

those who predicted "formula" pricing.

This last was accomplished by words which set forth clearly that the principles are to be used in evaluating costs only "where such evaluation is required to establish prices." Secondly, by conceded duplication, we reiterated much of the pricing philosophy contained in Section III, Part 8 of ASPR 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 retroactive, forward, and competitive pricing. Finally the principles were prescribed as a guide rather than as a basis for determining costs in the *fixed-price area*.

This brings us to the question of what then, is the significance of the principles insofar as fixed-price contracts are concerned? There will be my own opinions, 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. ^{The contractor} He is not even required to submit his cost or price proposals in connection with fixed-price contracts in accordance with the principles. However, I have hopes that they will be used intelligently and in consonance 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 submitting cost proposals using the principles as a guide. This would not prevent them from proposing so-called "unallowables" for consideration in negotiating a price, but they would be identified as such.

In this way, once past experience^{see} indicated 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-cautiousness 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 permissive use upon publication. Shortly after publication, however, it became apparent that additional policy guidelines were necessary to provide a more orderly application of the principles, particularly to cost reimbursement type contracts. Our first thought was naturally that it would be desirable to avoid having two sets of principles applicable to a contractor's business. Many were of the opinion that increased cost allowances, if any, under the new principles, would be more than offset by administrative savings through operating under one set of principles. Thus we first considered 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 understand why we soon began to have misgivings regarding this approach. There appeared the spectre of later charges of amendment without consideration. These misgivings were strengthened when one of our contractors offered himself as a guinea pig for test. We ^{in that company} studied the problem and concluded that mass cutover was not practical for

Several reasons. For example, the effect on future allowances of independent research and development cost under old long-term contracts could not be determined because of possible changes in the level of his R&D 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 might not be practicable. Likewise he would have to amend 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 reimbursement contracts would, in most instances, be costed out on the old basis. However, criteria were established to permit amendment 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 amend ^{the few remaining old} contracts to achieve the single costing basis. Obviously, no such amendment can be made without mutual consent of the two parties.

As to new cost-reimbursement 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 provision 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 minimize the administrative problems involved in the changeover period.

provision that I just outlined will carry ^{use of} the old cost principles past our

ously stipulated mandatory 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 inconsistent with any contractual provisions, understandings, or agreements established in the negotiation of the contract. As to 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 Government, we will use the termination cost principles which were in effect on the date of the contract. Terminated cost type contracts will, of course, be costed 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 anticipate 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 control, can help to avoid further expansion of red tape and Government regulation.

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SG.)

SUBJECT: Current East Principles and Procedures

By memorandum of May 13, 1957, you requested my approval of the May 1957 draft of east principles. In consideration of the very divergent viewpoints which had to be accommodated therein and the urgent need for principles in the negotiated East-West arms, I give my approval.

W. J. Kubacki

HOOVER COMMISSION

June 1955

Recommendation No. 3 - page 33

Contract cost principles. - Current efforts to revise the contract cost principles of Section XV, Armed Services Procurement Regulation, are commendable. The final products of this effort should result in a set of cost principles for cost reimbursement type contracts in keeping with recognized commercial accounting standards. These principles should be supplemented by guidelines for auditors in gathering cost information on fixed price contracts, including terminated contracts.

Hebert - Report on Aircraft Production
Costs and Profits
7/13/56

P-22,3123

VI. SALARIES, BONUSES, AND INCENTIVE PAYMENTS

These 12 companies have widely varying policies on the compensation for executives. Air Force and the Navy have different policies on allowances for salaries, bonuses, and incentive payments.

We were told during our hearings in March that the Defense Department had under consideration a definitive policy for both services. But, on January 4, 1956, and again on June 4, 1956, Air Force procurement circulars were issued, the general purport of which was that the Air Force would undertake to approve salaries in excess of \$25,000.

The Navy, on the other hand, has had no regulation and has handled executive salaries, bonuses, and incentives as cost allowances on a company-by-company basis, with no particular formula for any company.

There has not been forthcoming, from the Department of Defense, any statement of a unified policy.

Air Force Procurement Circular No. 19 of June 4, 1956, closely parallels Navy practice, as we view it. Paragraph 54-900 says that "any acceptance" of wage and salary schedules "should be considered as a determination of acceptance of costs resulting from such schedules for allocation to Air Force contracts."

Paragraph 54-904 provides that when salaries "appear as a part of a negotiated overhead rate" they must again be reviewed for acceptability.

Section 54-905(b) (1) covering salaries "in excess of \$25,000" provides for consultation and approval by Headquarters AMC "unless an agreement and approval had been reached prior to January 4, 1956," or the "contractor's proposals were not in excess of those previously approved" or if the administrative contracting officer "determines that prior approvals and authorizations ought to be reviewed, the matter should be referred to Headquarters AMC for final determination."

All of this means the same welter of confusion which has heretofore existed.

The subcommittee recognizes the importance of an adequate reward for the skilled management and executive competence. However, the subcommittee is not persuaded by company statements on the importance of salaries, or of incentive bonuses for doing a job for which a basic salary is paid and of the other devices which have been set out in the presentation of the several companies to us. We find there is no pattern among industrial concerns generally in this regard. (See exhibit A (pp. 3129 to 3139) on industrywide salaries, bonuses, etc.)

We think, in short, that the proposal to charge all executive salaries and bonuses, incentive or otherwise, as cost allowances on Government contracts, is unwarranted.

The position of the subcommittee is this:

There should be set up among all services a salary allowance schedule for

Executive compensation which could be included in the cost allowances for general overhead assigned against various contracts of the Government. Beyond such a level, which we think should be reasonably conservative, we believe that all additional compensation, be it salary, bonus, incentive payment, or the like, is a subject for payment out of the profit earned on Government contracts. It is a matter between executive officers and their board of directors to determine the use a company makes of its profits.

The Government has not stinted in supplying plant and working capital through the medium of advance capital, and balance sheets indicate that they are adequately rewarded for capital and management supplied, and are financially sound, even though almost entirely dependent upon Government business. The public has assessed that soundness in stock quotations of outstanding shares.

Earnings are clearly set forth in the foregoing tables and we think it unnecessary, in these circumstances, that excessive executive compensation should be made a part of the cost or overhead for performing Government contracts.

Contrasted with executive salaries are the salaries of their opposites in the military service who are expected to be qualified to contract in the name of the United States. We think a wage scale, which is generally GS-11, and in a few instances reaches GS-16, for men who are expected to match wits and wisdom with the representatives of the contracting companies, is grossly inadequate.

The Air Force, in testifying before the House Appropriations Committee, said that 95 percent of its procurement personnel are civilians with a tremendous value and a great responsibility resting upon them.

We recommend a reappraisal of qualifications and salaries of Government civilian procurement personnel and a prompt adjustment of salaries commensurate with responsibilities.

C O P Y

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
Washington 25, D. C.

RB

March 23, 1956

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (S&L)
DEPUTY ASSISTANT SECRETARY OF DEFENSE (COMP.)

SUBJECT: Approach to development of "one" set of cost principles

In order to avoid wasted effort, to the extent possible, in developing principles for the handling of individual elements of cost, we consider initial approval of our contemplated general approach to be desirable. It is set forth below:

1. Cost treatment should be equalized as much as possible 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., conditions surrounding the required product or services and the extent of any contingencies covering risks rather than external influences arising out of cost treatment.

2. Risk in the form of a contingency principle ought to be recognized in those instances in which there is risk exposure.

3. Our objective ought to be fairness and equity in the development of "one" set of cost principles. We should not deny nor restrict allowability of a cost otherwise fair because it would be costly to the Government, or because reasonableness of amount is difficult to assure.

4. 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.

/signed/

T. A. PILSON
Chief, Policies Branch
Purchasing & Contracting
Policies Division
OASD (S&L)

/signed/

K. K. KILGORE
Assistant Director
Accounting Policy Division
OASD (Comp.)

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
Washington 25, D. C.

November 5, 1956

MEMORANDUM FOR THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (S&L)
THE DEPUTY ASSISTANT SECRETARY OF DEFENSE (COMP.)

SUBJECT: Industry Proposals - "One Set" of Cost Principles

Attached (TAB A) is our appraisal of the five industrial proposals concerning "One Set". While there are some points upon which there is agreement, some upon which there is partial agreement, the industry proposals are not acceptable in the really important points made. We believe that industry has viewed this problem with something less than real objectivity, has been largely persuaded to its own self-interest, and has refused to see the nature of the DOD problem. In this paper, we have tried to state our problem.

This is a digest of our conclusions:

- (a) There is nothing really new in the proposals. We have read the same things as criticisms of previous Section XV drafts.
- (b) We believe that uniformity of treatment as between the several types of contracts is a MUST. Industry says "not necessarily".
- (c) We believe we must define "reasonableness" and "allocability". The words alone will not secure the needed uniformity - additional guidance must be found for some of the elements of cost.
- (d) We must reject the notion that the cost principles ought not be "explicit" or "specific". Reasonable uniformity is otherwise unobtainable.
- (e) We must establish reasonable accounting standards. "Generally accepted accounting principles and practices" is not enough.
- (f) NSIA is very close when they indicate that the principles ought to be applied in "negotiated contracts in which costs constitute to some degree a factor for consideration in contract negotiation."
- (g) If there is such a thing as an "unreasonable" or "unallocable" cost, we must state unallowability somehow. Industry must make the argument against the words to support consistently the ALL costs contention.
- (h) Indirect costs represent an important aspect of the "one set" problem. We believe that in the interest of "across-the-board" application, we must state our policies in generalized language. Furthermore, we do not believe that we can stress indirect expenses, and disregard direct - which may have been the industry goal.

- (i) Whether all "gains" obtained by industry in suits in the courts and the ASBCA ought to be considered allowable is dependent upon many circumstances. Rather than to allow the "gains" automatically, we ought to consider the items on their merits.

Where do we go from here? We suggest that the nature of the comment be revealed to industry through use of the DOD Procurement & Production Industry Advisory Committee. In light of the personal responsibility of the DASD (S&L) and the DASD (Comp.), it is our suggestion that both attend the meeting for the purpose of hearing industry present their point of view. We suggest also that the course of the meeting be controlled by limiting the subject matter to the important principles proposed by industry. Attached is an agenda which may be useful for the purpose. (TAB B)

It is our recommendation that Messrs. Pilson and Kilgore, at a minimum, be present for the purpose of exposing the industry contentions to the DOD problem, point out inconsistency of views, etc. This would enable Messrs. Lanphier and Shannon to occupy the place of judges evaluating the totality of the positions developed.

The above approach seems to be consistent with the revised modus operandi of the PPIAC.

T. A. Pilson
T. A. PILSON
Chief, Policies Branch
Purchasing & Contracting
Policies Division
OASD (S&L)

K. K. Kilgore
K. K. KILGORE
Assistant Director
Accounting Policy Division
OASD (Comp.)

- 2 Incls.
1. TAB A
2. TAB B

11/5/56

GENERAL EVALUATION OF INDUSTRY COMMENT

All Associations join in a criticism of all of the drafts of Section XV that they have seen, and their proposal for "One Set" largely represents these criticisms stated as suggestions. We do not believe that there is included in the proposals anything new.

CRITICISMS OF SECTION XV

As indicated above, there are universal industrial complaints that all editions of Section XV have been less than just and equitable. NSIA says that "the principles embody unduly severe restrictions". NAM expresses the same feeling in almost identical words. MAPI says that we talk of reasonableness but we then "negate this...general standard by an (objectionable) item-by-item specification and definition of allowable and unallowable costs". AMA discloses the restrictions to be "selling, distribution and advertising, contributions and donations, membership in and activities of trade, business and professional organizations, interest and other financial expenses, and depreciation and contingency reserves". In so doing, they say affirmatively and strongly urge that "one set" should recognize ALL of the legitimate costs of doing business without restriction.

UNIFORMITY IN COST TREATMENT

Several associations have inferred that there are cost differences which should be recognized as between the several types of contracts and particularly as between the cost-reimbursement contracts as a class and the so-called fixed price contracts as a class, BUT THEY DID NOT SAY WHAT THE DIFFERENCES WERE. They said only that cost reimbursement and pricing were not the same thing. AMA and NSIA seemed to recognize the "universal application" concept of the comprehensive set, although the latter preferred a contract clause for cost reimbursement purposes. NSIA came closest to expressing uniformity when it

TAB A

said, "... in contract negotiations some sort of rules or philosophies are logically required" and indicates that industries' apprehensions grow from the "severe restrictions" of Section XV. This raises the problem of viewing each cost element and ascertaining wherein there should be any cost difference.

COMMENT: At this time, we can see only contingencies as a possible area for different treatment, and then only where pricing judgments are future in their operation. If there are differences, industry must support them.

Since industry's "one set" proposals are the same as their criticisms heretofore levelled at Section XV, we must presume that if Section XV were to be modified to their satisfaction, uniformity would be well. Therefore, we conclude that industry believes that it is not possible at this time to get their ALL COSTS view accepted in Section XV and therefore, seek to establish the ALL COSTS basis in "one set". To do so, they must contend that there is a difference between it and cost reimbursement.

INDUSTRY ADVOCATED CONCEPTS

a. The basic objective should be one of fairness and justice to both parties to the negotiation, recognizing ALL COSTS OF DOING BUSINESS to the extent that they are (i) allocable and (ii) reasonable. Allocability and reasonableness are not further defined and, as to Section XV, industry has said that further definition is unnecessary.

COMMENT: The concepts of allocability and reasonableness are difficult. There are several possible bases for allocation, several of which are mentioned by industry. For example, NAM says, "... we recognize that there may be unusual situations wherein certain items of cost may apply in less degree to Government than to commercial business. There may be cases where none of a particular cost would apply--or perhaps 100% in other cases."

Again, reasonableness is not defined by industry, except that they

say that the expenses ought to be in accord with "good" and "sound" business practices. AMA says that whatever it is, it does not include second guessing by the Government. They say, "The principles should be based on the philosophy that the contractor has been selected because of reputation, ability and organization. Among other things, this means that its organizations must function through the judgments and discretion of its executives in accomplishing the purpose for which the contract has been let." NSIA says roughly the same thing. They say, "The Government should have the opportunity to review the accounting system of the contractor...and once approved...the results of consistent application of that system should not be questioned." We believe our definitions of the two terms, along with more detailed treatment in connection with certain individual cost elements, is the minimum acceptable.

b. The principles ought to be FLEXIBLE AND NOT EXPLICIT OR SPECIFIC. AIA suggests that the principles be stated in "broad terms". NAM says that accounting is not an exact science and precise determinations of all costs is not possible and therefore one set should not be "detailed treatment of the various cost elements...or cover peculiar circumstances or special cases." NSIA says that the principles ought to be "broad in scope, rather than detailed".

COMMENT: The DOD has always thought that its drafts provided the necessary flexibility both as to system and as to range of allowances in those expenses in which there ought to be a range of allowances. Our problem is that we can't see how we can act within any reasonable degree of uniformity of policy or practice, operating as we do in 100 plus principal purchasing offices and using some 6,000 audit personnel without some specific guidance. Furthermore, we believe that UNIFORMITY IS A MUST. In commenting on a previous Section XV draft, NSIA seemed to recognize this when they said: "the development of

uniformity of treatment by working level personnel in the application of cost principles" should be one of our objectives. We cannot see that this proper uniformity objective is achievable without guidance which is, to a proper extent, EXPLICIT AND SPECIFIC.

c. Industry reiterates that the test of a valid accounting system should be GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES, consistently applied. NAM speaks of "flexibility with respect to allowability" and "flexibility as to (accounting) systems". Only NSIA recognizes a government interest in the system. They say that the Government "should have the opportunity to REVIEW the accounting system and, where...(the) accounting system provides an equitable basis for the allocation of expenses, it should approve it. Once this is done, the results of consistent application of that system SHOULD NOT BE QUESTIONED." NSIA also speaks against "arbitrary allocation".

COMMENT: The Department of Defense is unable to fully accept either of the two above-mentioned philosophies as stated. Our experience is that a system can be developed and maintained "in accordance with generally accepted accounting principles and practices" and yet not necessarily yield costs related to the contract performance to the extent required for cost reimbursement or to support pricing judgments. Thus, we have accepted the concept in its correct sense by adding "applicable in the circumstance." The related point on "consistency" we view in the same way. Consistency is essential only so long as conditions remain static. When conditions change, a system change may be required also. Additionally, rather than BLIND TRUST as suggested, we must monitor the application of standards to a reasonable degree.

d. Industry stated that whatever principles are developed ought to be limited in their application to "COST RELATED AREAS," But the views were not unanimous as to what the cost related areas were. MAPI says that it "sees no reason for

the application of cost principles in any form to FIRM, FIXED-PRICE CONTRACTS". AMA says the same thing and adds that they ought not be applied in "instances of standard commercial product" nor to "a substantially similar modified version thereof" at least in instances in which pricing ought to be by "customary competitive factors such as quality, quantity, time of delivery, etc." NSIA states that the set ought to be applied in those "negotiated contracts...in which costs constitute to some degree a factor for consideration in contract negotiations". NSIA carves out formal advertising and competitive negotiation where "costs do not enter into the negotiations".

COMMENT: Our views are well expressed in the NSIA words. However, while in agreement that the commercial item would often be the one in which competition would tell the pricing story, we cannot see that that should be the basis for the exclusion. In the negotiated firm fixed-price contract area, estimated costs are often a very important consideration in pricing and ought to be evaluated on a consistent basis.

e. There were other ideas expressed upon which there ought to be some discussion:

1. We ought to rid ourselves of the concept of reimbursability and non-reimbursability and allowability and non-allowability.

COMMENT: Under whatever description, we can perceive of no way of expressing yes or no which the observer would accept. He actually is saying that there is no such thing as an unallowable cost. We don't agree.

2. Incorporation by reference should not occur at all, was expressed by one association. Another said that it should only be incorporated in cost reimbursement type contracts.

COMMENT: We ought to study this point carefully and to determine precisely when it ought to be incorporated by reference. In any event, we KNOW that

it should be incorporated into cost-type contracts.

3. One Association observes that direct costs do not represent a serious problem area--but notes that indirect costs do and, therefore, we should give much attention to the indirect cost area.

COMMENT: Industry, by and large, has been extremely critical of past efforts in clarifying the indirect cost area on the basis that it necessarily involves arbitrary allocation of these expenses. Accordingly, in one set we have tried to be rather general in our approach. On the basis of the present evidence, I believe that our approach is probably correct.

4. In the matter of the cost treatment of one set, one Association suggests that it ought to recognize as legitimate costs all gains for which industry has fought so hard in the ASBCA, and although not stated, they must logically say, the gains made in the courts.

COMMENT: We believe that these "gains" ought to be reappraised on an objective basis just as the other cost elements are. To the extent that this consideration indicates disallowance, they should be disallowed. ASBCA and court cases are determinations of existing facts only, which facts sometimes call for remedial action.

f. There were several other ideas expressed by industry which are generally acceptable to the DOD. These are:

1. We ought not to let this project interfere with the current emphasis upon firm fixed-price contracting.
2. Since the total price is important in fixed-price contracting, we ought not to become so preoccupied with the elements of costs to miss our fundamental target--price. Specifically, we ought not to become "profit-happy".
3. The concept of allowability may not be made dependent upon a negotiation--policy coverage must be found.
4. In pricing, the audit and price analysis aids must be made advisory if the one set target is not to result in "formula pricing".

11/5/56

PROPOSED PPIAC AGENDA ITEM ON "ONE SET"

We have received the proposals of five associations presenting their views as to the problem of one set of contract cost principles for application to all types of contracts and all contract situations. As we could expect, there are some similarities and some dissimilarities of views, and some proposals which do not now appear appropriate for application by the DOD. For this reason, I am dedicating our next meeting to this subject believing that from it will result uniformity of purpose. If so, the development work will be greatly facilitated.

Our appraisal of the industry comment brings into view the following areas for consideration:

- a. Standards of Cost. The observation is made that one set should recognize ALL COSTS OF DOING BUSINESS to the extent that they are (i) ALLOCABLE and (ii) REASONABLE. The question arises as to the meaning of allocable and reasonable. Once we reach a conclusion on this question, we will be in a position to apply it in the determination of standards of cost.
- b. To what extent should there be uniformity of cost treatment under the cost aspects of the several kinds of contracts and the several uses within the contracts?
- c. What are the specific COST RELATED AREAS in which an application of one set should be made?
- d. Ought this department specify accounting standards which may be more specific than GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES? Having determined the standard, to what extent should performance under the standard be subject to appraisal by the DOD, particularly as to Allocability and Reasonableness.

TAB B

- e. Is uniformity of treatment a valid objective? If so, how can we achieve it if our principles are FLEXIBLE, NOT EXPLICIT OR SPECIFIC, and STATED IN BROAD TERMS?
- f. How can one set be cast in terms of yes and no in relation to elements of cost if we do not do it in terms of reimbursability and non-reimbursability and allowability and non-allowability?
- g. In what situations should one set be incorporated by reference?
- h. How should we cover the difficult area of indirect cost? In terms of importance, should it be stressed in comparison with direct costs?
- i. Should the items determined allowable by the ASBCA and the courts be considered allowable without reappraisal?
- j. How can we best prevent the publication of one set from interfering with the current emphasis on firm fixed-price contracting?
- k. How can we best prevent a preoccupation with costs in negotiation resulting in failure to negotiate price?

June 11, 1957

THE PROBLEM OF ADOPTING A NEW SET OF COST PRINCIPLES

Background

In the summer of 1953, Mr. Bordner, of Mr. McNeil's staff, submitted for consideration of the military departments a set of cost principles which he had drafted which were intended to be applicable to all types of contracts. These were immediately opposed by the military departments for a variety of reasons, principally because it was believed that the "Applicability" section of these principles would tie the hands of negotiators in negotiating the prices of risk contracts, would subject all pricing to after-the-fact cost and profit reviews and would require a justification of negotiated forward pricing in terms of which projected costs were allowed and which were disallowed. It was felt that this would hamstring bargaining, compromise and negotiated conclusions.

As a result a meeting was held in the summer of 1953 attended by Mr. McNeil and Mr. Bordner and by Mr. Webster of S&L, with procurement representatives of the three military departments. It was concluded at this meeting that the problem would be given to an ASPR subcommittee made up of audit and procurement representatives of the three services. They were to use Mr. Bordner's statement as the take-off point for drafting a revised set of cost principles applicable to cost reimbursement contracts only (to replace the very general statements now in Part 2 of Section XV of ASPR for this purpose). It was agreed that after completion of this effort, but before publication, the product would be reviewed to determine its suitability for use as a comprehensive set of cost principles and decision as to how to publish would be reserved for that time.

The ASPR subcommittee was formed and had exhaustive meetings, usually two or three a week, through much of 1954 and 1955. Every word was carefully considered. Departmental positions were formed, compromised or fought out on a wide variety of minor issues. The subcommittee report was finally submitted to the ASPR Committee with a number of issues remaining. The ASPR Committee, through part of 1955 and into 1956, considered these issues, resolved many and ultimately submitted the package, with a few unresolved issues to the Materiel Secretaries.

