allowable are subject to adjustment according to the principles set forth in (v)(F) and (v)(G) below.

(iv) Stock Options. The cost of options to the employees to purchase stock of the contractor or of an affiliate, whether restricted or unrestricted as defined by Section 421 of the Internal Revenue Code, shall be allowed to the extent that the market value of the stock exceeds the option price at the date the option is granted. The current market value of the stock shall be determined according to the criteria set forth in paragraph (iii) above. If the exercise of an option is conditioned upon future contingencies, the cost will be amortized rateably over the period commencing from the issuance of the option to the earliest date (other than death of the employee) when the contingencies can be fulfilled. Allowable costs for options that may not be exercised will be adjusted according to the principles set forth in (v)(F) below.

# (v) 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 completion of the year in which the services are rendered, except that it does not include normal end of accounting period accruals, nor stock options. It includes contributions to pension, annuity, stock bonus, and profit sharing plans qualified within the meaning of Section 401 of the Internal Revenue Code; contributions to such plans that are not so qualified; and other deferred compensation, such as wages and salaries, bonuses and incentive awards, whether paid in cash or in stock. Deferred retirement compensation may include disability, withdrawal, insurance or survivorship benefits.
- (B) Deferred compensation is allowable to the extent that it is for services rendered during the contract period; is, together with all other compensation paid to the employee, reasonable in amount; and 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 consistently followed by the contractor which constitutes, in effect, an implicit agreement on the part of the contractor to make such payments.

- (C) Contributions to a plan that has been approved, pursuant to Section 401 of the Internal Revenue Code, by the Internal Revenue Service, will be presumed to meet requirements of (v)(B) above. Such amounts are allowable as a cost even though they are not currently deductible for Federal income tax purposes because of the limitations of Section 404 of the Internal Revenue Code, provided such payments are for services rendered during the contract period.
- (D) Contributions to a pension or annuity plan by a tax-exempt or nonprofit organization will be presumed to meet requirements of (v)(B) above if such plan, as determined by the Department to which audit cognizance is assigned, fulfills the requirements of a "qualified" plan according to Section 401 of the Internal Revenue Code and applicable Treasury regulations. A determination by one Department that a plan fulfills these requirements, in the absence of changed conditions, generally will be accepted by other departments.
- (E) Contributions to pension, annuity, profit sharing, and stock bonus plans which do not meet the requirements of Section 401 of the Internal Revenue Code (including plans from which approval of the Internal Revenue Service has been withdrawn effective during the course of performance of the contract) and other deferred compensation, are allowable to the extent that the total compensation paid to the employees involved, in whatever form, meets the requirements of (v)(B) above.
- (F) In determining the cost of deferred compensation allowable under the contract, appropriate adjustments will 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 will be made only for forfeitures which directly or indirectly

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inure to the benefit of the contractors; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's cost will not normally give rise to adjustment in contract costs. Adjustments for normal employee turnover will be based on the contractor's experience and on foreseeable prospects, and will be reflected in the amount of cost currently allowable. Such adjustment 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 will be effected according to the following rules:

- (1) Abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, will be reflected by an adjustment of current costs otherwise allowable.
- (2) Abnormal forfeitures, not within (1) 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.
- (G) In determining whether deferred compensation is for services rendered during the contract period, consideration will be given to conditions imposed upon eventual payment to determine whether or not such a portion of deferred compensation payment is for future services. A requirement of continued employment does not necessarily indicate that the deferred compensation pertains in part to future services.
- (vi) Fringe Benefits. See (o).
- (vii) Overtime, Extra-Pay Shift and Multi-Shift Premiums. See (y).
- (viii) Training and Education Expenses. See (qq).
- (ix) Insurance and Indemnification. See (p).

### (g) Contingency Reserves.

- (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, contingency reserves 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 situations where they exist, contingencies of this category are to be included in the estimates of future cost under the several elements of cost so as to provide the best estimate of performance costs.
  - (11) 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., possible inflation, 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).

# / (h) Contributions and Donations.

(1) Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable provided they (i) may reasonably be expected to result in future benefits to the contractor through advancing, directly or indirectly, the technology of his industry or increasing the supply of trained manpower available to it, (ii) are in lieu of the cost of similar facilities which the contractor would have to provide, such as employee medical or recreational facilities, (iii) 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, or (iv) contributions to local civil defense funds, or to local civil defense projects for use in the community in which the contractor operates, are allowable.