During the final ASPR considerations and while ^{under} consideration by the Secretaries - through much of 1956 - a pattern in these issues became apparent. The Air Force, because it does such a high percentage of its

business with contractors who are almost entirely in government work and who, therefore, are not substantially subject to the discipline imposed by the necessities of commercial competition, was in favor of disallowing several elements of cost, such as "profit sharing incentive compensation", which the other departments favored allowing to the extent such costs were kept within reasonable limits. These issues along with the whole package were submitted to Mr. Wilson in December of 1956 and again in March of 1957. His decision has been to treat profit sharing costs, most advertising expense, all contributions and donations, general research expense not specifically treated in the contract, sales expense other than consulting engineering and the like, and a few other less important items as wholly unallowable. His decision was clearly based on the concept that these principles were applicable only to cost-reimbursement "no-risk" contracts.

By agreement between Mr. McNeil and Mr. Lanphier, a member of each of their staffs, Mr. Kilgore and Mr. Pilson, did very extensive work during 1956 and early 1957 in the drafting of a comprehensive set of cost principles. This was completed and submitted for your consideration on 2 April 1957. This draft acknowledges and accepts in principle a statement of the applicability and use to be made of this comprehensive set of cost principles which, in my opinion, would now be acceptable to the military departments. A copy of this statement is attached. It is considered very important in a resolution of this problem. In its content, the comprehensive set of cost principles is far less rigid in its disallowances than Part 2 of Section XV. It is based on the concept that no legitimate cost of doing business is automatically unallowable although certain costs which have nothing to do with the conduct of government business are normally not allocable to us and many costs, though allowable and allocable to us, may be so unreasonable in amount as to be unacceptable. In other words, it substitutes careful and realistic administration for automatic disallowance. The administration will be more difficult in industries not subject to competitive disciplines and, hence, Air Force objections to this comprehensive set of cost principles can be anticipated.

Over this same period of time there have been two, and possibly more, official letters from the Comptroller General of the United States to Mr. Wilson urging the rapid adoption by the Department of Defense of a single, comprehensive set of cost principles applicable to all types of contracts. The last of these letters dated March 11, 1957 is still unanswered.

In its reports two years ago and again last year, the Special Investigations Staff of the House Appropriations Committee (originally the Flatley group) strongly urged the adoption of a single, comprehensive set of cost principles. In its report to the House in connection with the current DOD budget, the Appropriations Committee restated this need in emphatic terms.

In its hearings and report on aircraft procurement last year the Special Investigation Subcommittee of the House Armed Services Committee (the Hebert Subcommittee) brought out and stressed the fact that the practices of the Navy and the Air Force with respect to cost allowances in airframe contracts were different. This Committee pointed out that it was the immediate responsibility of the Department of Defense to eliminate these differences. On May 15 of this year, the Special Counsel of this Subcommittee, in a letter to General Ghormley, has put us on notice that the same issues will again arise in the hearings on procurement of aircraft engines next month. This Committee talks in terms of Part 2 of Section XV of ASPR and they might be satisfied if that Section were issued. However, the contracts they have investigated have been largely of the incentive type or other negotiated types not directly affected by Section XV, Part 2.

In the past, audits in connection with pricing have been conducted in the light of the present Part 2 of Section XV. Hence, the cost principles which are contained therein to govern questions of cost allowability under cost reimbursement contracts are also used by the auditor in setting out costs for special consideration by the negotiator when preparing advisory audits in connection with negotiated price contracts. To a very large extent, then, costs which are disallowed as a matter of regulation under cost reimbursement contracts are, in fact, excluded from pricing in other contracts. Hence, if the proposed Part 2 of Section XV were issued with its rather stringent disallowances, it would inevitably be carried over into the pricing of other types of contracts. This might have the effect of rendering it more difficult to adopt less stringent rules with respect to such other types in the future.

Summary of Present Situation

We presently have available for issuance to replace Part 2, Section XV of ASPR a proposed set of cost principles applicable by its own terms only to cost reimbursement contracts. This has been fully coordinated within the Department of Defense. When coordinated with industry there was considerable objection to its restrictions. The changes made as a result of discussions with Mr. Wilson, all of which added restrictions, have not been coordinated with industry.

We also have a complete draft of a comprehensive set of cost principles which has received no coordination, either with industry or within the Department of Defense.

The present line-up of the parties at interest is believed to be as follows:

Mr. Wilson has approved Part 2, Section XV and would have been willing to issue it but for Mr. McNeil's objection. Mr. Wilson has not seen the comprehensive set and there are differing guesses as to whether he would approve it.

Mr. McNeil is completely opposed to the issuance of Part 2, Section XV both because he considers it too restrictive and because he feels that the real need is for a set of cost principles for comprehensive application and not for a new set of principles for cost reimbursement.

The Air Force wants Part 2, Section XV issued immediately and can be expected to oppose the present draft of the comprehensive set either before or after the issuance of Part 2 of Section XV.

The Navy and the Army both feel that the present draft of Section XV, Part 2 is too restrictive, but would vastly prefer to have it issued to inaction. They point out the real embarrassment that continued DOD inaction in this field can cause all of us. They both recognize a continuing need for a comprehensive set of cost principles and probably, but for the delay factor, would generally support the new draft.

Industry can be expected to react violently if Section XV, Part 2 is issued in its present form. They will object both to its restrictions and to the fact that they were not consulted as to those which were most recently incorporated.

Arguments Concerning the Immediate Issuance of Part 2 of Section XV

In favor of immediate issuance

1. It is finished, coordinated and agreed to in detail by Sec/Def.
2. It is the culmination of a vast amount of committee work. It will pin down, for the record, a large number of agreements on principle and language which were reached only after much effort and compromise.
3. It will probably satisfy the Hebert Subcommittee in connection with its July hearings.

4. It is likely that the principles will be used in connection with all pricing and, therefore, the effects of a comprehensive set can be achieved immediately.

Opposed to issuance

1. We have presently in ASPR, a set of cost principles applicable to cost reimbursement contracts. There is no particular need for a new set. What is needed is a set which is applicable to all contracts.
2. Because of its austerity, industry will fight it as hard as possible. This opposition is likely to lead to firm industry opposition to any comprehensive set for fear that this, also, would reflect this pattern of disallowances. Industry opposition will be particularly strong because they were not consulted on the most recent changes.
3. Part 2, Section XV will not satisfy the GAO or the House Appropriations Committee since, by its terms, it is only applicable to cost reimbursement contracts. They specifically want a comprehensive set.
4. Part 2, Section XV, which will probably be used to some extent in connection with all pricing, is unsuited for such use. It treats as unallowable or requires special contractual treatment of costs which most parties would agree should be allowed if incurred subject to the disciplines of commercial competition. The allocation of such costs to government work should be controlled as to reasonableness but they should not be uniformly disallowed. This is the wrong way to arrive ultimately at a suitable comprehensive set.

Special Arguments Related to Proceeding with the Presently Drafted Comprehensive Set

In favor of proceeding

1. Such a set now appears feasible since we can apparently now agree with the Comptroller on our "applicability" section.
2. If there were not extended internal disagreements, it could probably be coordinated quickly.

3. If we were to proceed on this basis immediately, we could probably satisfy the Hebert Subcommittee in July and satisfy the Appropriations Committee and GAO quicker than any other course.

Opposed to proceeding

1. The Air Force will immediately oppose it and, hence, a delay is inevitable.
2. The Air Force will probably bring the proposed treatment of such factors as "profit sharing incentive payments", "advertising", "contributions and donations", "general research", et al to Mr. Wilson's attention immediately. While Mr. Shannon thinks that Mr. Wilson will agree to a different treatment of such costs in cost principles used predominantly for negotiating risk contracts, as contrasted with principles used in cost reimbursement, this is not clear. In any event, the comprehensive set cannot be issued without joining this issue before Mr. Wilson.

Conclusion

In view of Mr. McNeil's opposition to issuing Part 2, Section XV in its present form and the Air Force insistence on this issuance, coupled with the predictable Air Force opposition to the presently drafted comprehensive set it is clear that another decision by Mr. Wilson is inevitable. It would be very desirable if such a decision were a comprehensive one that resolves all of the issues that appear in this paper. The parties principally at interest should be able to present their arguments to Mr. Wilson. This could not be done as matters now stand, since neither the Air Force nor the other military departments has yet seen the comprehensive set of cost principles. Hence if we were to seek a final decision on all issues from Mr. Wilson, we would first need a briefing session with the military departments and we would have to allow them enough time to marshal their arguments on these issues.

It is my opinion that we should support the comprehensive set in substantially its present form.

If Mr. Wilson will not approve this set I think we should proceed with the issuance of Part 2, Section XV.


G. C. BANNERMAN
Director for Procurement Policy

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

August 21, 1957

MEMORANDUM FOR MR. McGUIRE

Marked in red

There are attached the sections of the cost principles which remain in dispute. These are ~~the~~ section on contributions and donations and the sections, within the compensation article, on stock options and profit sharing bonuses.

In the attached, these elements of cost are all shown as allowable subject to limitation. In each case the Air Force wants them shown as unallowable. Our compromise proposal has been to treat contributions and donations and stock options as unallowable with ~~executive~~ profit sharing bonuses as allowable.

All other elements of the cost principles has been agreed to by all three services in principle and the issues listed above are all that remain.

Bannerman

G. C. BANNERMAN

Attachments

A 9407

*
15-204.1 (b) The extent of allowability of selected costs covered in ASPR 15-204.2 has been stated so as to apply broadly to many accounting systems in varying contract situations. Thus as to any given contract the reasonableness and allocability of certain of the items of cost identified below in this paragraph (b) may be difficult to determine, particularly in the case of contractors whose business is predominantly or substantially with the Government. In order to avoid subsequent disallowance based on unreasonableness or non-allocability, the extent of allowability of such costs should be specifically negotiated and agreed to in advance of the contractor's incurring such costs under cost-reimbursement type contracts, fixed price incentive contracts, and fixed price contracts subject to retroactive 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.

✓

See pages 2 & 3

(f) Compensation for Personal Services.

(1) General.

a. Compensation for personal services includes all remuneration paid or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses, incentive awards, employee stock options, fringe benefits, and contributions to pension, annuity, stock-bonus and profit-sharing plans. ^{Retirement} Subject to the limitations set forth in this paragraph (f), such costs are allowable to the extent that the total compensation of individual employees, in whatever form paid, is reasonable for the services rendered.

b. Compensation is reasonable to the extent that the total amount paid or accrued, in whatever form, is commensurate with compensation 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 actually 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 included in (i) and (ii) above or (iv) to persons who are committed to acquire a substantial financial interest in the contractor's enterprise. In addition, compensation expenses must be particularly scrutinized in light of the presence or absence of the restraints occurring in the conduct of competitive business.

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

d In addition to the general requirements set forth in a through c above, certain forms of compensation are subject to further requirements as specified in (2) through (10) below.

(2) Salaries and Wages. Salaries and wages for current services include gross compensation paid to employees in the form of cash, products, or services, and may include payroll taxes, workmen's compensation insurance, and the cost of supplemental unemployment benefit plans, and are allowable subject to the qualifications of (8) below. Deferred wages and salaries are allowable to the extent authorized in (6) below.

(3) Cash Bonuses and Incentive Compensation. Cash bonuses and incentive compensation ^{AF} (whether or not) dependent upon or measured by profits based on production, cost reduction, or efficient management or performance, and suggestion awards and safety awards, ^{Not} 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. (But see ASPR 15-204.1 (b)). Deferred bonuses and incentive compensation are allowable to the extent authorized in (6) below.

** Reference is attached as last page*

(4) Bonuses and Incentive Compensation Paid in Stock. Costs of bonuses and incentive compensation paid in the stock of the contractor or of an affiliate, are allowable to the extent set forth in (3) above (including the incorporation of the principles of paragraph (6) below for deferred bonuses and incentive compensation), subject to the following additional require-

ments:

- (i) valuation placed on the stock shall be the fair market value, determined upon the most objective basis available; and
- (ii) accruals for stock prior to acquisition by the employees shall be subject to adjustment according to the possibilities what the employees will not acquire such stock and their interest in the accruals will be forfeited.

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (6) c and d below. (But see ASFR 15-204.1 (b)).

out (5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate, shall be allowed to the extent that the market value of the stock exceeds the option price at the date the option is granted. If employees are given the opportunity to purchase stock of the contractor at a certain time or during a certain period (other than through a stock option) the excess of the market value of the stock over the cost to the employee shall be allowed as a cost. The current market value of the stock shall be determined according to the criteria set forth in (4) above. If the exercise of an option is conditioned upon future contingencies, the cost shall 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 shall be adjusted according to the principles set forth in (6) c below.

sh (6) Deferred Compensation

a As used herein, deferred compensation includes all remuneration, in whatever form, for services currently rendered, for which the employee

is not paid until after the completion of the year in which the services are rendered, 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) disability, withdrawal, insurance, survivorship, and similar benefits, and (iii) other deferred compensation, such as salaries and wages and bonuses and incentive awards, whether paid in cash or in stock.

b Deferred compensation is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all other compensation paid to the employee, reasonable in amount; and (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, which constitutes, in effect, an agreement to make such payments. (But see ASFR 15-204.1(6)).

c In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally give rise to adjustment in contract costs. Adjustments for normal employees 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.

- (7) Fringe Benefits. See (o).
- (8) Overtime, Extra-Pay Shift and Multi-Shift Premiums.
See (y).
- (9) Training and Education Expenses. See (qq).
- (10) Insurance and Indemnification. See (p).

THE CONTINUATION OF THE EXISTING SET OF PRINCIPLES WITHOUT CHANGE. THE AIA HAD, HOWEVER, PREPARED MERITORIOUS COMMENTS WHICH WERE NOT FORTHCOMING, AND WHEN IT BECAME EVIDENT TO MR. MCILLAN OF THE AIA STAFF THAT WE WERE GOING AHEAD WITHOUT CONSIDERING THE AIA POINT OF VIEW AT ALL, HE INFORMALLY BOOTLEGGED A COPY FOR OUR CONSIDERATION. WE THEREUPON CONSIDERED THE AIA VIEW UPON THE MERITS AND DISCARDED THEIR DESIRE FOR A CONFERENCE AND THEIR DESIRE TO KEEP THE COST PRINCIPLES AS IS.

This "final" effort culminated in a meeting with all of the industrial associations on May 21, 1956, which was held for the purpose of informing industry of our final decisions. Notwithstanding the fact that there had been a succession of efforts with industry, industry strongly protested the procedure and indicated a desire to provide another comment on the basis of the draft distributed shortly before the 21 May meeting. Notwithstanding the fact that the latest comments were largely repetitions of comments previously submitted, we endeavored to consider their points of view anew. This effort was finally terminated with the preparation of a draft dated September 27, 1956. In light of the industrial differences, together with the fact that the Air Force was reluctant to accept one of the principles regarding a major item of cost, Mr. Laphier decided to confer with the Secretary of Defense and his Deputy about the problem.

COMPREHENSIVE SET OF COST PRINCIPLES: As indicated above, within the DOD there are currently two sets of cost principles for use, (1) in reimbursement of cost under cost-reimbursement type contracts and (2) as a basis for termination settlements. The GAO, certain Congressional groups and the Comptrollers (OSD and the military departments) have noted that these uses did not cover completely the areas of procurement in which costs represented a significant feature of the negotiation. Thus, they observed, costs are an important consideration in the development of price but there were no standards of cost to apply in aid of the judgment. This resulted in a misuse of Section XV for the broader purpose. It is estimated that approximately 15% of our procurement appropriation is spent under these so-called fixed-price contracts and without a yardstick to measure the cost. In facing this problem before the House Appropriations Committee, Secretaries Pike and McNeill agreed with the Committee that this problem should be explored and each designated one representative to more fully develop the proposed comprehensive set. At the meeting with industry on May 21, 1956, industry was taken into our confidence with respect to the project and an invitation was issued to the industrial associations to provide their philosophical proposals, which they believe should underlie the broader principles. As of November 5, 1956, five associations had submitted proposals.

Attached are three papers dated November 5, 1956, reporting:

- (1) The Task Force's report on their principles, including a digest appraisal of the comments;

yes or no

(h) Contributions and Donations.

(1) Reasonable contributions and donations to established nonprofit charitable, scientific, and educational organizations are allowable if 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) are contributions to local civil defense funds, or to local civil defense projects for use in the community in which the contractor operates. (But see ASPR 15-204.1(b)).

*← Refer to attach 1 as last page **

(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.

Office Memorandum • UNITED STATES GOVERNMENT

TO : Mr. G. C. Bannerman
Director for Procurement Policy

DATE: 18 July 1957

FROM : T. A. Pilson
Procurement Policies & Regulations Div.

SUBJECT: Comprehensive Set - Rationale for Allowability of Stock Options as Compensation.

In the "comprehensive" set, the compensation principle has been entirely recast. In so doing, we have accepted two basic concepts, strongly urged by industry in the industry proposals.

- (i) That if the expense is payment to the employee for services rendered, IT IS A COST to the contractor, and
- (ii) If it is a cost to the contractor, the DOD has the fundamental obligation to allow it, insofar as the compensation is reasonable in amount in light of the services rendered.

The above results in the conclusion that the DOD should not concern itself with the compensation technique employed, but should dedicate its attention to the more basic question, i.e., whether the total compensation to the individual, whatever technique or combination of techniques is employed, is reasonable in light of the services rendered.

We believe that the treatment provided in the "comprehensive" set results in fairness to the government and to the contractor. In the past development of the compensation principle, we have heard the argument that reasonableness of expenses is difficult to assure under certain of the techniques, and to allow as a cost the expenses of certain techniques would result in greater expenditures for defense products. In connection therewith, attention is called to the basic principles adopted at the outset of the "comprehensive" effort, wherein it is stated:

"Our objective ought to be fairness and equity in the development of 'one set' of cost principles. We should not deny nor restrict allowability of a cost otherwise fair because it would be costly to the government, or because reasonableness of amount is difficult to assure."

In any event, we believe that difficult fairness is to be preferred over simplified inequity.

The question arises as to whether the costs of stock options are to be considered as compensation of the individual for services rendered. If they are, the principle ought to be one of allowability of the stock option technique. The Supreme Court decided a case recently which gives guidance on this problem, and to us, conclusive guidance. The Case is Commissioner of Internal Revenue, Petitioner, v. Philip J. Lo Bue, 76 S. Ct 800. In that case, Lo Bue was given a series of stock options to purchase stock at great bargain prices, by his employer, in recognition of

of his "contribution and efforts in making the operation of the company successful." Lo Bue exercised his option to his advantage. In the suit for taxes on the gain, Lo Bue contended that:

"The said options were not intended by the Corporation or the petitioner to constitute additional compensation but were granted to permit the petitioner to acquire a proprietary interest in the Corporation and to provide him with the interest in the successful operation of the Corporation deriving from an ownership interest."

The Tax Court stated the issue this way:

"Lo Bue had a taxable gain if the options were intended as compensation but not if the options were designed to provide him with 'a proprietary interest in the business'".

The Supreme court ruled that the option gain was compensation. The syllabus of the case stating:

"When assets are transferred by an employer to an employee to secure better services, they are 'compensation' and it makes no difference if the compensation is paid in stock rather than in money."

"Where employee received very substantial economic and financial benefit, consisting of stock options, from his employer because of employer's desire to get better work from employee, this was 'compensation for personal service'"

Since, as the Court observed, the stock option technique was a method of providing "compensation for personal services," and since it is the fundamental premise of this paper that the total amount of the compensation is the critical consideration as to the allowability of the costs, we believe that a proper use of the technique must be "allowable."

The one possible argument against allowability of the technique is to contend that the item relates to the capital of the company and is therefore not a cost which can be allocated to the contract by reason of the definition of allocable cost (15-201.2) as follows:

(iii) Thus, a cost allocable to the Government contract is one which:

d. does not involve transactions relating to the capital of the business,"

The Lo Bue case did not, of course, cover specifically the problem of proper treatment of the expense by the contractor. It did, however, say this:

"Thus, at the end of these transactions, Lo Bue's employer was worth \$8,230 less to its stockholders and Lo Bue was worth \$8,230 more than before."

It must be pointed out that the "capital" argument applies in equal force to stock bonuses (paragraph iii), as both relate equally to capital of the Company. As to

stock bonuses, so far as we have been able to determine, the technique is presently allowable, has been allowable in all recent drafts of Section ~~Xv~~, at least not disapproved by the Material Secretaries Council in its many considerations of the Compensation principle.



DEPARTMENT OF DEFENSE
OFFICE OF GENERAL COUNSEL
WASHINGTON 25, D. C.

August 6, 1957

MEMORANDUM FOR MR. G. C. BANNERMAN
Director for Procurement Policy
Office of the Assistant Secretary of Defense
(Supply and Logistics)

SUBJECT: Treatment of Stock Option Arrangements as Costs by Contractors

Reference is made to your memorandum dated July 25, 1957, in which you ask the question whether it is legally proper for the Government to pay as part of the cost of a contract the amount that represents the difference in the fair market value of stock in the company and the price at which the stock is offered an employee under an employee stock option plan.

While it is technically legal for the Government to compensate a contractor for any legal expense, the question arises whether or not the Government should compensate a contractor for an expense not permitted as a business expense under Section 162 of the Internal Revenue Code of 1954.

Section 421 of the Internal Revenue Code provides that if an employee purchases stock under a restricted stock option, no income shall result to the individual at the time of transfer of such share upon his exercise of the option and that no deduction is allowable to any time to the employer under Section 162 (relating to trade and business expenses).

A restricted stock option is defined as an option granted to an individual for any reason connected with his employment by a corporation, if granted by the employer corporation or its parent or subsidiary corporation, to purchase stock of any such corporations, but only if —

- a. the option price is at least 85 per cent of the fair market value at such time of the stock subject to the option,
- b. the option by its terms is not transferable by such individual except by will or laws of descent and distribution, and is exercisable during his lifetime only by him,

0820 (235)
1821 VTC IS VN 8 48


RECEIVED

- c. the individual does not own more than 10 per cent of the total combined voting power of all classes of stock (with certain exceptions), and
- d. the option is not exercisable after the expiration of ten years from the date the option is granted.

It is understood that a preponderance of the employee stock options are now of the restricted type in order to permit the employee to avoid an increased income tax. It would appear anomalous for the Department of Defense to be more generous than the Internal Revenue Service.

Although your memorandum did not raise the question, this office expresses an interest in item (cc), Taxes, on page 26. This area is currently under consideration by this office as a result of litigation in California. We would like to look further into this proposed section and desire to comment on the subject at a later date.

RECEIVED


Jack L. Stempler
Assistant General Counsel (Logistics)

(1732) 0240

84 9 MA 15 BUA TEE

RECEIVED



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

SEP 27 1957

SUPPLY AND LOGISTICS
CD

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

*Decided to try the
in for a way in prelim in my plan.*

There is attached a comprehensive set of contract cost principles, designed for use in all types of pricing situations where costs are a factor in our contracts with commercial organizations. These principles will be used for accumulating, reporting and evaluating costs and cost estimates in connection with fixed price negotiations, price redetermination negotiations, cost allowances in cost reimbursement contracts and in the settlement of terminated contracts. Thus they will be used in connection with contracts having a high element of risk as well as in contracts with relatively little risk. Subject to the resolution of one remaining issue, which is described below, it is proposed that this set of cost principles be furnished immediately to the industrial associations for comment and, after full consideration of such comments and appropriate modifications of the principles, that they be incorporated in the Armed Services Procurement Regulation.

This set of cost principles is the result of an immense amount of work by many people. A large number of controversial issues have been resolved and the resultant principles, subject to one unresolved issue, have the full support of all interested elements within the Department.

The remaining issue is concerned with the treatment of cash bonuses and incentive compensation which are dependent upon or measured by profits. The Secretary of the Air Force is of the opinion that this portion of compensation should never be allowed or treated as a cost. The other Departments, Mr. McNeil and I are of the opinion that, where a contractor's income is predominantly derived from non-governmental work or from governmental work obtained as a result of price competition or from a combination of the two, the payment of bonuses or incentive compensation dependent upon or measured by profits should be allowed or treated as a cost provided the total compensation is reasonable. There are attached statements in support of each of these positions.

Inclosures

Perkins McGuire
PERKINS MCGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

10/78

1957

100

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SAL)

SUBJECT: Short History of the Cost Principles Problem

BADGES: Within the ASRA there are two sets of cost principles, (i) Section IV, directed for use ONLY for the reimbursement of costs under cost-reimbursement type contracts, and (ii) Part 4, Section VIII, Termination, a set slightly different from IV, for the use as a basis for Termination Settlements. Both sets are similar in format, but as indicated above are slightly different in treatment of the elements of cost. The format is one of merely naming the items of cost under three headings:

- (i) examples of items of allowable cost,
- (ii) examples of items of unallowable cost, and
- (iii) examples of subjects requiring special consideration.

The law, certain Congressional groups and the Comptrollers (GSD and the military departments), as well as the procurement elements of the Department of Defense have been critical of this format, contending that the principles should be considerably amplified by (i) providing a definition of each of the elements of cost and (ii) such additional guidance as will minimize the need for departmental implementation.

In addition to these, there was a general feeling that the existing principles ought to be reviewed and perhaps adjusted to provide a more equitable coverage of certain items of cost incurred by the contractor.

REVISION OF SECTION IV: Over a period of several years, several drafts have been submitted to the TIS industrial associations with whom we customarily coordinate our activities. As might be expected, the various elements of industry reacted differently. In General, the National Security Industrial Association, the National Association of Manufacturers, Machinery and Allied Products Institute, the Radio-Electronics-Television Manufacturers Association and the Automobile Manufacturers Association have provided useful philosophical guidance, which they desire that we substitute for that contained in the draft being criticized and constructive word changes embodying their proposed philosophies. The Aircraft Industries Association INTERESTINGLY DID NOT OFFICIALLY RESPOND AT ALL ON THE MERITS OF ONE SUCH DRAFT. THEIR RESPONSE WAS A SIMPLE ONE PAGE LETTER WHICH SAID IN EFFECT THAT ALL OF THE PHILOSOPHIES INCLUDED IN THE DRAFT WERE WRONG AND THAT CONSEQUENTLY THEY WOULD PREFER

- (ii) a full evaluation, including in more precise terms the industrial comment and more fully our appraisal, and
- (iii) a proposed Procurement and Production Industry Advisory Committee Agenda Item, reporting a proposed method of going ahead with the problem.

Since November 5, 1956, KEFMA has provided additional comment, which, to some extent, supports the staff appraisal but in material respects emphasizes the points of view already expressed by the other associations.

W. K. GORMLEY
Brigadier General, USA
Staff Director
Purchasing & Contracting
Policies Division

1 Incl.
Memo for Dep. Asst. Sec. Def. (Sal.)
and Dir. Asst. Sec. Def. (Comp.)
with Tabs A and B

Prepared by: TAPilson/lsh/1-18-57
KB 3-D-773 x72026
Coordinated with:
KB, Col. A. Fregosi _____



NUMBER 4105.49
DATE April 8, 1958

ASD(S&L)

Department of Defense Instruction

SUBJECT

Contractors' Costs for the Recruitment of Engineering
and Scientific Personnel

I. PURPOSE

The purpose of this Instruction is to prescribe the basic policy to be followed and the basic criteria to be used in determining reasonableness of costs incurred by contractors in connection with the recruitment of engineering and scientific personnel.

II. APPLICABILITY

The provisions of this Instruction apply in all cases where the determination of reasonableness of subject costs is a necessary adjunct to proper contract pricing.

III. GENERAL

There exists a strong nationwide demand for engineering and scientific personnel created by the rapid pace of technological development. This, together with the fact that the supply of such personnel is limited, has brought about an intense competition to recruit and hold qualified personnel and has led to costly recruitment programs and practices. This in turn has pointed up the need for assuring that contractors' recruitment costs are maintained at a reasonable level. Statistical data compiled with respect to selected contractors reveal extremely wide differences in such important conditions affecting recruitment as the nature of operations, the size of engineering and scientific staffs maintained, the amount and nature of recruitment costs incurred, the number of new employees hired, and the rate of employee turnover. In view of these differences, it is clear that the establishment of fixed quantitative standards to measure reasonableness is not practicable and that reasonableness must be judged on a case-by-case basis.

IV. POLICY

Reasonableness of recruitment costs will be determined on a case-by-case basis, taking into consideration all of the conditions bearing on the particular case, including the magnitude of the recruitment problem, the effectiveness of the control and administration exercised with respect to the formulation, direction and cost of recruitment programs and practices, and the effectiveness of the recruitment programs and practices themselves.

V. CRITERIA

In determining reasonableness of recruitment costs, due weight shall be given to the following criteria:


- (1) Evidence of effective budgetary control of recruitment costs.
- (2) Evidence of effective administrative control and direction in the formulation and operation of recruitment programs.
- (3) Evidence of other effective controls and reviews to detect and prevent indiscriminate, imprudent, and costly recruitment practices.
- (4) Evidence that the size of the engineering and scientific staffs recruited and maintained is in keeping with workload requirements.
- (5) Evidence of effective analysis to determine the cause and effect of the rate of employee turnover.
- (6) Evidence that payments of allowances to new and prospective employees are reasonable and governed by established policy.
- (7) Evidence that salaries and fringe benefits, including educational benefits, offered to new employees are reasonable and governed by established policy.
- (8) Evidence of violations of recruiting ethics in the form of proselyting.

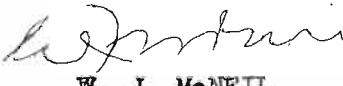
VI. IMPLEMENTATION

Each military department shall take appropriate action to assure that its existing instructions are consistent with this instruction. Four copies of existing or additional Instructions necessary to implement this Instruction will be submitted to the Assistant Secretary of Defense (Supply and Logistics) within 30 days from the date hereof.

VII. EFFECTIVE DATE

This Instruction is effective upon publication.


PERKINS MCGUIRE
Assistant Secretary of Defense
Supply and Logistics


W. J. McNEIL
Assistant Secretary of Defense
Comptroller

1/29/58

COMMENTS ON AIRCRAFT INDUSTRIES ASSOCIATION
STATEMENT TO SECRETARY OF DEFENSE
22 January 1958

CONTRACT COST PRINCIPLES

Cost principles for use in connection with cost-reimbursement type contracts have existed in one form or another since 1940. However, there has existed no guidance with respect to the handling of costs in connection with other types of negotiated contracts. These "other types," constituting some 67% of our procurement over the past six years, include reimbursable, incentive, and negotiated firm fixed-price contracts in which costs are often a major factor in determining price.

We have long recognized the need for cost principles for use in connection with the various types of so-called fixed-price contracts. More recently considerable pressure has been brought to bear by the Congress, the Comptroller General, and other outside organizations for adoption of cost principles of broader application.

AIA's major point in this connection is that cost principles should apply only to cost-reimbursement type contracts and that a separate set of guidelines should be established for use by auditors in gathering data with respect to fixed-price contracts. This view has received little support, either within or without Government. Costs are costs whatever the nature of the contract. Only the influence of those costs on pricing differs according to the type of contract and the individual conditions surrounding a particular procurement.

Under the existing condition in which there is no guidance relative to costs under fixed-price contracts, there is nonuniformity of treatment as between military departments, within departments, and between

contractors. As a result, whether certain costs, such as advertising, profit-sharing, and certain research, are considered in establishing a price depends upon policy of the negotiating agency, or bargaining position or negotiating ability of the contractor. Our position is that we must establish cost principles on a basis that will equalize cost treatment between the several types of contracts so that one type of contract will be neither less nor more attractive to either party by reason only of the cost treatment.

The other specific criticisms of the proposed principles by AIA will be covered in more detail in connection with our analysis of comments received from all of industry.



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS
CD

JUN 18 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Since 1949, the Armed Services Procurement Regulation has contained a very brief statement of the principles relating to the allowability of manufacturers' costs for use in connection with payments under contracts which are on a cost reimbursement basis. This statement has contained principally three listings, first, those types of costs which are regularly allowable, second, those which are regularly unallowable and, third, those which are allowable only to the extent specially treated in the contract. The regulations have contained no principles or policy guidance with respect to the method of dealing with costs or cost estimates in contracts of types other than cost reimbursement contracts.

For nearly five years there has been increasingly intensive pressure on the Department for the development of a new set of cost principles which would both give more detailed and precise policy guidance in the treatment of many cost elements and would be applicable to all types of contracting or contract settlement situations. Specifically, the adoption of such a uniform, comprehensive set of cost principles has been strongly advocated by the House Appropriations Committee, the Comptroller General of the United States, and the Hoover Commission.

We have been in the process of developing such a comprehensive set of cost principles for several years. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of cost principles has been a slow process. By last fall we had obtained sufficient agreement among the different elements within the Department of Defense to be able to issue a draft of the proposed principles to various industrial groups for their comment. These comments, which for the most part were quite critical of the proposed draft, have been reviewed, evaluated and thoroughly discussed with Assistant Secretary McNeil and the Materiel Assistant Secretaries of the three military departments preparatory to our undertaking discussions with industry groups in an effort to resolve our differences to the extent practical.

5325

Prior to our discussions with industry I believe that you should be aware of the policy approaches that we propose to take.

The industry comment was critical with respect to each element of cost, such as the cost of institutional and product advertising, which we had felt should not be charged to the government but which industry considered a normal cost of doing business. In other words they considered that all normal and proper costs of doing business should be allowed by the government to the extent they were reasonable and allocable under the contractor's accounting system even though some of such costs clearly have nothing to do with the conduct of government business. We feel that there are some costs, such as advertising or allowances for bad debts, which although necessary in the conduct of the business should not be allocated to government contracts.

2 The industry comment also made it clear that, so long as there were to be unallowable items of cost, industry did not favor the extension of the use of cost principles to incentive contracts, price redeterminable contracts and other negotiated "fixed price" type of contracts or to negotiated settlements of terminated contracts. The basis for this opposition seems to be a belief that the use of cost principles in these situations will lead to formula pricing rather than true negotiation. We believe that the description which we have included in the cost principles themselves of the methods of use of these principles in the pricing or settlement of these contracts is adequate to assure that they will not damage the negotiation process.

In our meetings with Mr. McNeil and the Materiel Assistant Secretaries consideration has been given to some twenty issues which were raised by industry. We have come to agreement among ourselves on all but one. On several of these issues we have agreed to accept the industry viewpoint whereas in a number of others we believe that we should not accept that viewpoint.

Tab A, attached, is a summary of the one remaining issue on which we do not have internal agreement and on which we seek your advice. This has to do with the allowability, as a part of total compensation to employees, primarily involving executive compensation, of that portion which is dependent upon or measured by profits. The Air Force is opposed to allowance whereas the Army, Navy, ASD(Comptroller) and ASD(Supply and Logistics) favor allowing. This problem has been with us for several years and it was previously decided by Mr. Wilson that such expenses should not be allowed as costs. The question is again raised by the industry comment and there is again a lack of agreement. The arguments on this subject are included in Tab A.

Tab B, attached, represents an identification and evaluation of the significant remaining issues with industry. Internally we are in complete agreement that these industry views should not be accepted in the proposed regulation.

Tab C, attached, is an identification of the principal changes to which we have agreed as a result of the industry comments.

Tab D, attached, is our timetable for the completion of this project and the issuance of this section of the regulation.

Perkins McGuire
PERKINS MCGUIRE

**Assistant Secretary of Defense
(Supply and Logistics)**

4 Inclosures

Tabs A, B, C and D

Issues Between the Air Force and Industry, (ASD(S&L), (COMP), Army and Navy)

COMPENSATION

INDUSTRY VIEW

(concurrent in by ASD(S&L), (Comp), Army and Navy)

Basic Contention: The critically important consideration underlying the compensation principle ought to be the reasonableness of the total compensation paid using any and all methods. The methods of compensation usable ought to be that determined by the contractor so long as the methods utilized are in keeping with sound accounting practices and the results achieved are reasonable in light of the services rendered.

A. COMPENSATION PLANS BASED UPON, MEASURED BY PROFITS.

Specifically, industry contends that compensation plans based upon and measured by profits:

1. Are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.
2. Are costs, as distinguished from a distribution of profits, by generally accepted accounting principles and practices.
3. Are allowable as costs for tax purposes and for renegotiation.
4. Are not logically separable into deferred or immediate distribution plans. The Air Force

AIR FORCE POSITION

Contentions: The Air Force position is that payments under profit-sharing plans should not be recognized as a cost of performing defense contracts.

1. Since January 1, 1955, the Air Force, in its negotiations with contractors, has taken the position that payments to management under profit-sharing plans are not allowable. The Air Force has no objection to profit-sharing plans as such. We do reject the philosophy that payments under such plans should be treated as a cost of performing the contract.

2. Profit-sharing is a method of distribution of profits realized. This is implicit in both the label and the conditions attached to this particular method of distributing corporate earnings. Distribution of profits under the various plans are, in general, determined in accordance with the profit position of a company at the end of the fiscal year. In a profit-sharing plan the contractor purports to be sharing his calculated profits with certain of his employees. If profit distributions are treated as costs in determining contract prices, the so-called "profit-sharing" is an illusion. For, while the contractor would be publicizing a program as "profit-sharing," the Government would, in fact, be bearing directly the cost of such plan.

position makes it clear that their opposition is only to "immediate distribution" plans and not to "deferred distribution" or "retirement" plans. Where each is based upon or measured by profits, it is difficult to see how one type can be considered a cost and the other not. The Air Force position does not explain this point.

5. Cannot logically be separated from bonuses (which are allowable), since both are treated alike by contractors for most purposes.
6. Were considered "essential to the ultimate maintenance of the Capitalistic System" in the one Congressional inquiry into such plans in 1939.

3. Under our contracting techniques we negotiate, contract by contract, a price based upon what the job is worth. This estimated profit is an incentive to the contractor and we allow him an opportunity, by reducing costs, to earn more profit. If, as a matter of corporate choice, profit-sharing is held out to the contractor's employees as an inducement to aid the contractor in earning more profit under the contract, the profits so earned should be the source of distribution of the rewards promised the employees. Having striven for the target profit, and, having achieved such profit or more and distributed a portion thereof to certain of its employees as "profit-sharing", the contractor should not confront the military department with a "voucher" for reimbursement of the profits distributed.

4. Profit-sharing is not necessarily identifiable with, nor measured by, efficiency. Net profits available for distribution may be the result of higher volume of business, sharp negotiations, or the peculiar tax situation of the contractor. In fact, a manufacturer who has not produced efficiently during a particular year could still, out of profits earned distribute bonuses measured by profits. The Government would not have derived any benefits from the operation of the profit-sharing plan.

5. Normally, management is confronted with conflicting interests of stockholders and

employees in the distribution of profits in the form of dividends for the former and profit-sharing plans, if any, for the latter. The normal pressures exerted by stockholders to prevent the indiscriminate distribution of profits under the profit-sharing plan disappears if the Government accepts payments under profit-sharing plans as an allowable cost, particularly in the case of companies predominantly in defense work.

6. It is significant that certain of our contractors, who have had profit-sharing plans in effect for a number of years, have never sought reimbursement for payments under such plans. The effect of a formal policy allowing payments under such plans would cause these companies to request reimbursement therefor and would stimulate interest in other companies to inaugurate such plans. The Air Force estimates existing profit-sharing plans could involve, for the Air Force alone, approximately \$25 million a year. Any general policy in favor of allowing payments under these plans could cause this amount to be increased significantly.

7. Our position is primarily addressed to profit-sharing plans of the "immediate" distribution type. We would not object to allowability of payments under profit-sharing "retirement" plans as presently contained in the latest DOD draft of the proposed cost principles, if such plans meet the requirements of the Internal Revenue Code and the regulations thereunder.

Identification and Evaluation of the Significant Remaining Issues
with Industry

ISSUE 1

Should there be an attempt to get uniformity of cost treatment in all of the various types of contractual situations where costs are a factor in pricing?

Industry Position

With very slight exception industry agrees with the objective of uniformity of cost treatment but is seriously concerned lest the application of these principles lead government contracting personnel to resolve controversial points of negotiation by unilateral accounting solutions rather than by overall bargaining. Specifically they fear that the description, contained in the document itself, of the "applicability" of these cost principles to fixed price types of contracts may lead to formula pricing rather than to negotiation based upon factors other than estimated costs.

Government Position

The "applicability" section of these cost principles makes it clear that they are for use only when costs are a factor in pricing. They do not enlarge, or even affect, the number of types of transactions where costs are to be considered nor do they suggest that a specific treatment of costs shall be paramount to other considerations in cases where estimated costs are one of several factors affecting the negotiation. The present guidance, contained elsewhere in ASPR, with respect to negotiation and pricing techniques and methods (which has the solid support of industry) remains in effect and is the basis for judgment as to when costs or cost estimates should be importantly considered in pricing. It is only when costs are considered that these cost principles apply. Hence it is not felt that the danger of formula pricing would be increased by the adoption of these principles. Rather, they would encourage a consistent treatment of costs where costs are dealt with at all. However, we have agreed to revised language to make these points completely clear (See Tab C, Item 1).

ISSUE 2

Should the cost principles provide for the non-acceptance by the government of any cost which is normal, legal, and reasonably necessary in the conduct of the contractor's business?

Industry Position

In general the industry view was that the government should accept its pro rata allocation of all normal and necessary costs of doing business. This view was very generally stated by all industry's groups as well as by the Comptrollers Institute.

Government Position

This is probably the most difficult issue to resolve to the satisfaction of all parties. 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. We have also considered that certain other individual expense items such as product and institutional advertising and contributions and donations, should not be accepted by the government.

ISSUE 3

Related to Issue 2 is the additional question as to whether the government should question the "reasonableness" or "allocability" to government work of a cost which is handled consistently under the contractor's normal accounting system in accordance with "generally accepted accounting principles". Stated differently, this question is whether the cost principles should contain rules or guidelines for determining the "reasonableness" or "allocability" of various cost elements or whether we should accept, as the criterion, "generally accepted accounting practices".

Industry Position

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

Government Position

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

ISSUE 4

The proposed cost principles point out that when we are buying from companies or industries actively engaged in commercial competition, we can normally rely on the restraints of competition to assure that certain items of expense, such as general research, are kept by management decision within reasonable bounds. However, where we are dealing with firms whose work is exclusively or predominantly with the government such competitive restraints do not exist. To provide appropriate control in such instances and to avoid unexpected disallowances of costs by the government, the cost principles suggest that, with respect to elements of cost where reasonableness is hard to determine, particularly with contractors whose work is predominantly with the government, there should be advance agreement as to the extent of allowability of such costs and that such agreements should be incorporated in the contracts. The issue is whether this provision is sound.

Industry Position

The industry comment generally objected to this provision on the ground (a) that it favored companies in a strong negotiating position, (b) promoted lack of uniformity of treatment and (c) limited management's discretion to make sound business decisions by requiring approval in advance of incurring legitimate business expenses.

Government Position

The industry comments seemed to assume that a failure to negotiate and agree on such costs would render them unallowable. This is erroneous. They would be unallowable only if subsequently found unreasonable which would not

happen if there had been an agreement. This point can undoubtedly be cleared up by a clearer rewrite of this section of the principles. Nevertheless, the basic issue will to some degree remain. We consider it highly desirable that there be an advance agreement on the ground rules when we are dealing with traditionally difficult questions of cost particularly where there is no motivation through the needs of competition to keep such costs within normal and reasonable limits. This will not lead to any less uniformity of treatment, probably to more, than we would have by complete reliance on the concept of "reasonableness" advocated in the industry comments. As to the infringement on management decisions we are simply telling management that, if they want reimbursement from us for exceptional or unusual expenses in these troublesome fields, they should get our concurrence. The only way we could avoid such infringement would be to allow whatever they spend without regard to our judgment as to reasonableness.

ISSUE 5

The subissues which follow have to do with our treatment of specific elements of cost. There are a number of minor points which are not considered in this paper. The following are the significant points which were commented on adversely by several or most industry groups.

5a. Advertising Costs

Industry Position

The industry comment strongly urged the allowability of institutional advertising in all media on the ground that it stimulates interest and the pursuit of careers in engineering and science, affects employee relations and, by keeping the company before the public assists the company in other ways which are of indirect advantage to the government, as in making it easier to attract investment capital. To a lesser extent industry urged the allowance of the costs of product advertising on the ground that the government benefits through cheaper prices for defense work from the creation of mass markets for commercial products.

Government Position

Product and institutional advertising are essentially selling expense and are designed to influence the general public. The costs thereof should be allocated to that portion of the contractor's business which is conducted with the general public. We have consistently held to this position for many years. We have, however, allowed advertising in trade and technical journals, provided products are not offered for sale. This we propose to continue.

5 b. Compensation for Personal Services

- (i) Compensation dependent upon or measured by profits. See Tab A.
- (ii) Stock Options.

Industry Position

Stock options are a proper means of compensating employees, they are recognized as costs by generally accepted accounting principles and, under some circumstances, are deductible for tax purposes.

Government Position

Stock options are not a cost of doing business in that they do not get on the contractors' statements of income and expense. In the form in which they are currently used by industry they are not deductible by the employer as a cost for tax purposes. They should not be allowed as a cost for pricing purposes.

5 c. Contributions and Donations

Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of governmental policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy. x //

TPB B

5 d. Interest

Industry Position

All industry comment indicates the belief that the interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts.