(2) The reasonableness 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, and should also be judged in the light of the presence or absence of restraints occurring in the conduct of competitive business. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost.

# (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) 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, including those recognized by Section 167 of the Internal Revenue Code of 1954, as follows:
    - (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 paragraph (A),
    - (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 paragraph (B).

- (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 multishift operations.
- (4) Where a contractor has received a determination of true depreciation from an Emergency Facilities Depreciation Board relating to an emergency facility covered by a certificate of necessity, it may elect to use either normal or true depreciation. However, 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 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 shall be allowed, as such, or as a rental or use charge, on assets still in use 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 defense contracts or subcontracts. Otherwise, a mutually agreed upon use charge may be allowed. 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.

- Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, 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), (o), and (pp)).
- (1) 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 operation of such services are allowable, (i) when it is the policy of the contractor to operate such services at a profit or at cost; and (ii) when it is the policy of the contractor to furnish such services at a loss, or without cost to the employee; provided, however, that such losses are allocated to all activities served. 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, and employee insurance, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor.

Dault 18/0976

### (p) Insurance and Indemnification.

- (1) Insurance includes (i) insurance which the contractor is required to carry under the terms of the contract, and (ii) any other insurance which the contractor maintains in connection with the general conduct of his business.
- (2) Indemnification involves a contractual commitment between the Government and the contractor whereby the Government agrees to secure the contractor against loss or damage falling upon the contractor from some stated responsibility assumed by the contractor or from a stated demand of a third party.
- (3) Costs of insurance required and maintained, pursuant to the contract, are allowable.
- (4) 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 Insurance shall be limited to exclude coverage of profit, interest, and any other items of cost unallowable under this Part;
  - (iii) cost 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 protection by such insurance or reserve;
  - (iv) contributions to a reserve for a self-insurance program if the types of coverage, extent of coverage, and the rates and premiums would have been allowed had insurance been purchasable to cover the risks; and
  - (v) costs of insurance on the lives of officers, partners, or proprietors are allowable to the extent that (i) the insurance is part of an employee plan, specified in (o), and (ii) additional insurance which represents compensation

to the officer, partner or proprietors for services rendered, within the provisions of (f). Premiums for insurance in which the contractor is the beneficiary directly or indirectly are not allowable.

- (5) Actual losses not reimbursed 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.
  - (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.
- (6) The Government is obligated to indemnify the contractor for losses sustained only to the extent expressly provided for in the contract.
- (q) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, 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) /but see (x)7.
- (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 as a cost of performance of the Government contract.

# (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:

- (i) In the event the contractor accrues maintenance and repair costs based upon a regular program for the maintenance and repair of facilities in accordance with sound industrial practice, such accruals are allowable.
- (ii) In the event a contractor does not accrue maintenance and repair costs, but charges them as incurred, such charges are allowable to the extent that they are reasonable and in line with prior experience of the contractor.
- (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) This item includes the net 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 over-runs, spoilage, or defective work. These costs are allowable subject, however, to the provisions of subparagraphs (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. Where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts will be allowed.
- (3) Reasonable adjustments arising from difference between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided that 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. In determining cost of material issued from stores, the contractor's usual method of inventory costing is acceptable if in accord with generally accepted accounting principles for inventory costing. When material in stores at the commencement date of a contract have a probable replacement cost significantly different from recorded cost, either party may elect to use the replacement cost in lieu of recorded cost in costing issues of such material. 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 also be used, but the basis of pricing must be disclosed.
- (5) Sales or transfers of materials, services, and supplies between plants, divisions or organizations, under a common control, ordinarily shall be stated on the basis of cost to the transferrer. However, a departure from this basis is permissible where (i) the item is regularly manufactured and sold through commercial channels, or (ii) it is the contractor's long established practice to price inter-organization transfers at other than cost for commercial work; provided in addition, that such price is not in excess of the transferrer's sales price to its most favored customer for the same item in like quantity, or the same or substantially similar items sold by other suppliers.