Government Position

It is felt that the allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and therefore would provide an incentive for borrowing for the performance of our contracts even where our cash requirements could be met out of available capital. The extent of capital requirements of our contracts should be considered in the fixing of fees or profits (See Tab C, Issue 2). ✓

5 e. Plant Reconversion Costs

Industry Position

Reconversion from defense work to civilian work may be very costly. Where unusually heavy expense is involved, allowability should not be precluded by the cost principles.

Government Position

The government does allow all initial set-up expense as a charge to its work. In addition it allows the cost of removal of special government furnished machinery when special installations, such as large concrete foundations, are involved. This is considered equitable and it is felt that we should continue the policy of requiring that, upon completion of government work, set-up or make-ready expense for commercial work be charged against ensuing production.

5 f. Research and Development

Industry Position

Under the ^{draft of 10 Sept 58} ~~proposed cost principles~~ pure research is allowed on a

pro-rated basis as a charge against any contracts. Product research or development is allowed only as a charge against the product or product line which is benefited. Product research or development is not allowed as a charge against government research contracts. Some industry comment opposed the distinction between pure research and product research, claiming that this would require a difficult segregation. Others felt that product research should be allocable to government research contracts. Others, ~~principally the Aircraft Industries Association~~, objected to the requirement for negotiation to predetermine reasonableness of R&D expense. *there was some feeling that capitalization of development expenses with amortization over a reasonable period should be permitted.*

Government Position

The allowance of pure research to the extent of reasonableness is new. Previously it was not allowed unless specially agreed on. Product research has been allowable as part of the price of products which are benefited. We feel that this is a reasonably clear and uncomplex segregation and that, for instance, the sale of an atomic reactor should not bear any part of the cost of developing a new line of refrigerators. Recent discussions with various industry groups seem to indicate a better understanding and more willing acceptance of this principle than the initial written comments showed. The point raised by the AIA with respect to the necessity for pre-agreement on reasonableness is covered under Issue 4 above.

5 g. Training and Educational Costs

Industry Position

The proposed cost principles:

- (i) allow in-training and out-training at vocational and non-college levels.
- (ii) allow part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary, straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).
- (iii) allow post-graduate tuition, fees, materials for full-time scientific and engineering education (BUT NO SALARY OR

SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) disallows grants to educational institutions since such grants are considered donations.

In connection with (ii), industry objects to the limitation of 2 hours a week for the study during working hours

In connection with (iii), industry objects to the non-allowability of salary and subsistence. Finally, industry objects to the non-allowance of grants in (iv).

Government Position

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

It was felt, in connection with (ii), that this sort of activity ought to be accomplished outside of working hours, but instances were found in which this was not possible. Two hours per work week appeared to be a reasonable solution. In connection with (iii) above, allocability of this expense against Government contracts is a tight question. As a matter of policy, therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive. Grants, in (iv) above, were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

Issues on Which the Industry Views Have Been Adopted in Whole
or in Part

1. Industry Position

Industry strongly approves the existing section of ASPR that describes our negotiation and pricing policies. These policies emphasize negotiated bargaining toward reasonable overall pricing. The industry comments express the fear that the proposed new cost principles would undermine this policy and lead to formula pricing based solely on audit reports.

Government Position

Since the intent of the proposed draft was to continue our existing pricing policies and since this intent was not understood from a reading of the draft, the "Applicability" section of the draft is being rewritten to make this intent clear and, hence, to accommodate the industry views.

2. Industry Position

Industry strongly urges that interest on borrowings be allowed as a cost.

Government Position

While we do not feel that we should accede to this position (See Tab B, Issue 5 d), we have emphasized, elsewhere in ASPR, that the extent of the contractor's capital investment in the performance of the contract shall be taken into account in negotiating the amount of fee or profit.

3. Industry Position

Industry felt that the treatment of overtime pay, extra pay shift premiums and multi-shift premiums was unnecessarily complicated and would lead to confusion among the services to the disadvantage of industry.

Government Position

Since the original submission of the draft for industry comments, the policy with respect to overtime, extra pay shifts and multi-shifts has been greatly simplified in its administration and this simplification, carried into the cost principles, satisfies the industry objection.

12

Timetable for Completion

July 1958	Meetings with industry associations
September	Completion of revisions stemming from meetings with industry
October	Coordination of final proposal internally and with General Accounting Office
November	Publication



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS
CD

JUN 18 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Since 1949, the Armed Services Procurement Regulation has contained a very brief statement of the principles relating to the allowability of manufacturers' costs for use in connection with payments under contracts which are on a cost reimbursement basis. This statement has contained principally three listings, first, those types of costs which are regularly allowable, second, those which are regularly unallowable and, third, those which are allowable only to the extent specially treated in the contract. The regulations have contained no principles or policy guidance with respect to the method of dealing with costs or cost estimates in contracts of types other than cost reimbursement contracts.

For nearly five years there has been increasingly intensive pressure on the Department for the development of a new set of cost principles which would both give more detailed and precise policy guidance in the treatment of many cost elements and would be applicable to all types of contracting or contract settlement situations. Specifically, the adoption of such a uniform, comprehensive set of cost principles has been strongly advocated by the House Appropriations Committee, the Comptroller General of the United States, and the Hoover Commission.

We have been in the process of developing such a comprehensive set of cost principles for several years. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of cost principles has been a slow process. By last fall we had obtained sufficient agreement among the different elements within the Department of Defense to be able to issue a draft of the proposed principles to various industrial groups for their comment. These comments, which for the most part were quite critical of the proposed draft, have been reviewed, evaluated and thoroughly discussed with Assistant Secretary McNeil and the Materiel Assistant Secretaries of the three military departments preparatory to our undertaking discussions with industry groups in an effort to resolve our differences to the extent practical.

5029

Prior to our discussions with industry I believe that you should be aware of the policy approaches that we propose to take.

The industry comment was critical with respect to each element of cost, such as the cost of institutional and product advertising, which we had felt should not be charged to the government but which industry considered a normal cost of doing business. In other words they considered that all normal and proper costs of doing business should be allowed by the government to the extent they were reasonable and allocable under the contractor's accounting system even though some of such costs clearly have nothing to do with the conduct of government business. We feel that there are some costs, such as advertising or allowances for bad debts, which although necessary in the conduct of the business should not be allocated to government contracts.

2 The industry comment also made it clear that, so long as there were to be unallowable items of cost, industry did not favor the extension of the use of cost principles to incentive contracts, price redeterminable contracts and other negotiated "fixed price" type of contracts or to negotiated settlements of terminated contracts. The basis for this opposition seems to be a belief that the use of cost principles in these situations will lead to formula pricing rather than true negotiation. We believe that the description which we have included in the cost principles themselves of the methods of use of these principles in the pricing or settlement of these contracts is adequate to assure that they will not damage the negotiation process.

In our meetings with Mr. McNeil and the Materiel Assistant Secretaries consideration has been given to some twenty issues which were raised by industry. We have come to agreement among ourselves on all but one. On several of these issues we have agreed to accept the industry viewpoint whereas in a number of others we believe that we should not accept that viewpoint.

Tab A, attached, is a summary of the one remaining issue on which we do not have internal agreement and on which we seek your advice. This has to do with the allowability, as a part of total compensation to employees, primarily involving executive compensation, of that portion which is dependent upon or measured by profits. The Air Force is opposed to allowance whereas the Army, Navy, ASD(Comptroller) and ASD(Supply and Logistics) favor allowing. This problem has been with us for several years and it was previously decided by Mr. Wilson that such expenses should not be allowed as costs. The question is again raised by the industry comment and there is again a lack of agreement. The arguments on this subject are included in Tab A.

Tab B, attached, represents an identification and evaluation of the significant remaining issues with industry. Internally we are in complete agreement that these industry views should not be accepted in the proposed regulation.

Tab C, attached, is an identification of the principal changes to which we have agreed as a result of the industry comments.

Tab D, attached, is our timetable for the completion of this project and the issuance of this section of the regulation.

Perkins McGuire
PERKINS MCGUIRE

**Assistant Secretary of Defense
(Supply and Logistics)**

4 Inclosures

Tabs A, B, C and D

Issues Between the Air Force and Industry, (ASD(S&L), (COMP), Army and Navy)

COMPENSATION

INDUSTRY VIEW

(concurrent in by ASD(S&L), (Comp), Army and Navy)

Basic Contention: The critically important consideration underlying the compensation principle ought to be the reasonableness of the total compensation paid using any and all methods. The methods of compensation usable ought to be that determined by the contractor so long as the methods utilized are in keeping with sound accounting practices and the results achieved are reasonable in light of the services rendered.

A. COMPENSATION PLANS BASED UPON, MEASURED BY PROFITS.

Specifically, industry contends that compensation plans based upon and measured by profits:

1. Are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.
2. Are costs, as distinguished from a distribution of profits, by generally accepted accounting principles and practices.
3. Are allowable as costs for tax purposes and for renegotiation.
4. Are not logically separable into deferred or immediate distribution plans. The Air Force

AIR FORCE POSITION

Contentions: The Air Force position is that payments under profit-sharing plans should not be recognized as a cost of performing defense contracts.

1. Since January 1, 1955, the Air Force, in its negotiations with contractors, has taken the position that payments to management under profit-sharing plans are not allowable. The Air Force has no objection to profit-sharing plans as such. We do reject the philosophy that payments under such plans should be treated as a cost of performing the contract.

2. Profit-sharing is a method of distribution of profits realized. This is implicit in both the label and the conditions attached to this particular method of distributing corporate earnings. Distribution of profits under the various plans are, in general, determined in accordance with the profit position of a company at the end of the fiscal year. In a profit-sharing plan the contractor purports to be sharing his calculated profits with certain of his employees. If profit distributions are treated as costs in determining contract prices, the so-called "profit-sharing" is an illusion. For, while the contractor would be publicizing a program as "profit-sharing," the Government would, in fact, be bearing directly the cost of such plan.

position makes it clear that their opposition is only to "immediate distribution" plans and not to "deferred distribution" or "retirement" plans. Where each is based upon or measured by profits, it is difficult to see how one type can be considered a cost and the other not. The Air Force position does not explain this point.

5. Cannot logically be separated from bonuses (which are allowable), since both are treated alike by contractors for most purposes.
6. Were considered "essential to the ultimate maintenance of the Capitalistic System" in the one Congressional inquiry into such plans in 1939.

3. Under our contracting techniques we negotiate, contract by contract, a price based upon what the job is worth. This estimated profit is an incentive to the contractor and we allow him an opportunity, by reducing costs, to earn more profit. If, as a matter of corporate choice, profit-sharing is held out to the contractor's employees as an inducement to aid the contractor in earning more profit under the contract, the profits so earned should be the source of distribution of the rewards promised the employees. Having striven for the target profit, and, having achieved such profit or more and distributed a portion thereof to certain of its employees as "profit-sharing", the contractor should not confront the military department with a "voucher" for reimbursement of the profits distributed.

4. Profit-sharing is not necessarily identifiable with, nor measured by, efficiency. Net profits available for distribution may be the result of higher volume of business, sharp negotiations, or the peculiar tax situation of the contractor. In fact, a manufacturer who has not produced efficiently during a particular year could still, out of profits earned distribute bonuses measured by profits. The Government would not have derived any benefits from the operation of the profit-sharing plan.

5. Normally, management is confronted with conflicting interests of stockholders and

employees in the distribution of profits in the form of dividends for the former and profit-sharing plans, if any, for the latter. The normal pressures exerted by stockholders to prevent the indiscriminate distribution of profits under the profit-sharing plan disappears if the Government accepts payments under profit-sharing plans as an allowable cost, particularly in the case of companies predominantly in defense work.

6. It is significant that certain of our contractors, who have had profit-sharing plans in effect for a number of years, have never sought reimbursement for payments under such plans. The effect of a formal policy allowing payments under such plans would cause these companies to request reimbursement therefor and would stimulate interest in other companies to inaugurate such plans. The Air Force estimates existing profit-sharing plans could involve, for the Air Force alone, approximately \$25 million a year. Any general policy in favor of allowing payments under these plans could cause this amount to be increased significantly.

7. Our position is primarily addressed to profit-sharing plans of the "immediate" distribution type. We would not object to allowability of payments under profit-sharing "retirement" plans as presently contained in the latest DOD draft of the proposed cost principles, if such plans meet the requirements of the Internal Revenue Code and the regulations thereunder.

Identification and Evaluation of the Significant Remaining Issues
with Industry

ISSUE 1

Should there be an attempt to get uniformity of cost treatment in all of the various types of contractual situations where costs are a factor in pricing?

Industry Position

With very slight exception industry agrees with the objective of uniformity of cost treatment but is seriously concerned lest the application of these principles lead government contracting personnel to resolve controversial points of negotiation by unilateral accounting solutions rather than by overall bargaining. Specifically they fear that the description, contained in the document itself, of the "applicability" of these cost principles to fixed price types of contracts may lead to formula pricing rather than to negotiation based upon factors other than estimated costs.

Government Position

The "applicability" section of these cost principles makes it clear that they are for use only when costs are a factor in pricing. They do not enlarge, or even affect, the number of types of transactions where costs are to be considered nor do they suggest that a specific treatment of costs shall be paramount to other considerations in cases where estimated costs are one of several factors affecting the negotiation. The present guidance, contained elsewhere in ASPR, with respect to negotiation and pricing techniques and methods (which has the solid support of industry) remains in effect and is the basis for judgment as to when costs or cost estimates should be importantly considered in pricing. It is only when costs are considered that these cost principles apply. Hence it is not felt that the danger of formula pricing would be increased by the adoption of these principles. Rather, they would encourage a consistent treatment of costs where costs are dealt with at all. However, we have agreed to revised language to make these points completely clear (See Tab C, Item 1).

ISSUE 2

Should the cost principles provide for the non-acceptance by the government of any cost which is normal, legal, and reasonably necessary in the conduct of the contractor's business?

Industry Position

In general the industry view was that the government should accept its pro rata allocation of all normal and necessary costs of doing business. This view was very generally stated by all industry's groups as well as by the Comptrollers Institute.

Government Position

X This is probably the most difficult issue to resolve to the satisfaction of all parties. 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. We have also considered that certain other individual expense items such as product and institutional advertising and contributions and donations, should not be accepted by the government.

ISSUE 3

Related to Issue 2 is the additional question as to whether the government should question the "reasonableness" or "allocability" to government work of a cost which is handled consistently under the contractor's normal accounting system in accordance with "generally accepted accounting principles". Stated differently, this question is whether the cost principles should contain rules or guidelines for determining the "reasonableness" or "allocability" of various cost elements or whether we should accept, as the criterion, "generally accepted accounting practices".

Industry Position

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

Government Position

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

ISSUE 4

The proposed cost principles point out that when we are buying from companies or industries actively engaged in commercial competition, we can normally rely on the restraints of competition to assure that certain items of expense, such as general research, are kept by management decision within reasonable bounds. However, where we are dealing with firms whose work is exclusively or predominantly with the government such competitive restraints do not exist. To provide appropriate control in such instances and to avoid unexpected disallowances of costs by the government, the cost principles suggest that, with respect to elements of cost where reasonableness is hard to determine, particularly with contractors whose work is predominantly with the government, there should be advance agreement as to the extent of allowability of such costs and that such agreements should be incorporated in the contracts. The issue is whether this provision is sound.

Industry Position

The industry comment generally objected to this provision on the ground (a) that it favored companies in a strong negotiating position, (b) promoted lack of uniformity of treatment and (c) limited management's discretion to make sound business decisions by requiring approval in advance of incurring legitimate business expenses.

Government Position

The industry comments seemed to assume that a failure to negotiate and agree on such costs would render them unallowable. This is erroneous. They would be unallowable only if subsequently found unreasonable which would not

happen if there had been an agreement. This point can undoubtedly be cleared up by a clearer rewrite of this section of the principles. Nevertheless, the basic issue will to some degree remain. We consider it highly desirable that there be an advance agreement on the ground rules when we are dealing with traditionally difficult questions of cost particularly where there is no motivation through the needs of competition to keep such costs within normal and reasonable limits. This will not lead to any less uniformity of treatment, probably to more, than we would have by complete reliance on the concept of "reasonableness" advocated in the industry comments. As to the infringement on management decisions we are simply telling management that, if they want reimbursement from us for exceptional or unusual expenses in these troublesome fields, they should get our concurrence. The only way we could avoid such infringement would be to allow whatever they spend without regard to our judgment as to reasonableness.

ISSUE 5

The subissues which follow have to do with our treatment of specific elements of cost. There are a number of minor points which are not considered in this paper. The following are the significant points which were commented on adversely by several or most industry groups.

5a. Advertising Costs

Industry Position

The industry comment strongly urged the allowability of institutional advertising in all media on the ground that it stimulates interest and the pursuit of careers in engineering and science, affects employee relations and, by keeping the company before the public assists the company in other ways which are of indirect advantage to the government, as in making it easier to attract investment capital. To a lesser extent industry urged the allowance of the costs of product advertising on the ground that the government benefits through cheaper prices for defense work from the creation of mass markets for commercial products.

Government Position

Product and institutional advertising are essentially selling expense and are designed to influence the general public. The costs thereof should be allocated to that portion of the contractor's business which is conducted with the general public. We have consistently held to this position for many years. We have, however, allowed advertising in trade and technical journals, provided products are not offered for sale. This we propose to continue.

5 b. Compensation for Personal Services

- (i) Compensation dependent upon or measured by profits. See Tab A.
- (ii) Stock Options.

Industry Position

Stock options are a proper means of compensating employees, they are recognized as costs by generally accepted accounting principles and, under some circumstances, are deductible for tax purposes.

Government Position

Stock options are not a cost of doing business in that they do not get on the contractors' statements of income and expense. In the form in which they are currently used by industry they are not deductible by the employer as a cost for tax purposes. They should not be allowed as a cost for pricing purposes.

5 c. Contributions and Donations

Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of governmental policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy. X

5 d. Interest

Industry Position

All industry comment indicates the belief that the interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts.

Government Position

It is felt that the allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and therefore would provide an incentive for borrowing for the performance of our contracts even where our cash requirements could be met out of available capital. The extent of capital requirements of our contracts should be considered in the fixing of fees or profits (See Tab C, Issue '2). ✓

5 e. Plant Reconversion Costs

Industry Position

Reconversion from defense work to civilian work may be very costly. Where unusually heavy expense is involved, allowability should not be precluded by the cost principles.

Government Position

The government does allow all initial set-up expense as a charge to its work. In addition it allows the cost of removal of special government furnished machinery when special installations, such as large concrete foundations, are involved. This is considered equitable and it is felt that we should continue the policy of requiring that, upon completion of government work, set-up or make-ready expense for commercial work be charged against ensuing production.

5 f. Research and Development

Industry Position

Under the ^{draft of 10 Sept 58} ~~proposed cost principles~~ pure research is allowed on a

pro-rated basis as a charge against any contracts. Product research or development is allowed only as a charge against the product or product line which is benefited. Product research or development is not allowed as a charge against government research contracts. Some industry comment opposed the distinction between pure research and product research, claiming that this would require a difficult segregation. Others felt that product research should be allocable to government research contracts. Others, ~~principally the Aircraft Industries Association~~, objected to the requirement for negotiation to predetermine reasonableness of R&D expense. *there was some feeling that capitalization of development expenses with amortization over a reasonable period should be permitted.*

Government Position

The allowance of pure research to the extent of reasonableness is new. Previously it was not allowed unless specially agreed on. Product research has been allowable as part of the price of products which are benefited. We feel that this is a reasonably clear and uncomplex segregation and that, for instance, the sale of an atomic reactor should not bear any part of the cost of developing a new line of refrigerators. Recent discussions with various industry groups seem to indicate a better understanding and more willing acceptance of this principle than the initial written comments showed. The point raised by the AIA with respect to the necessity for pre-agreement on reasonableness is covered under Issue 4 above.

5 g. Training and Educational Costs

Industry Position

The proposed cost principles:

- (i) allow in-training and out-training at vocational and non-college levels.
- (ii) allow part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary, straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).
- (iii) allow post-graduate tuition, fees, materials for full-time scientific and engineering education (BUT NO SALARY OR

SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) disallows grants to educational institutions since such grants are considered donations.

In connection with (ii), industry objects to the limitation of 2 hours a week for the study during working hours

In connection with (iii), industry objects to the non-allowability of salary and subsistence. Finally, industry objects to the non-allowance of grants in (iv).

Government Position

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

It was felt, in connection with (ii), that this sort of activity ought to be accomplished outside of working hours, but instances were found in which this was not possible. Two hours per work week appeared to be a reasonable solution. In connection with (iii) above, allocability of this expense against Government contracts is a tight question. As a matter of policy, therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive. Grants, in (iv) above, were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

Issues on Which the Industry Views Have Been Adopted in Whole
or in Part

1. Industry Position

Industry strongly approves the existing section of ASPR that describes our negotiation and pricing policies. These policies emphasize negotiated bargaining toward reasonable overall pricing. The industry comments express the fear that the proposed new cost principles would undermine this policy and lead to formula pricing based solely on audit reports.

Government Position

Since the intent of the proposed draft was to continue our existing pricing policies and since this intent was not understood from a reading of the draft, the "Applicability" section of the draft is being rewritten to make this intent clear and, hence, to accommodate the industry views.

2. Industry Position

Industry strongly urges that interest on borrowings be allowed as a cost.

Government Position

While we do not feel that we should accede to this position (See Tab B, Issue 5 d), we have emphasized, elsewhere in ASPR, that the extent of the contractor's capital investment in the performance of the contract shall be taken into account in negotiating the amount of fee or profit.

3. Industry Position

Industry felt that the treatment of overtime pay, extra pay shift premiums and multi-shift premiums was unnecessarily complicated and would lead to confusion among the services to the disadvantage of industry.

Government Position

Since the original submission of the draft for industry comments, the policy with respect to overtime, extra pay shifts and multi-shifts has been greatly simplified in its administration and this simplification, carried into the cost principles, satisfies the industry objection.

Timetable for Completion

July 1958	Meetings with industry associations
September	Completion of revisions stemming from meetings with industry
October	Coordination of final proposal internally and with General Accounting Office
November	Publication

✓
See Note

August 4, 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Suggested Language for the Cost Principle Covering Executive
Bonuses Based Upon Profit

At the meeting in your office, on the contract cost principles, on August 1, 1958, you asked that we send you the proposed language for inclusion in the principles to make profit sharing payments an allowable part of compensation to the extent total compensation is reasonable.

Since the profit sharing method is simply one portion of the overall treatment of the subject of "compensation" in the principles, there are already general statements under this subject which are applicable. A description of two of these follows:

1. After citing examples of the various methods of compensation, the statement is made that: "Except as otherwise specifically provided in this paragraph, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered."

2. This is followed by an expansion on the general "reasonableness" provision as follows: "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 competitive bidding in the conduct of competitive business."

In discussing this subject in that portion of the cost principles where allowability of specific types of compensation is dealt with in detail, the following language would be used (the portion in brackets is the only new material):

Cash Bonuses and Incentive Compensation. [Incentive compensation for management employees (whether or not dependent ~~on or contingent on profits~~) cash bonuses, suggestion awards, and safety awards, based on production, cost reduction or efficient management or performance, are allowable to the extent that the award compensation is determined to be reasonable and such costs are paid as required pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1(b).)]

The reference to ASPR 15-204.1(b) is to that section of the cost principles which we discussed with you, which states that where contractors are predominantly engaged in government work and where the reasonableness of a cost may be difficult to determine, the contractor should arrive at an agreement with the government as to such costs in advance of incurring them.

It is recommended that you approve the above language in inclusion in the cost principles.

8/14/59

Notes below are from Mr. Guadalupe. Jim & I concluded that summary ~ 8 Aug. The memo to ASD(SEL) & info below are essentially similar. 1st/2nd/3rd/4th/5th/6th/7th/8th/9th/10th/11th/12th/13th/14th/15th/16th/17th/18th/19th/20th/21st/22nd/23rd/24th/25th/26th/27th/28th/29th/30th/31st/32nd/33rd/34th/35th/36th/37th/38th/39th/40th/41st/42nd/43rd/44th/45th/46th/47th/48th/49th/50th/51st/52nd/53rd/54th/55th/56th/57th/58th/59th/60th/61st/62nd/63rd/64th/65th/66th/67th/68th/69th/70th/71st/72nd/73rd/74th/75th/76th/77th/78th/79th/80th/81st/82nd/83rd/84th/85th/86th/87th/88th/89th/90th/91st/92nd/93rd/94th/95th/96th/97th/98th/99th/100th/101st/102nd/103rd/104th/105th/106th/107th/108th/109th/110th/111th/112th/113th/114th/115th/116th/117th/118th/119th/120th/121st/122nd/123rd/124th/125th/126th/127th/128th/129th/130th/131st/132nd/133rd/134th/135th/136th/137th/138th/139th/140th/141st/142nd/143rd/144th/145th/146th/147th/148th/149th/150th/151st/152nd/153rd/154th/155th/156th/157th/158th/159th/160th/161st/162nd/163rd/164th/165th/166th/167th/168th/169th/170th/171st/172nd/173rd/174th/175th/176th/177th/178th/179th/180th/181st/182nd/183rd/184th/185th/186th/187th/188th/189th/190th/191st/192nd/193rd/194th/195th/196th/197th/198th/199th/200th/201st/202nd/203rd/204th/205th/206th/207th/208th/209th/210th/211st/212nd/213th/214th/215th/216th/217th/218th/219th/220th/221st/222nd/223rd/224th/225th/226th/227th/228th/229th/230th/231st/232nd/233rd/234th/235th/236th/237th/238th/239th/240th/241st/242nd/243rd/244th/245th/246th/247th/248th/249th/250th/251st/252nd/253rd/254th/255th/256th/257th/258th/259th/260th/261st/262nd/263rd/264th/265th/266th/267th/268th/269th/270th/271st/272nd/273rd/274th/275th/276th/277th/278th/279th/280th/281st/282nd/283rd/284th/285th/286th/287th/288th/289th/290th/291st/292nd/293rd/294th/295th/296th/297th/298th/299th/300th/301st/302nd/303rd/304th/305th/306th/307th/308th/309th/310th/311st/312nd/313th/314th/315th/316th/317th/318th/319th/320th/321st/322nd/323rd/324th/325th/326th/327th/328th/329th/330th/331st/332nd/333rd/334th/335th/336th/337th/338th/339th/340th/341st/342nd/343rd/344th/345th/346th/347th/348th/349th/350th/351st/352nd/353rd/354th/355th/356th/357th/358th/359th/360th/361st/362nd/363rd/364th/365th/366th/367th/368th/369th/370th/371st/372nd/373rd/374th/375th/376th/377th/378th/379th/380th/381st/382nd/383rd/384th/385th/386th/387th/388th/389th/390th/391st/392nd/393rd/394th/395th/396th/397th/398th/399th/400th/401st/402nd/403rd/404th/405th/406th/407th/408th/409th/410th/411st/412nd/413th/414th/415th/416th/417th/418th/419th/420th/421st/422nd/423rd/424th/425th/426th/427th/428th/429th/430th/431st/432nd/433rd/434th/435th/436th/437th/438th/439th/440th/441st/442nd/443rd/444th/445th/446th/447th/448th/449th/450th/451st/452nd/453rd/454th/455th/456th/457th/458th/459th/460th/461st/462nd/463rd/464th/465th/466th/467th/468th/469th/470th/471st/472nd/473rd/474th/475th/476th/477th/478th/479th/480th/481st/482nd/483rd/484th/485th/486th/487th/488th/489th/490th/491st/492nd/493rd/494th/495th/496th/497th/498th/499th/500th/501st/502nd/503rd/504th/505th/506th/507th/508th/509th/510th/511st/512nd/513th/514th/515th/516th/517th/518th/519th/520th/521st/522nd/523rd/524th/525th/526th/527th/528th/529th/530th/531st/532nd/533rd/534th/535th/536th/537th/538th/539th/540th/541st/542nd/543rd/544th/545th/546th/547th/548th/549th/550th/551st/552nd/553rd/554th/555th/556th/557th/558th/559th/560th/561st/562nd/563rd/564th/565th/566th/567th/568th/569th/570th/571st/572nd/573rd/574th/575th/576th/577th/578th/579th/580th/581st/582nd/583rd/584th/585th/586th/587th/588th/589th/590th/591st/592nd/593rd/594th/595th/596th/597th/598th/599th/600th/601st/602nd/603rd/604th/605th/606th/607th/608th/609th/610th/611st/612nd/613th/614th/615th/616th/617th/618th/619th/620th/621st/622nd/623rd/624th/625th/626th/627th/628th/629th/630th/631st/632nd/633rd/634th/635th/636th/637th/638th/639th/640th/641st/642nd/643rd/644th/645th/646th/647th/648th/649th/650th/651st/652nd/653rd/654th/655th/656th/657th/658th/659th/660th/661st/662nd/663rd/664th/665th/666th/667th/668th/669th/670th/671st/672nd/673rd/674th/675th/676th/677th/678th/679th/680th/681st/682nd/683rd/684th/685th/686th/687th/688th/689th/690th/691st/692nd/693rd/694th/695th/696th/697th/698th/699th/700th/701st/702nd/703rd/704th/705th/706th/707th/708th/709th/710th/711st/712nd/713th/714th/715th/716th/717th/718th/719th/720th/721st/722nd/723rd/724th/725th/726th/727th/728th/729th/730th/731st/732nd/733rd/734th/735th/736th/737th/738th/739th/740th/741st/742nd/743rd/744th/745th/746th/747th/748th/749th/750th/751st/752nd/753rd/754th/755th/756th/757th/758th/759th/760th/761st/762nd/763rd/764th/765th/766th/767th/768th/769th/770th/771st/772nd/773rd/774th/775th/776th/777th/778th/779th/780th/781st/782nd/783rd/784th/785th/786th/787th/788th/789th/790th/791st/792nd/793rd/794th/795th/796th/797th/798th/799th/800th/801st/802nd/803rd/804th/805th/806th/807th/808th/809th/810th/811st/812nd/813th/814th/815th/816th/817th/818th/819th/820th/821st/822nd/823rd/824th/825th/826th/827th/828th/829th/830th/831st/832nd/833rd/834th/835th/836th/837th/838th/839th/840th/841st/842nd/843rd/844th/845th/846th/847th/848th/849th/850th/851st/852nd/853rd/854th/855th/856th/857th/858th/859th/860th/861st/862nd/863rd/864th/865th/866th/867th/868th/869th/870th/871st/872nd/873rd/874th/875th/876th/877th/878th/879th/880th/881st/882nd/883rd/884th/885th/886th/887th/888th/889th/890th/891st/892nd/893rd/894th/895th/896th/897th/898th/899th/900th/901st/902nd/903rd/904th/905th/906th/907th/908th/909th/910th/911st/912nd/913th/914th/915th/916th/917th/918th/919th/920th/921st/922nd/923rd/924th/925th/926th/927th/928th/929th/930th/931st/932nd/933rd/934th/935th/936th/937th/938th/939th/940th/941st/942nd/943rd/944th/945th/946th/947th/948th/949th/950th/951st/952nd/953rd/954th/955th/956th/957th/958th/959th/960th/961st/962nd/963rd/964th/965th/966th/967th/968th/969th/970th/971st/972nd/973rd/974th/975th/976th/977th/978th/979th/980th/981st/982nd/983rd/984th/985th/986th/987th/988th/989th/990th/991st/992nd/993rd/994th/995th/996th/997th/998th/999th/1000th/1001st/1002nd/1003rd/1004th/1005th/1006th/1007th/1008th/1009th/1010th/1011st/1012nd/1013th/1014th/1015th/1016th/1017th/1018th/1019th/1020th/1021st/1022nd/1023rd/1024th/1025th/1026th/1027th/1028th/1029th/1030th/1031st/1032nd/1033rd/1034th/1035th/1036th/1037th/1038th/1039th/1040th/1041st/1042nd/1043rd/1044th/1045th/1046th/1047th/1048th/1049th/1050th/1051st/1052nd/1053rd/1054th/1055th/1056th/1057th/1058th/1059th/1060th/1061st/1062nd/1063rd/1064th/1065th/1066th/1067th/1068th/1069th/1070th/1071st/1072nd/1073rd/1074th/1075th/1076th/1077th/1078th/1079th/1080th/1081st/1082nd/1083rd/1084th/1085th/1086th/1087th/1088th/1089th/1090th/1091st/1092nd/1093rd/1094th/1095th/1096th/1097th/1098th/1099th/1100th/1101st/1102nd/1103rd/1104th/1105th/1106th/1107th/1108th/1109th/1110th/1111st/1112nd/1113th/1114th/1115th/1116th/1117th/1118th/1119th/1120th/1121st/1122nd/1123rd/1124th/1125th/1126th/1127th/1128th/1129th/1130th/1131st/1132nd/1133rd/1134th/1135th/1136th/1137th/1138th/1139th/1140th/1141st/1142nd/1143rd/1144th/1145th/1146th/1147th/1148th/1149th/1150th/1151st/1152nd/1153rd/1154th/1155th/1156th/1157th/1158th/1159th/1160th/1161st/1162nd/1163rd/1164th/1165th/1166th/1167th/1168th/1169th/1170th/1171st/1172nd/1173rd/1174th/1175th/1176th/1177th/1178th/1179th/1180th/1181st/1182nd/1183rd/1184th/1185th/1186th/1187th/1188th/1189th/1190th/1191st/1192nd/1193rd/1194th/1195th/1196th/1197th/1198th/1199th/1200th/1201st/1202nd/1203rd/1204th/1205th/1206th/1207th/1208th/1209th/1210th/1211st/1212nd/1213th/1214th/1215th/1216th/1217th/1218th/1219th/1220th/1221st/1222nd/1223rd/1224th/1225th/1226th/1227th/1228th/1229th/1230th/1231st/1232nd/1233rd/1234th/1235th/1236th/1237th/1238th/1239th/1240th/1241st/1242nd/1243rd/1244th/1245th/1246th/1247th/1248th/1249th/1250th/1251st/1252nd/1253rd/1254th/1255th/1256th/1257th/1258th/1259th/1260th/1261st/1262nd/1263rd/1264th/1265th/1266th/1267th/1268th/1269th/1270th/1271st/1272nd/1273rd/1274th/1275th/1276th/1277th/1278th/1279th/1280th/1281st/1282nd/1283rd/1284th/1285th/1286th/1287th/1288th/1289th/1290th/1291st/1292nd/1293rd/1294th/1295th/1296th/1297th/1298th/1299th/1300th/1301st/1302nd/1303rd/1304th/1305th/1306th/1307th/1308th/1309th/1310th/1311st/1312nd/1313th/1314th/1315th/1316th/1317th/1318th/1319th/1320th/1321st/1322nd/1323rd/1324th/1325th/1326th/1327th/1328th/1329th/1330th/1331st/1332nd/1333rd/1334th/1335th/1336th/1337th/1338th/1339th/1340th/1341st/1342nd/1343rd/1344th/1345th/1346th/1347th/1348th/1349th/1350th/1351st/1352nd/1353rd/1354th/1355th/1356th/1357th/1358th/1359th/1360th/1361st/1362nd/1363rd/1364th/1365th/1366th/1367th/1368th/1369th/1370th/1371st/1372nd/1373rd/1374th/1375th/1376th/1377th/1378th/1379th/1380th/1381st/1382nd/1383rd/1384th/1385th/1386th/1387th/1388th/1389th/1390th/1391st/1392nd/1393rd/1394th/1395th/1396th/1397th/1398th/1399th/1400th/1401st/1402nd/1403rd/1404th/1405th/1406th/1407th/1408th/1409th/1410th/1411st/1412nd/1413th/1414th/1415th/1416th/1417th/1418th/1419th/1420th/1421st/1422nd/1423rd/1424th/1425th/1426th/1427th/1428th/1429th/1430th/1431st/1432nd/1433rd/1434th/1435th/1436th/1437th/1438th/1439th/1440th/1441st/1442nd/1443rd/1444th/1445th/1446th/1447th/1448th/1449th/1450th/1451st/1452nd/1453rd/1454th/1455th/1456th/1457th/1458th/1459th/1460th/1461st/1462nd/1463rd/1464th/1465th/1466th/1467th/1468th/1469th/1470th/1471st/1472nd/1473rd/1474th/1475th/1476th/1477th/1478th/1479th/1480th/1481st/1482nd/1483rd/1484th/1485th/1486th/1487th/1488th/1489th/1490th/1491st/1492nd/1493rd/1494th/1495th/1496th/1497th/1498th/1499th/1500th/1501st/1502nd/1503rd/1504th/1505th/1506th/1507th/1508th/1509th/1510th/1511st/1512nd/1513th/1514th/1515th/1516th/1517th/1518th/1519th/1520th/1521st/1522nd/1523rd/1524th/1525th/1526th/1527th/1528th/1529th/1530th/1531st/1532nd/1533rd/1534th/1535th/1536th/1537th/1538th/1539th/1540th/1541st/1542nd/1543rd/1544th/1545th/1546th/1547th/1548th/1549th/1550th/1551st/1552nd/1553rd/1554th/1555th/1556th/1557th/1558th/1559th/1560th/1561st/1562nd/1563rd/1564th/1565th/1566th/1567th/1568th/1569th/1570th/1571st/1572nd/1573rd/1574th/1575th/1576th/1577th/1578th/1579th/1580th/1581st/1582nd/1583rd/1584th/1585th/1586th/1587th/1588th/1589th/1590th/1591st/1592nd/1593rd/1594th/1595th/1596th/1597th/1598th/1599th/1600th/1601st/1602nd/1603rd/1604th/1605th/1606th/1607th/1608th/1609th/1610th/1611st/1612nd/1613th/1614th/1615th/1616th/1617th/1618th/1619th/1620th/1621st/1622nd/1623rd/1624th/1625th/1626th/1627th/1628th/1629th/1630th/1631st/1632nd/1633rd/1634th/1635th/1636th/1637th/1638th/1639th/1640th/1641st/1642nd/1643rd/1644th/1645th/1646th/1647th/1648th/1649th/1650th/1651st/1652nd/1653rd/1654th/1655th/1656th/1657th/1658th/1659th/1660th/1661st/1662nd/1663rd/1664th/1665th/1666th/1667th/1668th/1669th/1670th/1671st/1672nd/1673rd/1674th/1675th/1676th/1677th/1678th/1679th/1680th/1681st/1682nd/1683rd/1684th/1685th/1686th/1687th/1688th/1689th/1690th/1691st/1692nd/1693rd/1694th/1695th/1696th/1697th/1698th/1699th/1700th/1701st/1702nd/1703rd/1704th/1705th/1706th/1707th/1708th/1709th/1710th/1711st/1712nd/1713th/1714th/1715th/1716th/1717th/1718th/1719th/1720th/1721st/1722nd/1723rd/1724th/1725th/1726th/1727th/1728th/1729th/1730th/1731st/1732nd/1733rd/1734th/1735th/1736th/1737th/1738th/1739th/1740th/1741st/1742nd/1743rd/1744th/1745th/1746th/1747th/1748th/1749th/1750th/1751st/1752nd/1753rd/1754th/1755th/1756th/1757th/1758th/1759th/1760th/1761st/1762nd/1763rd/1764th/1765th/1766th/1767th/1768th/1769th/1770th/1771st/1772nd/1773rd/1774th/1775th/1776th/1777th/1778th/1779th/1780th/1781st/1782nd/1783rd/1784th/1785th/1786th/1787th/1788th/1789th/1790th/1791st/1792nd/1793rd/1794th/1795th/1796th/1797th/1798th/1799th/1800th/1801st/1802nd/1803rd/1804th/1805th/1806th/1807th/1808th/1809th/1810th/1811st/1812nd/1813th/1814th/1815th/1816th/1817th/1818th/1819th/1820th/1821st/1822nd/1823rd/1824th/1825th/1826th/1827th/1828th/1829th/1830th/1831st/1832nd/1833rd/1834th/1835th/1836th/1837th/1838th/1839th/1840th/1841st/1842nd/1843rd/1844th/1845th/1846th/1847th/1848th/1849th/1850th/1851st/1852nd/1853rd/1854th/1855th/1856th/1857th/1858th/1859th/1860th/1861st/1862nd/1863rd/1864th/1865th/1866th/1867th/1868th/1869th/1870th/1871st/1872nd/1873rd/1874th/1875th/1876th/1877th/1878th/1879th/1880th/1881st/1882nd/1883rd/1884th/1885th/1886th/1887th/1888th/1889th/1890th/1891st/1892nd/1893rd/1894th/1895th/1896th/1897th/1898th/1899th/1900th/1901st/1902nd/1903rd/1904th/1905th/1906th/1907th/1908th/1909th/1910th/1911st/1912nd/1913th/1914th/1915th/1916th/1917th/1918th/1919th/1920th/1921st/1922nd/1923rd/1924th/1925th/1926th/1927th/1928th/1929th/1930th/1931st/1932nd/1933rd/1934th/1935th/1936th/1937th/1938th/1939th/1940th/1941st/1942nd/1943rd/1944th/1945th/1946th/1947th/1948th/1949th/1950th/1951st/1952nd/1953rd/1954th/1955th/1956th/1957th/1958th/1959th/1960th/1961st/1962nd/1963rd/1964th/1965th/1966th/1967th/1968th/1969th/1970th/1971st/1972nd/1973rd/1974th/1975th/1976th/1977th/1978th/1979th/1980th/1981st/1982nd/1983rd/1984th/1985th/1986th/1987th/1988th/1989th/1990th/1991st/1992nd/1993rd/1994th/1995th/1996th/1997th/1998th/1999th/2000th/2001st/2002nd/2003rd/2004th/2005th/2006th/2007th/2008th/2009th/2010th/2011st/2012nd/2013th/2014th/2015th/2016th/2017th/2018th/2019th/2020th/2021st/2022nd/2023rd/2024th/2025th/2026th/2027th/2028th/2029th/2030th/2031st/2032nd/2033rd/2034th/2035th/2036th/2037th/2038th/2039th/2040th/2041st/2042nd/2043rd/2044th/2045th/2046th/2047th/2048th/2049th/2050th/2051st/2052nd/2053rd/2054th/2055th/2056th/2057th/2058th/2059th/2060th/2061st/2062nd/2063rd/2064th/2065th/2066th/2067th/2068th/2069th/2070th/2071st/2072nd/2073rd/2074th/2075th/2076th/2077th/2078th/2079th/2080th/2081st/2082nd/2083rd/2084th/2085th/2086th/2087th/2088th/2089th/2090th/2091st/2092nd/2093rd/2094th/2095th/2096th/2097th/2098th/2099th/2100th/2101st/2102nd/2103rd/2104th/2105th/2106th/2107th/2108th/2109th/2110th/2111st/2112nd/2113th/2114th/2115th/2116th/2117th/2118th/2119th/2120th/2121st/2122nd/2123rd/2124th/2125th/2126th/2127th/2128th/2129th/2130th/2131st/2132nd/2133rd/2134th/2135th/2136th/2137th/2138th/2139th/2140th/2141st/2142nd/2143rd/2144th/2145th/2146th/2147th/2148th/2149th/2150th/2151st/2152nd/2153rd/2154th/2155th/2156th/2157th/2158th/2159th/2160th/2161st/2162nd/2163rd/

AUG 4 1958

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Suggested Language for the Cost Principle Covering Executive Bonuses Based Upon Profit

At the meeting in your office, on the contract cost principles, on August 1, 1958, you asked that we send you the proposed language for inclusion in the principles to make profit sharing payments an allowable part of compensation to the extent total compensation is reasonable.

Since the profit sharing method is simply one portion of the overall treatment of the subject of "compensation" in the principles, there are already general statements under this subject which are applicable. A description of two of these follows:

1. After citing examples of the various methods of compensation, the statement is made that: "Except as otherwise specifically provided in this paragraph, such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered."

2. This is followed by an expansion on the general "reasonableness" provision as follows: "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 D (Bonner)

In discussing this subject in that portion of the cost principles where allowability of specific types of compensation is dealt with in detail, the following language would be used (the portion in brackets is the only new material):

out? → Cash Bonuses and Incentive Compensation. [^oIncentive compensation for management employees (whether ~~or not dependent upon or measured by profits~~),] cash bonuses, suggestion awards, and safety awards, based on production, cost reduction or efficient management or performance, are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1(b).)"

The reference to ASPR 15-204.1(b) is to that section of the cost principles which we discussed with you, which states that where contractors are predominantly engaged in government work and where the reasonableness of a cost may be difficult to determine, the contractor should arrive at an agreement with the government as to such costs in advance of incurring them.

It is recommended that you approve the above language for inclusion in the cost principles.

SIGNED

W. J. McNEIL
Assistant Secretary of Defense
(Comptroller)

SIGNED

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

Prepared by: GCBannerman and
KKilgore/kh/4 Aug 58
78177

McELROY MEETING ON COST PRINCIPLES -- 8/6/58

1. Approved concept of including incentive compensation of the profit sharing type as part of total compensation, subject to reasonableness.
2. Include a caveat that we do not allow any part of compensation not allowed for tax purposes.
3. Delete parentheses (whether or not dependent upon or measured by profits) from suggested treatment in 8/4 memo.
4. Consider if we can beef-up definition of "reasonableness" as applied to compensation.
5. Provide procedure for joint consideration of determination of reasonableness by three departments when compensation is large and business is predominately with the Government. This may best be handled separately through an administrative instruction.
6. Provide for some type of control of total compensation during transition period so as to preclude increases in total compensation, above that heretofore allowed, merely as a result of our policy change.
7. Develop, as best we can, additional guidelines or standards to measure reasonableness of total compensation.
8. Submit entire package to Hébert Committee after issuance.