- (w) Organization Costs. Expenditures, such as incorporation fees, attorney's 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, 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 distributed rateably 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. Similar consideration governs their inclusion in or exclusion from the base for overhead distribution. The amount of overtime costs, when allowable, shall be equitable in relation to (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: (i) by initial agreement between the contractor and the contracting officer that the accomplishment of the contract schedule requires the use of such premium labor to a stated or contemplated extent; and (ii) to meet unexpected emergencies arising in the course of the contract, not contemplated by the contracting parties.
- (3) Overtime, extra pay shift and multi-shift premiums are allowable as follows:
  - (i) To the extent that the contractor and the contracting officer initially agree that such premiums are necessary in order to comply with the contract schedule, such costs are allowable.
  - (ii) With respect to situations arising in the course of the contract, such costs are unallowable if the contractor is already obligated to meet the stated delivery schedule without additional compensation therefor, as in the firm fixed price type contract. Such allowance may be made in cost type contracts

and in the fixed-price incentive type and the price redetermination type contracts until the prices become fixed with the approval or ratification of the contracting officer.

- (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 by the Government, are allowable. (See also (ii) and (jj) below).
  - (aa) Pension Plans (see (f)).
- (bb) Plant Protection Costs. Costs of items such as wages, uniforms and equipment of personnel engaged in plant protection; depreciation on plant protection capital assets; and necessary expenses to comply with military security requirements are allowable.

### (cc) Plant Rehabilitation Costs.

- (1) Plant rehabilitation costs are those incurred in the restoration of the contractor's premises to approximately the same condition as that which existed immediately prior to the commencement of the military contract work, fair wear and tear excepted.
- (2) The costs of the removal of machinery, tools, and equipment, including restoration costs incident thereto, are allowable, provided such costs are not recovered, or are not recoverable, under a specific contract clause in the contract under which the costs are claimed, or in another Government contract.
- (3) The costs involved in the reinstallation of pre-existing, and the installation of new machinery, tools and equipment are not allowable.
- (dd) Precontract Costs. Precontract costs are those which are incurred prior to the effective date of the contract, are incurred directly pursuant to the negotiation for and in anticipation of the award of the contract, under circumstances in which such anticipation 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.
- (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)).

(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;
- (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) 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.
- (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. 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 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 allowable 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, contractors may seek the future advantage that follows a large research program substantially financed by Government contracts. 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.

### (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) Such expenses are allowable to the extent that the costs are allocable to Government business.
- (3) Salesmen's or agents' compensation, fees, commissions, percentages, or brokerage fees which are contingent upon or resulting from an award of a contract, are allowable only when paid to bona fide employees or 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 contract terms covering the sale of defense products include such an obligation without additional separate payment, service and warranty costs are allowable. In pricing actions which involve estimates of this element of cost, care 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. Costs of special tooling acquired for performance of the contract are allowable and shall be charged directly thereto.

### (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) 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 cost 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 and 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, and 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 to the extent reasonable.
- (2) <u>Subscriptions</u>. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.
- (3) <u>Meetings and Conferences</u>. 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 full-time 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 direct 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 Expenses.

- (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 are allowable and 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 may be charged to the contract in accordance with the principle of direct costing (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.

those who predicted "formula" pricing.

This last was accomplished by words which set forth clearly that the principles are to be used in swallesting costs only "where such evaluation is required to establish prices." Secondly, by contested duplication, we reiterated such of the pricing philosophy contained in Section III, Part 8 of AIPR by stating that "cost and accounting data may provide guides for ascertaining fair compensation, but are not rigid measures of it" and then going on to describe more fully, the degree to which costs should be evaluated in varying situations such as retrusctive, forward, and competitive pricing. Finally the principles were prescribed as a guide rather than as a basis for determining costs. "The first-price data."

This brings me to the question of what them, is the significance of the principles insofar as fixed-price contracts are concerned? These will be my emopinious, not necessarily shared by all others. The principles probably are not "legally" binding (in the strict sense of the word) on the contractor. They are not required to be incorporated in the contract. He is not even required to schmit his cost or price proposals in connection with fixed-price contractly in accordance with the principles. However, I have hopes that they will be used intelligently and in conscenance with the spirit in which they were promulgated. For example, when a disagreement revolves around a specific element of cost and there are no other overriding considerations, I will expect the principles to govern. Likewise, I would anticipate that contractors will recognize the benefits of substituting cost proposals using the principles as a guide. This would not prevent them from proposing so-called mailtonables, for consideration in negotiating a price, but they would be identified as such.

to this way, once past experience, indicates to negotiators or auditors that a contractor's proposal does not have a lot of hidden unknown's, they will be able to rely upon it as a basis for pricing with a minimum of audit and analysis. To some, it may seem that the wording used in describing applicability of the principles to fixed-price contracts represents over-captiousness to the point of ineffectiveness. They may be right. If so, the guidance will have to be strengthened after we have had some experience.