ORDER FOR THE ASSISTANT SECRETARY OF DEFENSE (ASD)

10 September 1957 (Amended) Contract Cost Principles - Training and Educational Costs

In accordance with the request of your office, we have reviewed the proposed treatment of allowability of training and educational costs, contained in subject version of "Contract Cost Principles." The proposed treatment was originally developed and conceived by the Military Department, ASD (Comp.), ASD (SA), and this office in 1955.

It is our opinion that the proposed treatment of training and educational costs is realistic in terms of the current manpower situation, which is characterized by shortages of technical and scientific personnel. At the same time, it is believed that the limitations and standards of allowability are reasonable and proper.

While the proposed treatment is responsive to the current manpower situation, it deals only with training for the purpose of up-grading technical and scientific skills of personnel employed on defense contracts, and is in that respect directed at affording better performance on defense contracts in this period of military demands for personnel of increasing quality and complexity. It is not, however, directed at solving the overall national skill-shortage problem in the case of financing the strengthening of the educational system, or of financing college education for producing high school graduates employed on defense contracts. It has been our feeling that Federal spending for such general educational purposes should be handled by the Office of Education, rather than by use of military contract provisions. The narrative March 1956, in fact, was prepared in ASD as a general approach of this kind which is discussed through the Office of Education. Besides to say, this office and the Department of Defense are officially on record in support of A. B. 3.

In the light of the foregoing, this office concurs in the proposed treatment of the above subject.

Covering Brief

PROBLEM: To furnish data on recruitment costs of engineering and scientific personnel as requested by the Sub-Committee on Manpower Utilization of the House Committee on Post Office and Civil Service.

BACKGROUND: In a letter dated January 20, 1960, Chairman James C. Davis of the Sub-Committee requested a report on personnel recruiting costs in FY 1959 of a sample of Defense contractors, in order to gauge the effectiveness of Defense policies in "adjudging the recruitment expenditures by Defense contractors." The requested study paralleled a report for FY 1956 which was furnished to the Committee. However, the FY 1959 study was limited to engineers and scientists with degrees or experience equivalent to a degree, while the earlier study did not contain this limitation and therefore also included supporting technical personnel.

DISCUSSION: The attached lists submitted by the Army, Navy and Air Force in response to the Committee request contain data for 102 companies which have been assigned numerical codes to avoid revealing their identities. Of the total, 76 had a preponderance of sales (more than 50%) to the Government while the other 26 had a preponderance of sales to non-governmental organizations.

In FY 1959 recruiting costs for engineers and scientists averaged \$1,022 per new hire for companies doing business mostly with the Government, compared to \$751 for companies selling mostly to non-governmental customers. In the case of the former group, such recruiting costs represented \$1.97 per \$1,000 of sales, while in the case of the latter, they represented \$.58 per \$1,000 of sales. Almost one-third of the recruiting costs of the

...ent business" group went for help-wanted ads, as against slightly less than one-fourth for the "commercial business" firms.

Both groups increased the size of their engineering and scientific staffs between the beginning and end of the fiscal year: the "Government business" group by 10% and the other group by 9%. Personnel turnover was higher for the former group (14.2%) than for the latter (12.3%).

Although figures for FY 1959 are not comparable with those for FY 1956 because of the inclusion in the latter of supporting technical personnel, the Committee probably will compare average recruitment costs for these periods. In tabular form the comparative figures are as follows:

<u>Fiscal Year</u>	<u>No. of Companies</u>		<u>Recruitment Costs Per New Hire</u>	
	<u>G - 50%*</u>	<u>51 - 100 %</u>	<u>G - 50%*</u>	<u>51 - 100%</u>
<u>All Companies in Sample</u>				
FY 1959	26	76	\$751	\$1,022
FY 1956	56	97	551	482
% Increase			36%	112%
<u>Identical Companies Reported in Each Year</u>				
FY 1959	9	39	\$776	\$1,100
FY 1956	9	39	295	413
% Increase			163%	166%

~~Footnote~~ * Refers to ratio of Government sales to total.

In terms of all companies in the sample, those with a preponderance of Government business showed an increase of 112% in average recruitment cost between FY 1956 and FY 1959, whereas other companies showed an increase of 36%. However, for identical companies reported in both years, the increase is about the same (163%).

RECOMMENDATION: That you sign letter transmitting list (without any summary data) to the Committee.

Concluded
ASD Corp Mr. Kilgore - 10-24-59
ASD Corp T



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

SELDEF MEETING

AUG. 6, 1958

AUG. 6, 1958

CP

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)


SUBJECT: Contract Cost Principles

We are in the process of changing the 10 September 1957 draft of the Contract Cost Principles to give effect to the recent decisions made by Mr. McElroy as well as certain other changes which were indicated by industry comments. I estimate that we will have a new draft available for forwarding to industry in about two weeks. We are planning to set up our industry meeting for early October. I will provide you with a specific proposal for the conduct of this meeting in the near future.

It is my understanding that the following decisions were made by the Secretary of Defense with respect to the compensation principle at the 6 August 1958 meeting:

1. Incentive compensation of the profit sharing type would be an allowable cost to be considered as a portion of total compensation. Total compensation would, of course, be subject to the overall test of reasonableness.
2. Include a provision in the compensation principle to the effect that we would not allow any part of compensation not deductible for tax purposes.
3. Delete the words "(whether or not dependent upon or measured by profits)" from the paragraph entitled "Cash Bonuses and Incentive Compensation" in your memorandum of 4 August 1958 to the Secretary of Defense.
4. Endeavor, as best we can, to expand our treatment of "reasonableness" as applied to compensation. Additional guidelines or standards to measure the reasonableness of total compensation should be developed to the extent practicable.
5. Provide for joint action by the Departments in those situations where there is a mutual interest and where the determination as to the reasonableness of compensation is difficult.
6. Provide for some type of control over total compensation during the transition period so as to preclude the allowance of increased compensation over that previously paid by the company merely by reason of our action in allowing profit sharing plans as part of total compensation.

7. Submit the new cost principles to the Hébert Committee after we have issued them.


G. C. BANNERMAN
Director for Procurement Policy

ASD(SVL) has seen & concurs - per Jim B ^{8/14}



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

See Mr. McElroy's comment on page 2.
AUG 8 1958 *gmu*

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

We are in the process of changing the 10 September 1957 draft of the Contract Cost Principles to give effect to the recent decisions made by Mr. McElroy as well as certain other changes which were indicated by industry comments. I estimate that we will have a new draft available for forwarding to industry in about two weeks. We are planning to set up our industry meeting for early October. I will provide you with a specific proposal for the conduct of this meeting in the near future.

It is my understanding that the following decisions were made by the Secretary of Defense with respect to the compensation principle at the 6 August 1958 meeting:

1. Incentive compensation of the profit sharing type would be an allowable cost to be considered as a portion of total compensation. Total compensation would, of course, be subject to the overall test of reasonableness.
2. Include a provision in the compensation principle to the effect that we would not allow any part of compensation not deductible for tax purposes.
3. Delete the words "(whether or not dependent upon or measured by profits)" from the paragraph entitled "Cash Bonuses and Incentive Compensation" in your memorandum of 4 August 1958 to the Secretary of Defense.
4. Endeavor, as best we can, to expand our treatment of "reasonableness" as applied to compensation. Additional guidelines or standards to measure the reasonableness of total compensation should be developed to the extent practicable.
5. Provide for joint action by the Departments in those situations where there is a mutual interest and where the determination as to the reasonableness of compensation is difficult.
6. Provide for some type of control over total compensation during the transition period so as to preclude the allowance of increased compensation over that previously paid by the company merely by reason of our action in allowing profit sharing plans as part of total compensation.

7. Submit the new cost principles to the Hébert Committee after we have issued them.

SIGNED
G. C. BANNERMAN
Director for Procurement Policy

8/14/58
Look for
a response to
my letter by
the results
of the meeting
of the
Board

CF

OCT 58

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contributions and Donations - Armed Services' Associations.

Mr. McNeil's memorandum of 17 September brings up the question of allowability of contributions and donations. He says:

"To my mind it is questionable whether contributions to any of the Armed Services' associations should be recognized as legitimate business expense...."

You will recall that the allowability of contributions and donations is one of the issues which is included in the agenda for consideration at the DOD--industry meeting of 15 October. You will recall also that this is one of the issues which we discussed with the Secretary of Defense in our memorandum of 18 June, 1958 and at the several meetings held with him pursuant thereto. Attached to this letter was the following indication of the Industry and Government position:

Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of governmental policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy.

The Secretary agreed that our position was proper for the purpose of the conduct of the meeting.

Mr. Pelson

To apply this conclusion to the problem at hand, our position, at this time, is that "ALL CONTRIBUTIONS AND DONATIONS SHOULD NOT BE ALLOWABLE." All contributions would, of course, include contributions made to the Armed Services Associations.

J. J. PHILLAN, JR.
Acting Director for Procurement Policy

Prepared by TA Pilson/rbs/10Oct58
3D774 OASD (S&L) X79391

Coordinated by:
Col. W.A. Fickling _____

THE NUMBERS GAME

In presenting its statistical argument about the number of costs disallowed, industry is playing the numbers game. They can (as did NSIA who cited 52 items) list a number of "areas in which there is failure to recognize true costs in whole or in part," and make it appear that we are being more restrictive rather than more liberal. There are several reasons:

(1) We explain the treatment of costs in more detail in the present proposal. Thus whereas "general research unless specifically provided for in the contract" was classed as one unallowable in Sec. XV, NSIA listed several elements of R&D costs as accounting for four items of unallowables. Yet we have liberalized this element substantially. Likewise NSIA lists five such items under compensation, three under depreciation, four under insurance, three under material, three under rental, three under royalties, and four under training. In none of these items is allowability more restricted, and in several it is liberalized.

(2) We provide policy guidance on many items now included in ASPR XV, Part 5, where they are classed as for "Special Consideration."

(3) Many of the items have had to be covered more specifically and their allowability restricted because of abuse by some contractors in the absence of prescribed handling (e.g., sale and leaseback, recruiting, and training).

No doubt the source of much of the attack on this score is the fact that they have been reimbursed in the past for many of the "unallowable" costs through the mechanism of pricing under several of the types of so-called fixed price contracts.

M. K. KILGORE

JUN 18 1958

CD

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Since 1949, the Armed Services Procurement Regulation has contained a very brief statement of the principles relating to the allowability of manufacturers' costs for use in connection with payments under contracts which are on a cost reimbursement basis. This statement has contained principally three listings, first, those types of costs which are regularly allowable, second, those which are regularly unallowable and, third, those which are allowable only to the extent specially treated in the contract. The regulations have contained no principles or policy guidance with respect to the method of dealing with costs or cost estimates in contracts of types other than cost reimbursement contracts.

For nearly five years there has been increasingly intensive pressure on the Department for the development of a new set of cost principles which would both give more detailed and precise policy guidance in the treatment of many cost elements and would be applicable to all types of contracting or contract settlement situations. Specifically, the adoption of such a uniform, comprehensive set of cost principles has been strongly advocated by the House Appropriations Committee, the Comptroller General of the United States, and the Hoover Commission.

We have been in the process of developing such a comprehensive set of cost principles for several years. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of cost principles has been a slow process. By last fall we had obtained sufficient agreement among the different elements within the Department of Defense to be able to issue a draft of the proposed principles to various industrial groups for their comment. These comments, which for the most part were quite critical of the proposed draft, have been reviewed, evaluated and thoroughly discussed with Assistant Secretary McNeil and the Materiel Assistant Secretaries of the three military departments preparatory to our undertaking discussions with industry groups in an effort to resolve our differences to the extent practical.

C P Chever

Prior to our discussions with industry I believe that you should be aware of the policy approaches that we propose to take.

The industry comment was critical with respect to each element of cost, such as the cost of institutional and product advertising, which we had felt should not be charged to the government but which industry considered a normal cost of doing business. In other words they considered that all normal and proper costs of doing business should be allowed by the government to the extent they were reasonable and allocable under the contractor's accounting system even though some of such costs clearly have nothing to do with the conduct of government business. We feel that there are some costs, such as advertising or allowances for bad debts, which although necessary in the conduct of the business should not be allocated to government contracts.

The industry comment also made it clear that, so long as there were to be unallowable items of cost, industry did not favor the extension of the use of cost principles to incentive contracts, price redeterminable contracts and other negotiated "fixed price" type of contracts or to negotiated settlements of terminated contracts. The basis for this opposition seems to be a belief that the use of cost principles in these situations will lead to formula pricing rather than true negotiation. We believe that the description which we have included in the cost principles themselves of the methods of use of these principles in the pricing or settlement of these contracts is adequate to assure that they will not damage the negotiation process.

In our meetings with Mr. McNeil and the Materiel Assistant Secretaries consideration has been given to some twenty issues which were raised by industry. We have come to agreement among ourselves on all but one. On several of these issues we have agreed to accept the industry viewpoint whereas in a number of others we believe that we should not accept that viewpoint.

Tab A, attached, is a summary of the one remaining issue on which we do not have internal agreement and on which we seek your advice. This has to do with the allowability, as a part of total compensation to employees, primarily involving executive compensation, of that portion which is dependent upon or measured by profits. The Air Force is opposed to allowance whereas the Army, Navy, ASD(Comptroller) and ASD(Supply and Logistics) favor allowing. This problem has been with us for several years and it was previously decided by Mr. Wilson that such expenses should not be allowed as costs. The question is again raised by the industry comment and there is again a lack of agreement. The arguments on this subject are included in Tab A.

Tab B, attached, represents an identification and evaluation of the significant remaining issues with industry. Internally we are in complete agreement that these industry views should not be accepted in the proposed regulation.

Tab C, attached, is an identification of the principal changes to which we have agreed as a result of the industry comments.

Tab D, attached, is our timetable for the completion of this project and the issuance of this section of the regulation.

SIGNED

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

4 Inclosures
Tabs A, B, C and D

Prepared by: GCBannerman/kh
CD 6 June 58 X78177
Rewritten by: GCBannerman/jb/17 June 58
(See attached coordination)

Issues Between the Air Force and Industry, (ASD(S&L), (COMP), Army and Navy)**COMPENSATION****INDUSTRY VIEW**

(concurrent in by ASD(S&L), (Comp), Army and Navy)

Basic Contention: The critically important consideration underlying the compensation principle ought to be the reasonableness of the total compensation paid using any and all methods. The methods of compensation usable ought to be that determined by the contractor so long as the methods utilized are in keeping with sound accounting practices and the results achieved are reasonable in light of the services rendered.

A. COMPENSATION PLANS BASED UPON MEASURED BY PROFITS. ☒

Specifically, industry contends that compensation plans based upon and measured by profits:

1. Are becoming increasingly more widely used as a means of compensating employees and officers for services rendered.
2. Are costs, as distinguished from a distribution of profits, by generally accepted accounting principles and practices.
3. Are allowable as costs for tax purposes and for renegotiation.
4. Are not logically separable into deferred or immediate distribution plans. The Air Force

AIR FORCE POSITION

Contentions: The Air Force position is that payments under profit-sharing plans should not be recognized as a cost of performing defense contracts.

1. Since January 1, 1955, the Air Force, in its negotiations with contractors, has taken the position that payments to management under profit-sharing plans are not allowable. The Air Force has no objection to profit-sharing plans as such. We do reject the philosophy that payments under such plans should be treated as a cost of performing the contract.

2. Profit-sharing is a method of distribution of profits realized. This is implicit in both the label and the conditions attached to this particular method of distributing corporate earnings. Distribution of profits under the various plans are, in general, determined in accordance with the profit position of a company at the end of the fiscal year. In a profit-sharing plan the contractor purports to be sharing his calculated profits with certain of his employees. If profit distributions are treated as costs in determining contract prices, the so-called "profit-sharing" is an illusion. For, while the contractor would be publicizing a program as "profit-sharing," the Government would, in fact, be bearing directly the cost of such plan.

position makes it clear that their opposition is only to "immediate distribution" plans and not to "deferred distribution" or "retirement" plans. Where each is based upon or measured by profits, it is difficult to see how one type can be considered a cost and the other not. The Air Force position does not explain this point.

5. Cannot logically be separated from bonuses (which are allowable), since both are treated alike by contractors for most purposes.
6. Were considered "essential to the ultimate maintenance of the Capitalistic System" in the one Congressional inquiry into such plans in 1939.

3. Under our contracting techniques we negotiate, contract by contract, a price based upon what the job is worth. This estimated profit is an incentive to the contractor and we allow him an opportunity, by reducing costs, to earn more profit. If, as a matter of corporate choice, profit-sharing is held out to the contractor's employees as an inducement to aid the contractor in earning more profit under the contract, the profits so earned should be the source of distribution of the rewards promised the employees. Having striven for the target profit, and, having achieved such profit or more and distributed a portion thereof to certain of its employees as "profit-sharing", the contractor should not confront the military department with a "voucher" for reimbursement of the profits distributed.

4. Profit-sharing is not necessarily identifiable with, nor measured by, efficiency. Net profits available for distribution may be the result of higher volume of business, sharp negotiations, or the peculiar tax situation of the contractor. In fact, a manufacturer who has not produced efficiently during a particular year could still, out of profits earned, distribute bonuses measured by profits. The Government would not have derived any benefits from the operation of the profit-sharing plan.

5. Normally, management is confronted with conflicting interests of stockholders and

employees in the distribution of profits in the form of dividends for the former and profit-sharing plans, if any, for the latter. The normal pressures exerted by stockholders to prevent the indiscriminate distribution of profits under the profit-sharing plan disappears if the Government accepts payments under profit-sharing plans as an allowable cost, particularly in the case of companies predominantly in defense work.

6. It is significant that certain of our contractors, who have had profit-sharing plans in effect for a number of years, have never sought reimbursement for payments under such plans. The effect of a formal policy allowing payments under such plans would cause these companies to request reimbursement therefor and would stimulate interest in other companies to inaugurate such plans. The Air Force estimates existing profit-sharing plans could involve, for the Air Force alone, approximately \$25 million a year. Any general policy in favor of allowing payments under these plans could cause this amount to be increased significantly.

7. Our position is primarily addressed to profit-sharing plans of the "immediate" distribution type. We would not object to allowability of payments under profit-sharing "retirement" plans as presently contained in the latest DOD draft of the proposed cost principles, if such plans meet the requirements of the Internal Revenue Code and the regulations thereunder.

Identification and Evaluation of the Significant Remaining Issues
with Industry

ISSUE 1

Should there be an attempt to get uniformity of cost treatment in all of the various types of contractual situations where costs are a factor in pricing?

Industry Position

With very slight exception industry agrees with the objective of uniformity of cost treatment but is seriously concerned lest the application of these principles lead government contracting personnel to resolve controversial points of negotiation by unilateral accounting solutions rather than by overall bargaining. Specifically they fear that the description, contained in the document itself, of the "applicability" of these cost principles to fixed price types of contracts may lead to formula pricing rather than to negotiation based upon factors other than estimated costs.

Government Position

The "applicability" section of these cost principles makes it clear that they are for use only when costs are a factor in pricing. They do not enlarge, or even affect, the number of types of transactions where costs are to be considered nor do they suggest that a specific treatment of costs shall be paramount to other considerations in cases where estimated costs are one of several factors affecting the negotiation. The present guidance, contained elsewhere in ASPR, with respect to negotiation and pricing techniques and methods (which has the solid support of industry) remains in effect and is the basis for judgment as to when costs or cost estimates should be importantly considered in pricing. It is only when costs are considered that these cost principles apply. Hence it is not felt that the danger of formula pricing would be increased by the adoption of these principles. Rather, they would encourage a consistent treatment of costs where costs are dealt with at all. However, we have agreed to revised language to make these points completely clear (See Tab C, Item 1).

ISSUE 2

Should the cost principles provide for the non-acceptance by the government of any cost which is normal, legal, and reasonably necessary in the conduct of the contractor's business?

Industry Position

In general the industry view was that the government should accept its pro rata allocation of all normal and necessary costs of doing business. This view was very generally stated by all industry's groups as well as by the Comptrollers Institute.

Government Position

This is probably the most difficult issue to resolve to the satisfaction of all parties. 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. We have also considered that certain other individual expense items such as product and institutional advertising and contributions and donations, should not be accepted by the government.

ISSUE 3

Related to Issue 2 is the additional question as to whether the government should question the "reasonableness" or "allocability" to government work of a cost which is handled consistently under the contractor's normal accounting system in accordance with "generally accepted accounting principles". Stated differently, this question is whether the cost principles should contain rules or guidelines for determining the "reasonableness" or "allocability" of various cost elements or whether we should accept, as the criterion, "generally accepted accounting practices".

Industry Position

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

Government Position

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

ISSUE 4

The proposed cost principles point out that when we are buying from companies or industries actively engaged in commercial competition, we can normally rely on the restraints of competition to assure that certain items of expense, such as general research, are kept by management decision within reasonable bounds. However, where we are dealing with firms whose work is exclusively or predominantly with the government such competitive restraints do not exist. To provide appropriate control in such instances and to avoid unexpected disallowances of costs by the government, the cost principles suggest that, with respect to elements of cost where reasonableness is hard to determine, particularly with contractors whose work is predominantly with the government, there should be advance agreement as to the extent of allowability of such costs and that such agreements should be incorporated in the contracts. The issue is whether this provision is sound.

Industry Position

The industry comment generally objected to this provision on the ground (a) that it favored companies in a strong negotiating position, (b) promoted lack of uniformity of treatment and (c) limited management's discretion to make sound business decisions by requiring approval in advance of incurring legitimate business expenses.

Government Position

The industry comments seemed to assume that a failure to negotiate and agree on such costs would render them unallowable. This is erroneous. They would be unallowable only if subsequently found unreasonable which would not

happen if there had been an agreement. This point can undoubtedly be cleared up by a clearer rewrite of this section of the principles. Nevertheless, the basic issue will to some degree remain. We consider it highly desirable that there be an advance agreement on the ground rules when we are dealing with traditionally difficult questions of cost particularly where there is no motivation through the needs of competition to keep such costs within normal and reasonable limits. This will not lead to any less uniformity of treatment, probably to more, than we would have by complete reliance on the concept of "reasonableness" advocated in the industry comments. As to the infringement on management decisions we are simply telling management that, if they want reimbursement from us for exceptional or unusual expenses in these troublesome fields, they should get our concurrence. The only way we could avoid such infringement would be to allow whatever they spend without regard to our judgment as to reasonableness.

ISSUE 5

The subissues which follow have to do with our treatment of specific elements of cost. There are a number of minor points which are not considered in this paper. The following are the significant points which were commented on adversely by several or most industry groups.

5a. Advertising Costs

Industry Position

The industry comment strongly urged the allowability of institutional advertising in all media on the ground that it stimulates interest and the pursuit of careers in engineering and science, affects employee relations and, by keeping the company before the public assists the company in other ways which are of indirect advantage to the government, as in making it easier to attract investment capital. To a lesser extent industry urged the allowance of the costs of product advertising on the ground that the government benefits through cheaper prices for defense work from the creation of mass markets for commercial products.

Government Position

Product and institutional advertising are essentially selling expense and are designed to influence the general public. The costs thereof should be allocated to that portion of the contractor's business which is conducted with the general public. We have consistently held to this position for many years. We have, however, allowed advertising in trade and technical journals, provided products are not offered for sale. This we propose to continue.

5 b. Compensation for Personal Services

(i) Compensation dependent upon or measured by profits. See Tab A.

(ii) Stock Options.

Industry Position

Stock options are a proper means of compensating employees, they are recognized as costs by generally accepted accounting principles and, under some circumstances, are deductible for tax purposes.

Government Position

Stock options are not a cost of doing business in that they do not get on the contractors' statements of income and expense. In the form in which they are currently used by industry they are not deductible by the employer as a cost for tax purposes. They should not be allowed as a cost for pricing purposes.

5 c. Contributions and Donations

Industry Position

The making of contributions is essential to the conduct of a business and the failure to do so adversely affects the contractor's standing in the community and, hence, his employee relations. Such contributions aid in the development of technical education and scientific research. These costs are deductible for tax purposes.

Government Position

The allowance of contributions and donations would put contractors in the position of being able to give away the government's money. They bear no relation to the conduct of government work. As a matter of governmental policy these costs have never been allowed under any prior cost principles and we feel that we should not change this policy.

5 d. Interest

Industry Position

All industry comment indicates the belief that the interest on borrowings made necessary by our contracts should be allowed as a cost against our contracts.

Government Position

It is felt that the allowance of interest as a cost would provide a preference for one method of obtaining capital requirements over other methods and therefore would provide an incentive for borrowing for the performance of our contracts even where our cash requirements could be met out of available capital. The extent of capital requirements of our contracts should be considered in the fixing of fees or profits (See Tab C, Issue 2).

5 e. Plant Reconversion Costs

Industry Position

Reconversion from defense work to civilian work may be very costly. Where unusually heavy expense is involved, allowability should not be precluded by the cost principles.

Government Position

The government does allow all initial set-up expense as a charge to its work. In addition it allows the cost of removal of special government furnished machinery when special installations, such as large concrete foundations, are involved. This is considered equitable and it is felt that we should continue the policy of requiring that, upon completion of government work, set-up or make-ready expense for commercial work be charged against ensuing production.

5 f. Research and Development

Industry Position

Under the proposed cost principles pure research is allowed on a

pro-rated basis as a charge against any contracts. Product research or development is allowed only as a charge against the product or product line which is benefited. Product research or development is not allowed as a charge against government research contracts. Some industry comment opposed the distinction between pure research and product research, claiming that this would require a difficult segregation. Others felt that product research should be allocable to government research contracts. Others, principally the Aircraft Industries Association, objected to the requirement for negotiation to predetermine reasonableness of R&D expense.

Government Position

The allowance of pure research to the extent of reasonableness is new. Previously it was not allowed unless specially agreed on. Product research has been allowable as part of the price of products which are benefited. We feel that this is a reasonably clear and uncomplex segregation and that, for instance, the sale of an atomic reactor should not bear any part of the cost of developing a new line of refrigerators. Recent discussions with various industry groups seem to indicate a better understanding and more willing acceptance of this principle than the initial written comments showed. The point raised by the AIA with respect to the necessity for pre-agreement on reasonableness is covered under Issue 4 above.

5 g. Training and Educational Costs

Industry Position

The proposed cost principles:

- (i) allow in-training and out-training at vocational and non-college levels.
- (ii) allow part-time technical, engineering and scientific education, including materials, textbooks, fees, tuition, and, if necessary, straight time compensation for attendance of classes during working hours for 2 hours a week for the year (1 course).
- (iii) allow post-graduate tuition, fees, materials for full-time scientific and engineering education (BUT NO SALARY OR

SUBSISTENCE), for bona fide employees for one school year for each employee so trained.

(iv) disallows grants to educational institutions since such grants are considered donations.

In connection with (ii), industry objects to the limitation of 2 hours a week for the study during working hours.

In connection with (iii), industry objects to the non-allowability of salary and subsistence. Finally, industry objects to the non-allowance of grants in (iv).

Government Position

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

It was felt, in connection with (ii), that this sort of activity ought to be accomplished outside of working hours, but instances were found in which this was not possible. Two hours per work week appeared to be a reasonable solution. In connection with (iii) above, allocability of this expense against Government contracts is a tight question. As a matter of policy, therefore, we sought a reasonable solution and one in which a discipline to reasonableness would be provided. Sharing of the expenses provides this incentive. Grants, in (iv) above, were disallowed on the basis that grants are in fact donations and should be allowed only if contributions generally are allowable (See Item #4).

Issues on Which the Industry Views Have Been Adopted in Whole
or in Part

1. Industry Position

Industry strongly approves the existing section of ASPR that describes our negotiation and pricing policies. These policies emphasize negotiated bargaining toward reasonable overall pricing. The industry comments express the fear that the proposed new cost principles would undermine this policy and lead to formula pricing based solely on audit reports.

Government Position

Since the intent of the proposed draft was to continue our existing pricing policies and since this intent was not understood from a reading of the draft, the "Applicability" section of the draft is being rewritten to make this intent clear and, hence, to accommodate the industry views.

2. Industry Position

Industry strongly urges that interest on borrowings be allowed as a cost.

Government Position

While we do not feel that we should accede to this position (See Tab B, Issue 5 d), we have emphasized, elsewhere in ASPR, that the extent of the contractor's capital investment in the performance of the contract shall be taken into account in negotiating the amount of fee or profit.

3. Industry Position

Industry felt that the treatment of overtime pay, extra pay shift premiums and multi-shift premiums was unnecessarily complicated and would lead to confusion among the services to the disadvantage of industry.

Government Position

Since the original submission of the draft for industry comments, the policy with respect to overtime, extra pay shifts and multi-shifts has been greatly simplified in its administration and this simplification, carried into the cost principles, satisfies the industry objection.

Timetable for Completion

July 1958	Meetings with industry associations
September	Completion of revisions stemming from meetings with industry
October	Coordination of final proposal internally and with General Accounting Office
November	Publication



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

SUPPLY AND LOGISTICS

OCT 14 1958

CR

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY & LOGISTICS)

SUBJECT: Comparison of Proposed Cost Principles with Current Practices

Messrs. Kilgore and Pilson have undertaken another review of the present cost practices and those proposed under the current draft. The nature of the present ASPR in brevity of the coverage makes it difficult to know precisely what the present coverage is, when subjected to the additional tests of "reasonableness" and "allocability."

The industry statistics presume that reasonableness and allocability are not applied at present and that any specific provision thereof included in the comprehensive set represents a retrogression from current practice. Needless to say this is spurious.

As a matter of fact, we can see only three principles in which there are slight facets which may be less generous than present practices, as follows:

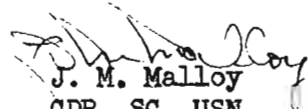
1. Plant reconversion costs. The draft does not allow plant reconversion costs, while at present such costs may be negotiated.
2. Pre-contract costs are narrowly allowable under the current draft, while it is possible that greater allowability may be negotiated under current practices.
3. The Sale and Leaseback aspects of Rental Costs are restricted under the current draft, while greater allowability may be negotiated under current practices.

At the same time, the following costs are MORE GENEROUS:

1. Bidding costs
2. Compensation
3. Food services and dormitory
4. Insurance

5. Interest (allowable in profit or fee)
6. Materials cost
7. Overtime
8. Research and development
9. Selling costs (Government sales aspects)
10. Service and warranty
11. Severance pay
12. Training and education

The remainder of the costs represent no change from current practices.


J. M. Malloy
CDR, SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

COVERING BRIEF

CR

JUL 8 1959

TO: The Assistant Secretary of Defense (Supply and Logistics)
FROM: Staff Director, ASPR Division, Office of Procurement Policy

Problem: To provide the Secretary of Defense with an overall status report of the contract cost principles project.

Discussion: During our discussion of the contract cost principles held on 1 July 1959, it was decided that a short overall statement of the current status of the cost principles project should be provided to the Secretary of Defense. This statement was to include information concerning our coordination with industry, a statement of some of the principal issues involved and an indication of the current course of action which we are pursuing. The attached memorandum is designed to accomplish these objectives.

Recommendation: That you sign the attached memorandum.

Concurrence: The Assistant Secretary of Defense (Comptroller).

As Cdr Mallory

COPY

ASSISTANT SECRETARY OF DEFENSE
Washington 25, D.C.

Supply and Logistics

CR

21 July 1959

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Approximately one year ago, Assistant Secretary McNeil, the Materiel Assistant Secretaries of the Military Departments, and I discussed with you certain issues within Department of Defense and with industry concerning the proposed comprehensive cost principles applicable to all types of negotiated contracts in which costs are a factor in pricing.

Due to the inherently controversial nature of these cost principles, achieving even reasonably close agreement between all parties concerned has been a slow process. We have given industry more than the customary opportunities to present their views. These have included written comment on the 10 September 1957 draft, an open discussion meeting on 15 October 1958 followed by a second written comment, and finally a detailed discussion with four industry representatives on 1-3 April 1959.

Our current proposal is the result of thorough consideration of industry and military department views. Outlined below are its most significant provisions, primarily from the standpoint that they represent a change from present policy or practice, or are opposed by industry.

1. Applicability -- The principles will be incorporated by reference in cost-reimbursement type contracts and will form the basis for determination of costs thereunder. They will also serve as guidance in the evaluation of costs in pricing negotiated fixed-price type contracts where such evaluation is required in the establishment of prices.

2. Advance Agreements -- In order to avoid disagreements with respect to costs during or after performance of a contract, the principles encourage the negotiation of advance agreements as to the handling and the degree of allowability of certain items of cost, particularly in connection with firms or separate divisions thereof whose work is primarily with the Government. Industry has some reservations concerning this provision, but we believe it is entirely reasonable and will work to the benefit of all concerned.

3. Compensation -- As decided in our above-mentioned discussion, compensation of contractor officers and employees is allowable if reasonable. Thus, compensation dependent upon or measured by profits is not, per se, unallowable.

4. Research and Development Costs -- In line with national policy of encouraging research and development, we propose to provide for acceptance as allowable costs, our share of a contractor's independent research. We will treat his independent development costs similarly to the extent that they relate to product lines for which the Government has contracts. Restrictions are provided, however, to limit these costs to reasonable amounts and to prevent unwarranted duplication of efforts in the same area by different contractors. In return for our support of current research programs, we will not accept similar costs incurred by the contractor in the past, even though we may receive some of the benefits thereof.

5. Minor Costs Disallowed -- Industry has long objected to our disallowance of certain items which it considers to be normal and proper costs of doing business. We maintain the position that, for reasons of public policy, equity, or absence of benefit to the Government, we should disallow certain costs. Among these are contributions and donations, interest, bad debts, and product and institutional advertising.

We believe that to try further to resolve the remaining differences with industry would serve only to delay this much needed guidance and deprive us of the benefits which are expected to flow from it. We anticipate that the issuance of these cost principles will result in greater uniformity of treatment of contractors, more effective and economical audit of contractors' costs, and a more orderly procurement process.

One possible hurdle, yet to be overcome, is discussion of the principles with the Comptroller General. While it is within the authority of Department of Defense to issue such regulations without reference to the General Accounting Office, we recognize its interest. Based upon comments of the Comptroller General on earlier drafts and informal staff discussion, we know that he favors a much more rigid application of the principles to all contract pricing -- an approach which industry and many of us fear will remove bargaining from the negotiation process and result in formula pricing. The possibility exists that he may be critical of our effort. However, Mr. McNeil and I plan to discuss the matter with him on 23 July to point out the reasons why we believe we are proposing the best possible solution at this time.

My position, concurred in by Mr. McNeil and the military Departments,

is that the principles should be published in the Armed Services Procurement Regulation immediately, to become effective on 1 January 1960. Barring objection from you, or insurmountable opposition from the Comptroller General, I propose to do so.

(Signed)

PERKINS McGUIRE
ASSISTANT SECRETARY OF DEFENSE
(Supply and Logistics)

Prepared by: KK Kilgore 7/8/59
3C885 X76321

Concurrence:
Mr. McNeil _____
Cdr Malloy _____

September 30, 1959

Jim:

I am very opposed to the issuance of a press release on Cost Principles now. My reasons are, in part:

1. It would reduce our flexibility to make changes in the next 2 weeks.
2. It would or could open up old arguments or pressures which might be effective if the words are not frozen in print.
3. It would induce a flock of inquiries and requests for copies.

I could probably think up others, but my overall feeling is that it would be a tactical blunder. I had planned to get out a press release some time before they hit the street, may be a week before. At that time, I would have copies available for all, including DOD people.

Another point just occurred to me. We must treat Cong. Hebert carefully here. I plan to transmit him a copy over Mr. McGuire's signature prior to actual publication and prior to any press release. On the other hand, we should not let him know until the package is frozen, i. e. in about 2 weeks.

Pending your consideration of these views I will sit tight. I have discussed this with Ken Kilgore who feels as strongly as I do.

Pete



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

CR

SUPPLY AND LOGISTICS

5 October 1959

MEMORANDUM FOR THE RECORD

SUBJECT: Meeting with Dr. Raymond J. Saulnier on 28 September 1959
With Respect to Contract Cost Principles.

A meeting was held in Dr. Saulnier's office on 28 September 1959 in connection with the proposed Department of Defense Contract Cost Principles. Those present were:

Mr. James F. Falvey - Deputy Assistant Secretary of Defense
(Supply and Logistics)

Mr. G. C. Bannerman - Director for Procurement Policy
Office of the Secretary of Defense
(Supply and Logistics)

Cdr. J. M. Malloy - Staff Director, ASPR Division, Office
of Procurement Policy

Dr. Raymond Saulnier - Chairman, Committee on Government Activities
Affecting Costs and Prices

Mr. John Hamlin - Staff Assistant, Committee on Government
Activities Affecting Costs and Prices

This meeting was held in response to a request from Dr. Saulnier which was transmitted to Assistant Secretary Perkins McGuire by memorandum dated 24 February 1959. Dr. Saulnier had expressed a desire to be advised concerning the Department of Defense efforts in revising the contract cost principles applicable to cost-reimbursement type contracts.

The Department of Defense representatives presented the background of the development of the current set of cost principles and elaborated on the current need within the Department of Defense for the issuance of the principles in the very near future. The Defense representatives advised Dr. Saulnier of their opinion that the revised cost principles would not have an inflationary impact on the national economy. In fact, it was stated that the principles, particularly when used in the area of fixed-price contracts, might well have a deflationary tendency.

Dr. Saulnier expressed appreciation for the background briefing and indicated that no further action need be taken by the Department of Defense in connection with his memorandum of 24 February 1959.

The Defense representatives delivered to Dr. Saulnier a letter dated 25 September 1959 which was responsive to Dr. Saulnier's memorandum of 24 February 1959. A copy of this letter is attached.

J. M. MALLOY
Cdr., SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

1 Incl.
Ltr. to Dr. Saulnier
dtd Sept 25, 1959

COPY

February 24, 1959

MEMORANDUM FOR: Mr. Perkins McGuire
Assistant Secretary of Defense

It has come to my attention that certain revisions in the cost principles of ASPR are under consideration in the Department of Defense, that such revisions are about to be made, and that they are likely to have a significant effect on costs under cost-reimbursement type contracts.

I would appreciate an opportunity to have this matter discussed before the Committee on Government Activities Affecting Costs and Prices, naturally, in advance of the issuance of such revisions. Would you be good enough to suggest an appropriate date for such a discussion? I would appreciate it if you would notify John Hamlin, Executive Secretary of the Committee, of the date you would find agreeable.

(Signed)

Raymond J. Saulnier

COPY

ASSISTANT SECRETARY OF DEFENSE
Washington 25, D.C.

Supply and Logistics
CR

September 25, 1959

Dear Dr. Saulnier:

In Mr. McGuire's absence, I am responding to your memorandum of 24 February 1959, in which you expressed a desire to be advised concerning the Department of Defense efforts in revising the contract cost principles applicable to cost-reimbursement type contracts. Your interest in this matter stems from the activity of the Committee on Government Activities Affecting Costs and Prices. Your memorandum indicates a belief that our new cost principles "are likely to have a significant effect on costs under cost-reimbursement type contracts."

The Department of Defense has been working on a revision of Section XV of the Armed Services Procurement Regulation with respect to contract cost principles for a considerable period of time. This task has been difficult because of the widely divergent views of all the interests so vitally concerned. We have received the views of industry on numerous occasions and, for the most part, the industry view is that our proposals (now incorporated in the new cost principles) are much too harsh.

We are, I think, approaching the culmination of our efforts in this field. I would like to indicate to you our own appraisal of this project. In the first place, we do not feel that our revised cost principles are significantly different from our present practices with respect to the allowability of costs under cost-reimbursement type contracts. Our revised principles provide more detailed guidelines for both procurement and audit personnel with the end in view of achieving greater uniformity of current practices throughout the Department of Defense. We have, however, provided for the use of these cost principles as a guide in the negotiation of the various types of fixed-type price contracts where costs are an important factor in the establishment of prices. We anticipate that our action in this regard will result in a tightening up of present practices in some areas.

Since, as indicated above, our proposed cost principles will not have a significant effect on costs under cost-reimbursement type contracts, I do not feel that a discussion before the Committee on Government Activities Affecting Costs and Prices would be helpful.

These are the considerations which have prompted me to present this matter to you personally and to explain the urgency which compels us to proceed with publication of our revised regulation at the earliest possible time.

Sincerely yours,

(Signed)

J. P. FALVEY
Deputy Assistant Secretary of Defense
(Supply and Logistics)

Honorable Raymond J. Saulnier, Chairman
Council of Economic Advisers

Prepared by: JMalloy/rbs25Sept59
3D774 X72026

CR

Dear Mr. Mahon:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I feel certain that you share my feeling that the publication of Contract Cost Principles for use in the evaluation of costs when costs are a factor in Defense contracting represents a substantial forward step in our efforts to improve our procurement activities. We have been in the process of developing this comprehensive set of Cost Principles for a considerable period of time. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of Cost Principles has been a slow process.

I have decided, however, that further refinements should not be made at this time. After we have gained some experience in the use of this new Regulation, we will be in a position to make such revisions as are deemed necessary or desirable.

Sincerely yours,

Inclosure

ASPR Revision
Contract Cost Principles

Honorable George J. Mahon
Chairman, Subcommittee on Defense
Appropriations
House Appropriations Committee
House of Representatives

Prepared by: JMMalloy/jm/20 Oct 59
3D774 X-72026

Coordinated with:

Mr. Bannerman _____
LC _____
Mr. Kilgore _____

Copy to: Mr. Kilgore
Mr. Pilson

Oct 59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)
FROM: Director for Procurement Policy

Problem: To provide the Atomic Energy Commission with an advance copy of our Contract Cost Principles.

Discussion: The attached letter transmits an advance copy of the Cost Principles to the General Manager of the Atomic Energy Commission for information. We have consulted with Staff elements of the Atomic Energy Commission on several occasions in connection with earlier drafts of the Principles. Representatives of the Commission sat in on our meeting with industry on October 15, 1958. Subsequent to that meeting, we received a letter from the General Manager, Atomic Energy Commission, making certain comments on the then current draft and concluding as follows: "We think it represents an excellent piece of work and that the principles are sound and generally acceptable." Our last discussion with AEC representatives took place a few months ago. The AEC Comptroller acted as spokesman for the AEC representatives. Most of the individual comments which they had were satisfactorily resolved during this discussion. The AEC representatives indicated that the Commission would probably adopt the Principles contained in our Regulation with the exception of 2 or 3 cost elements in which they felt the problems peculiar to Atomic Energy contractors required special treatment somewhat different from our proposals. Basically, however, they are in agreement and will undoubtedly promulgate principles almost identical to our own.

Malley

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

CR

Dear Mr. Hebert:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I feel certain that you share my feeling that the publication of Contract Cost Principles for use in the evaluation of costs when costs are a factor in Defense contracting represents a substantial forward step in our efforts to improve our procurement activities. We have been in the process of developing this comprehensive set of Cost Principles for a considerable period of time. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of Cost Principles has been a slow process.

I have decided, however, that further refinements should not be made at this time. After we have gained some experience in the use of this new Regulation, we will be in a position to make such revisions as are deemed necessary or desirable.

Sincerely yours,

Inclosure
ASPR Revision
Contract Cost Principles

Honorable F. Edward Hebert
Chairman, Subcommittee for Special
Investigations
Committee on Armed Services
House of Representatives

Prepared by: JMMalloy/jm/20 Oct 59
3D774 X-72026

Coordinated with:

Mr. Bannerman _____

LC _____

Mr. Kilgore _____

Copy to: Mr. Kilgore
Mr. Pilson

0-59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)
FROM: Director for Procurement Policy

Problem: To provide an advance copy of the new Cost Principles to Congressman Hebert for information.

Discussion: The attached letter to Congressman Hebert is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with Congressman Hebert prior to their publication. We feel, however, that we should give him an advance copy as a matter of courtesy in view of his sustained interest in this subject.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)
General Counsel

cdw mal



OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

OCT 21 1959

CR

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY & LOGISTICS)

SUBJECT: Request for Approval of the Press Release to be Issued on
the New Contract Cost Principles

I am attaching a draft of the press release which we propose to issue on 2 November 1959 in connection with the issuance of the new Contract Cost Principles. This draft was developed by Commander Malloy and Mr. Kilgore and has been reviewed by staff members of the Office of Public Information.

Our plans now contemplate the issuance of this press release on 2 November 1959, which is the date that we expect the ASPR Revision to be available at the Government Printing Office. The Office of Public Information has recommended that a press interview be granted by a DOD spokesman when the press release is issued. Subject to your approval, I have directed that Commander Malloy undertake this task.

We have several letters prepared to interested Congressional Committees and to other Government Departments which will be released in about one week. These letters will provide the recipients with advance copies of the Regulation. In addition, we are preparing letters to each of the Industrial Associations which have commented on the cost principles. These letters will be released concurrently with the publication of our press release.

A copy of the attached press release is being submitted to the ASD(Comp) for his review and approval concurrently with the forwarding of this memorandum to you.

G. C. Bannerman
G. C. BANNERMAN

Director for Procurement Policy

Incl

Draft - Press Release

10/22
Approved by FPM
[Signature]

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To advise the Material Secretaries of our specific plans for publishing the cost principles.

Discussion: It is important that the Military Departments be aware of our specific plans in connection with the publication of the cost principles. The attached memorandum sets forth our plans together with a timetable for each action.

Recommendation: That you sign the attached memorandum.

copy

Malley

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To advise Mr. Gates of the specific actions which we contemplate in connection with the issuance of our cost principles regulation.