Finally I'd like to touch upon some of the problems involved in implementation, that is, in switching over from the old to the new principles. You will recall that Revision 50 of the ASPR published on 2 November 1959 prescribed mandatory use of the new principles after 1 July 1960, with persissive use upon publication. Shortly after publication, however, it became apparent that viditional policy guidelines were necessary to provide a more orderly applicaion of the principles, particularly to cost reinburgement type contracts. Our first thought was naturally that it would be desirable to avoid having two sate of principles applicable to a contractor's business. Many were of the picton that increased cost allowances, if any, under the new principles, would he more than offest by administrative savings through operating under one set of principles. Thus we first tousidered seriously a general policy finding to this effect, permitting amendment of old contracts to incorporate the new principles without a contract-by-contract analysis to determine the specific effect. The lawyers among you can readily unlerstand why we soon began to have misgivings regarding this approach. There appeared the spectra of later larges of azenizent without consideration. These misgivings were strengthened when one of our contractors offered himself as a guinem pig for test. We Spiled the problem, and concluded that mee cutover was not practical for

Averal reasons. For sample, the effect on future allowances of intependent research and development cost under old long-term contracts could not be determined because of possible changes in the level of his NAD effort. To achieve the objective of a single set of cost principles, subcontracts which he was performing under other contractor's primes would have to be amended—but this night not be practicable. Likewise he would have to smend subcontracts under his own primes. Finally, because of the almost insurmountable problems due to contract-by-contract analyses of effects, the sheer volume of old contracts, and the subcontract complication, we concluded that mass conversion would be impractical.

Thus, in the policy guidelines issued on 10 February 1960, it was indicated that existing cost reisburwement contracts would, in most instances, he costed not on the old basis. However, criteria were established to permit assemblent under circumstances wherein the administrative burden would not be unreasonable. Under these criteria, and later on, when the volume of old contracts has been reduced, we believe it will be practicable to assemble contracts to achieve the single reting basis. Obviously, on such assendment can be made without sutual content of the two parties.

As to new cost-relaburament type contracts, we want to start using the new principles as soon as possible. However, where all of a contractor's contracts are now being costed under the old cost principles, any new contracts will provide for the use of the revised cost principles, but may carry a provise for the use of the old principles for the period between the date of the contract and the end of the contractor's fiscal year. Our aim here, of course, is to minimise the schinistrative problems involved in the changeover period.

\*\*provision that I just outlined will carry the old cost principles past our

fourly stipulated mandatury date of 1 July 1960 in some cases.

In the case of existing fixed-price type contracts, we will use the new principles as a guide as soon as possible. Such use, however, will be only to the extent that it is not inconststent with any contractual provisions, understandings, or agreements established in the negotiation of the contract. As the new fixed-price type contracts, our contracting officers will be expected to use the new principles as a guide as soon as practicable, but in no event later than 1 July 1960.

In the case of fixed-price contracts terminated for the convenience of the covernment, we will use the termination cost principles which were in effect on the date of the contract. Terminated cost type contracts will, of course, to mated out in accordance with the allowable cost clause in the particular contract at the time of termination.

In these introductory remarks I have touched on only a few high spots to try to give you some of my views on why the principles are as they are, how I articipate that they will be used, but most important of all--how I believe industry, by following the dictates of good conscience and the exercise of self-cutrol, can help to avoid further expansion of red tape and Government regulation.

WERGEARCH FOR ASSISTANT SECRETARY OF PETENSE CALL) SPRINCIPAL CONTRACT CAST PRINCIPALS and Principals By minural and way 15, 1989, you requested ay depressed of the May little death of root principles. In consideration f the many divergent vices where only had to be accommodated time well area, I give my a proved.