Discussion: The attached memorandum was prepared at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to provide Mr. Gates with information as to the current status of this project and to indicate the specific actions which we contemplate.

Recommendation: That you sign the attached memorandum.

Malloy

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide Mr. McGillicuddy of the Preparedness Investigating Subcommittee of the Senate Committee on Armed Services with a copy of the contract cost principles and a copy of the press release in connection with the publication of the cost principles.

Discussion: The attached letter was prepared at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to inform Mr. McGillicuddy of the culmination of our efforts in connection with the publication of the contract cost principles.

Recommendation: That you sign the attached letter.

Mulloy

Classification: Unclassified

WHITE HOUSE INFORMATION BRIEF

Department of Defense

Office of Origin: Assistant Secretary of Defense (Supply and Logistics)

Date of Brief: 28 October 1959

Subject: Publication of a Revision of Department of Defense regulations covering cost principles for use in Defense contracts

Brief: The Department of Defense will publish an important revision of its procurement regulations on 2 November 1959. This revision covers the subject of cost allowances under Defense contracts. The new regulation provides a single comprehensive set of cost principles which will give more detailed and precise policy guidance in treating cost elements. They apply to all types of contracting situations. The new cost principles will replace similar principles which have been in use for a number of years. They have been adopted after extensive consideration within the Department of Defense and after considering the views of a cross section of industry.

The new regulation does not materially change our current practices when cost-reimbursement type contracts are used. The new feature of the regulation is its use in providing guidance for the treatment of costs under negotiated fixed price type contracts. This new regulation should ultimately lead to more efficient negotiation and administration of Defense contracts.

We expect some adverse comment from industry on this new regulation. Congressional reaction should be favorable. The Comptroller General has long advocated the adoption of comprehensive cost principles. He has recently concurred in the desirability of publication of the new Defense regulation.

A copy of the press release which will announce publication of this regulation is attached.

Attachment
Press Release

Prepared by: JMMalloy/jm/23 Oct 59
3D 774 X-72026

Coordinated with: Mr. Bannerman

CR

Dear Mr. McGillicuddy:

I am attaching a copy of a revision to the Armed Services Procurement Regulation dealing with contract cost principles for your information. I recall that you attended our industry meeting on this subject on 15 October 1958 and that you expressed a continuing interest in our efforts to promulgate this important regulation. I am also attaching a copy of our press release on this subject which may be of interest to you.

Sincerely yours,

Attachments

1. Contract Cost Principles
2. Press Release

Mr. D. F. McGillicuddy, Jr.
Assistant Staff Director
Preparedness Investigating
Subcommittee of the
Senate Committee on
Armed Services
U. S. Senate

Prepared by: JMMalloy/jm/22 Oct 59
3D774 X-72026

Coordinated with: Mr. Bannerman

Malloy

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To notify the Secretary of Defense of the publication of the contract cost principles and to provide him with a copy of our press release.

Discussion: The attached memorandum has been developed at the request of the Assistant Secretary of Defense (Supply and Logistics). It is designed to notify the Secretary of Defense of the action which we have taken and to provide him with a copy of our press release for his background information.

Recommendation: That you sign the attached memorandum.

QUESTION AND ANSWER SHEET - COST PRINCIPLES

1. Q. How do these new cost principles change what the Department of Defense has been doing in the past?
 - A. The Department of Defense has prescribed cost principles for cost reimbursement type contracts for many years. These principles have been prescribed for use only for cost reimbursement contracts. As to this type of contract, the new principles will not materially change our operations although they provide more definite rules and to some extent cover cost elements not previously defined. The new principles will eliminate separate cost principles which we now have for use in negotiating termination settlements. The most significant new feature of the regulation is its use with fixed price contracts. We have not had cost principles for this purpose in the past. The new regulation will be used as a guide in the negotiation of prices under fixed price negotiated contracts to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices.
2. Q. What will be the affect of the new cost principles with respect to cost recovery be a contractor for (a) cost reimbursement contracts and (b) fixed price contracts?
 - A. As to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. A definitive answer cannot be given to the question of contractor recovery in the fixed price area since the range of situations here is too complex for generalization. Since we have not provided specific guidance in the past, these new principles will, at least in some instances, result in reduced recovery by contractors for certain particular items of expense. For example, interest has previously been an allowable cost in termination situations. In the future, interest will not be allowed.
3. Q. How much money will these new cost principles cost the Department of Defense or how much will be saved?
 - A. As indicated previously, about the same result will be experienced in connection with cost reimbursement contracts. In the fixed price area, we expect that the new principles will ultimately result in more efficient procurement and, hence, savings will accrue in the long run. It is not possible to put a dollar sign on any such savings at this time.

4. Q. Why has the Department of Defense not promulgated cost principles for general use in the past? Why has it taken you so long to do this job?
- A. The Department of Defense has had cost principles for cost type contracts and for termination settlements. The extension of cost principles to the fixed price area is a very complicated and controversial subject. It has been necessary to take into consideration the strongly held views of the many parties at interest, including those of industry. The resolution of these areas of controversy has been difficult and, hence, progress has been somewhat slow.
5. Q. What are the more important areas of cost disallowance:
- A. These would include most advertising costs, bad debts, entertainment, contributions and donations, and interest on borrowings.
6. Q. How do the new cost principles treat research and development expenses?
- A. A contractor's independent research costs are allowable. Independent development costs are allowable to the extent that they are related to the product lines for which the Government has contracts. We have provided for certain administrative controls and limitations to insure that these costs are reasonable.
7. Q. Are executive profit sharing plans allowable?
- A. We regard compensation measured by profit sharing plans as a portion of an individual's over-all compensation. Such compensation is allowable to the extent that an individual's total compensation is reasonable in amount.
8. Q. What affect do these cost principles have on profit?
- A. The cost principles do not cover the subject of profit. Our profit policies are covered fully in Section III, Part 8 of the Armed Services Procurement Regulation.
9. Q. Will this new regulation lead to "formula pricing?"
- A. Formula pricing means the resolution of each item of cost by unilateral accounting decisions. We do not anticipate that the new regulation will have this result. Our over-all pricing philosophy remains in effect.

10. Q. What application will these cost principles have to contracts awarded by formal advertising?
- A. The evaluation of costs is not appropriate under contracts awarded by formal advertising. The cost principles will, however, continue to be used as a guide for terminated contracts, including terminated contracts originally awarded after formal advertising.
11. Q. What do you mean by the statement that the cost principles will be used "as a guide" in negotiating fixed price contracts?
- A. We realize that hard and fast rules with respect to costs are not appropriate for many pricing situations encountered under fixed price contracts, particularly in those instances where prices are being established for a future period. Government personnel will be expected to be guided by these principles to the extent appropriate in conducting negotiations in the fixed price contract area to the extent that the pricing action requires the evaluation of costs. Any departure from the basic policies now established will require adequate explanation and justification.
12. Q. Is this new regulation agreeable to industry?
- A. Industry has traditionally opposed any of our regulations which set forth specific costs as unallowable. Industry contends that the Government should allow all normal costs of doing business. For this reason, industry is opposed generally to most of the disallowances we have prescribed. Industry is also opposed to the utilization of cost principles in the fixed price area.
13. Q. Have the Military Departments concurred in this new regulation?
- A. Yes.
14. Q. Has the new regulation been approved by the Secretary of Defense?
- A. Yes.
15. Q. Has the Comptroller General approved this regulation?
- A. The Comptroller General has been in favor of a single comprehensive set of cost principles for some time. He has concurred in the desirability of publishing the new regulation without committing himself as to agreement on all details.

16. Q. What Congressional reaction do you expect?
- A. We expect that our new regulation will be well received by the Congress.
17. Q. How does the new regulation affect Small Business?
- A. We believe it will assist many Small Business concerns in that it is designed to foster an atmosphere of mutual understanding among contractors and contracting officers as well as provide guidance on the handling of many items not previously covered.
18. Q. Why is the new regulation not mandatorily effective until July 1, 1960?
- A. There are many details in this new regulation which will require study for both contractors and Government personnel. A longer period than usual was established in this instance to afford ample opportunity for familiarization with the new rules.
19. Q. Are these cost principles going to be used on a Government-wide basis?
- A. We expect that cost principles substantially similar to our new regulation will be adopted on a Government-wide basis.
20. Q. Will these cost principles mean more negotiated contracts?
- A. No.
21. Q. Will the new cost principles require contractors to establish new accounting systems?
- A. No. The revised cost principles are not an accounting blueprint which will require any appreciable change in the accounting systems of most Government contractors.

Office of the Assistant Secretary of
Defense (Supply and Logistics)
26 October 1959



FORM 12-1
12-12-12

Department of Defense Instruction

SUBJECT

Price Revision Negotiations

I. PURPOSE

The purpose of this instruction is to provide uniform policy guidance in the negotiation in price revision proceedings under fixed-price contracts providing for the redetermination of price.

II. CANCELLATION

This instruction cancels that portion of Munitions Board memorandum dated 15 November 1949 to the Secretaries of the Army, Navy and Air Force, wherein it is provided that in negotiating prices under fixed-price contracts, the contract cost principles, as set forth in Section XV of ASPR, may be used "by the contracting officers to the extent that they deem it advisable as a working guide only".

III. APPLICABILITY

The policies set forth below shall be applicable to all price revision proceedings under fixed-price contracts providing for the redetermination of price. This instruction is not applicable to fixed-price incentive-type contracts.

IV. POLICY

- A. In price revision negotiations, the objective of the Contracting Officer shall be to negotiate a fair and reasonable revised price in which due weight is given to all relevant factors, including those taken into account when the initial contract price was negotiated. By way of illustration, but not limitation, full consideration shall be given to such matters as the contractor's general performance, efficiency, economy and ingenuity displayed in meeting contract requirements, including the delivery schedules, quality of the product, the character and extent of the subcontracting, cost data including questioned costs and the allocability and reasonableness of costs, changes in market conditions, competitive aspects of the original negotiation, as well as the competitive prices

for the same or similar items, extent of contractor's technical, production and financial risk, and Government assistance in the form of facilities, equipment, or financing. All of the above factors shall be considered to the extent pertinent to the specific negotiation and no price revision negotiation shall be based solely on a single factor. The record of the negotiations should be in sufficient detail to reflect the most significant considerations controlling the establishment of the revised price.

- B. Compliance with the policy stated in paragraph A requires that Contracting Officers rely on educated judgment and not on mechanical rules or mathematical formulas. Compliance further requires that pricing decisions shall not be made solely on the basis of a determination of cost and profit. It follows that the Contracting Officer need not negotiate agreements with contractors as to the individual elements of cost.
- C. In order that the positions of the Government and the Contractor will not be prejudiced in price revision proceedings, such negotiations shall be conducted promptly.

V. EFFECTIVE DATE

This instruction is effective from the date of its receipt.

VI. IMPLEMENTATION

The Military Departments shall promulgate this instruction as soon as possible. Copies of the Departmental implementations pertaining to this instruction will be forwarded to the Assistant Secretary of Defense (Supply and Logistics) for information within thirty (30) days of the date of its issuance.



T. P. FINE
Assistant Secretary of Defense
(Supply & Logistics)

Office Memorandum • UNITED STATES GOVERNMENT

TO : CDR J. M. Malloy, OSD

DATE: 27 November 1959

FROM : E. T. Cook, CAD, NavCompt

SUBJECT:

Dear Pete:

Enclosed for your information is a copy of the article as sent to the Journal on the new cost principles. I will let you know when I hear whether they are interested in publishing it.

Sincerely,

Ed.

58

OFFICE OF THE NAVY COMPTROLLER
CONTRACT AUDIT DIVISION
WASHINGTON 25 D C

Page 1 of 5

Analysis of Treatment Accorded Specific Categories, Items, or Subitems in
Revised Part 2, Section XV, ASPR, dated 2 November 1959

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallow- able
Advertising:					
In trade and technical journals valuable for dissemination of technical information within the contractor's industry, provided ads do not offer products or services for sale	15-205.1(a)(i)	X			
Help-wanted	15-205.1(a)(ii)	X			
Costs of participation in exhibits upon invitation of Government or where exhibits are for purpose of disseminating technical information within the contractor's industry and provided specific products or services are not offered for sale	15-205.1(a)(iii)	X			
To obtain scarce materials, plant or equipment or disposing of scrap or surplus materials	15-205.1(a)(iv)	X			
All other	15-205.1(b)				X
Bad Debts	15-205.2				X
Bidding Costs:					
Incurred in current accounting period	15-205.3	X			
" " past " periods	15-205.3				X
(Note: Alternative methods permissible)	15-205.3				
Bonding Costs:					
Bonding required by contract	15-205.4(b)	X			
Required in general conduct of business	15-205.4(c)	X			
Civil Defense Costs:					
On contractor's premises pursuant to suggestions or requirements of civil defense authorities	15-205.5(a)	X			
(Note: Costs of capital assets allowable only as depreciation)	15-205.5(b)				
Contributions to local civil defense funds and projects	15-205.5(c)				X
Compensation for Personal Services:					
To extent the total compensation of individual employees is reasonable for services rendered and not in excess of amounts allowable under Internal Revenue Code	15-205.6(a)(1)		X		
In lieu of salary for services rendered by partners and sole proprietors provided such compensation does not constitute a distribution of profits	15-205.6(a)(3)		X		
Salaries and wages for current services	15-205.6(b)	X			
Premiums for overtime, extra pay shifts and multishift work	15-205.6(b)		X		
Cash bonuses and incentive compensation	15-205.6(c)		X		
Bonuses and incentive compensation paid in stock	15-205.6(d)		X		
Stock options	15-205.6(e)	X			
Deferred compensation for services rendered during current period and for past service pension and retirement costs	15-205.6(f)		X		
Fringe benefits	15-205.6(g)		X		
Contingencies:					
In historical costing, except certain minor items	15-205.7(b)				X
In estimating future costs:	15-205.7(c)				
Where related to known and existing conditions which can be measured with reasonable accuracy		X			
Where related to known or unknown conditions which cannot be measured closely enough to provide equitable results					X
Contributions and Donations	15-205.8				X

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
Material Costs					
Reasonable overruns, spoilage, or defective work	15-205.22(a)	X			
Cash discounts not taken because of reasonable circumstances	15-205.22(b)	X			
Adjustments for differences between physical and book inventories related to period of contract performance	15-205.22(c)	X			
Interplant, interdivision or intraorganization transfers:					
Ordinarily allowable at lower of cost to transferor or market	15-205.22(e)	X			
On a price basis	15-205.22(e)		X		
Organization Costs:					
Incorporation fees, attorneys' fees, accountants' fees, brokers' fees and fees to promoters and organizers, for organization, reorganization or raising capital	15-205.23				X
Other Business Expenses:					
Registry and transfer charges resulting from changes in ownership of securities issued by contractor	15-205.24	X			
Cost of shareholders' meetings	15-205.24	X			
Normal proxy solicitations	15-205.24	X			
Preparation and publication of reports to shareholders	15-205.24	X			
Preparation and submission of required reports and forms to taxing and other regulatory bodies	15-205.24	X			
Incidental costs of directors and committee meetings	15-205.24	X			
Overtime, Extra-Pay Shift and Multi-Shift Premiums	15-205.25		X		
Patent Costs:					
Preparing disclosures, reports and other documents required by the contract	15-205.26	X			
Searching the art as necessary to make invention disclosures	15-205.26	X			
Preparing documents and other costs in connection with filing patent applications where title is conveyed to Government in accordance with contract clauses	15-205.26	X			
Plant Protection Costs:					
Wages, uniforms and equipment of personnel	15-205.28	X			
Depreciation on plant protection capital assets	15-205.28	X			
Necessary compliance with military security requirements	15-205.28	X			
Plant Reconversion Costs:					
Cost of removing Government property and related restoration rehabilitation costs	15-205.29	X			
Additional costs to extent agreed upon before incurrence	15-205.29	X			
All other reconversion costs	15-205.29				X
Precontract Costs:					
To extent allowable if incurred after date of contract	15-205.30	X			
Professional Service Costs - Legal, Accounting, Engineering, and Other:					
Rendered by members of a profession who are not employees of the contractor	15-205.31(a)		X		
Retainer fees supported by evidence of bona fide services available or rendered	15-205.31(b)		X		
Legal, accounting, and consulting services, and related costs, in connection with organizations and reorganizations, defense of anti-trust suits and the prosecution of claims against the Government	15-205.31(c)				X
Legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation	15-205.31(c)			X	
Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets	15-205.32				X
Recruiting Costs:					
Help-wanted advertising	15-205.33	X			
Operating costs of employment office	15-205.33	X			
Operating and aptitude and educational testing program	15-205.33	X			
Travel costs of employees while engaged in recruiting personnel	15-205.33	X			
Travel costs of applicants for interviews for prospective employment	15-205.33	X			

Item	Paragraph Number	Allowable Subject to Usual Tests	Allowable if it Meets Special Tests or has Special Approval	Allowable only if Provided for in Contract	Unallowable
Termination Costs: (Cont'd.)					
Loss of useful value of special tooling, special machinery and equipment	15-205.42(d)		X		
Rental costs under unexpired leases	15-205.42(e)		X		
Cost of alterations of leased property	15-205.42(e)		X		
Reasonable restoration to leased property required by provisions of lease	15-205.42(e)	X			
Accounting, legal, clerical, and similar costs reasonably necessary for preparation and presentation of settlement claims, and the termination and settlement of sub-contracts	15-205.42(f)	X			
Storage, transportation, protection and disposition of property acquired or produced for the contract	15-205.42(f)	X			
Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the contractor	15-205.42(g)	X			
Trade, Business, Technical and Professional Activity Costs:					
Memberships in trade, business, technical, and professional organizations	15-205.43(a)	X			
Subscriptions to trade, business, professional, or technical periodicals	15-205.43(b)	X			
Meetings and conferences, including cost of meals, transportation, rental of facilities for meetings, and costs incidental thereto	15-205.43(c)		X		
Training and Educational Costs:					
Programs of instruction at noncollege level designed to increase the vocational effectiveness of bona fide employees	15-205.44(a)	X			
Part-time education at an under-graduate or post-graduate college level relating to the job requirements of bona fide employees:					
Training materials, text books, and fees charged by education institutions	15-205.44(b)	X			
Tuition charged by educational institutions	15-205.44(b)	X			
In lieu of tuition, instructors' salaries and related share of indirect cost of the institution not in excess of the tuition which would have been paid	15-205.44(b)	X			
Straight time compensation to employees for time spent attending classes during working hours not in excess of 156 hours per year	15-205.44(b)		X		
Tuition, fees, training materials and textbooks in connection with full time scientific and engineering education at a post-graduate level related to job requirements of bona fide employees - not to exceed one year for each employee trained	15-205.44(c)	X			
Subsistence, salary or other emoluments in connection with full time scientific and engineering education at post-graduate level	15-205.44(c)				X
Tuition, fees, training materials, text books, subsistence, salary or other emoluments in connection with full time education at an under-graduate level	15-205.44(c)				X
Maintenance expense and normal depreciation or fair rental on facilities owned or leased by the contractor for training purposes	15-205.44(d)	X			
Grants to educational or training institutions including the donation of facilities or other properties, scholarships or fellowships	15-205.44(e)				X
Transportation Costs:					
Freight, express, cartage and postage charges on goods purchased, in process, or delivered	15-205.45	X			
Outbound freight	15-205.45				X- As a direct cost only
Travel Costs:					
On an actual basis or on a per diem or mileage basis	15-205.46(b)	X			
Incurred in the normal course of over-all administration of the business	15-205.46(c)	X			X- As an indirect cost
Directly attributable to performance of a specific contract	15-205.46(d)	X			
Necessary, reasonable costs of family movements and personnel movements of a special or mass nature	15-205.46(e)	X			X- Special allocation required where appropriate

Aerojet-General[®] CORPORATION

AZUSA, CALIFORNIA • TELEPHONES: LOS ANGELES, CUMBERLAND 3-6111 • AZUSA, EDGEWOOD 4-6211

A SUBSIDIARY OF THE GENERAL TIRE & RUBBER COMPANY



IN REPLY REFER TO:

920:3005

MAY - 3 1960

The Honorable Philip LeBoutillier, Jr.
Deputy Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

Subject: Amending Contracts to Incorporate New Contract
Cost Principles Issued November 2, 1959

Reference: (a) Letter from Deputy Assistant Secretary of
Defense to Aerojet-General Corporation,
dated April 1, 1960, Serial: CR

My dear Mr. LeBoutillier:

On behalf of Aerojet-General Corporation, I wish to thank you and your staff for the effort and consideration given to our offer to serve as a pilot company in establishing a procedure for amending contracts to incorporate the new Contract Cost Principles.

While we share your regret that the new Cost Principles cannot be incorporated in all cost-reimbursement type contracts simultaneously, we appreciate the difficulties which you may have encountered in applying such a procedure to the multitude of contractors within the industry. Viewed in this light, the strength of the policy adopted seems evident since it is sufficiently broad to allow inclusion of the Cost Principles in existing contracts when precautionary conditions are met. We are still hopeful of completing the change-over to the new Cost Principles at an early date, for it appears desirable, in light of the fact that the old principles will phase out eventually, to establish uniform operations under current regulations at the earliest possible time.

You may be interested that Aerojet-General Corporation is presently availing itself of the important provision in the new Cost Principles covering advance understandings. We are currently in the process of reaching an advance understanding concerning allowability of independent research and development costs,

The Honorable Philip LeBoutillier, Jr.

920:3005

an area which has provided a fruitful source of dissension in the past. Our program for the current year is presently under consideration by the Tri-Departmental Committee, established to review such programs as a result of the provisions contained in the new Cost Principles.

Your letter, referenced in (b) above, indicated that a review of the present policy on incorporating the new Cost Principles into existing contracts is planned in about a year. If this company can assist you at that time, we will be pleased to do so. Of course, in the interim, if we can be of service to you or your staff, please call upon us.

Very truly yours,

AEROJET-GENERAL CORPORATION

A handwritten signature in dark ink, appearing to read "B. A. Kvist", is written over the typed name.

B. A. Kvist
Director of Contracts

APR 1 1960

Dear Mr. Reichardt:

I appreciate the information forwarded by Mr. B. A. Reist on 7 March 1960 in connection with establishing a procedure for amending existing cost-reimbursement type contracts with your company to incorporate the new contract cost principles.

We have given this information careful consideration. In addition, we have received and analyzed a report from our field auditors which commented on the feasibility of amending your existing contracts. It appears to us that the administrative problems which would be encountered in endeavoring to make an accurate appraisal of the practical effect of the new cost principles on your existing contracts would be very great. This is particularly true with respect to attempting an analysis of the impact of the principles down the subcontract chain. For these reasons, we regret that it is not feasible to grant your request for amendment of existing cost-reimbursement type contracts to incorporate the new cost principles. We have recently established a uniform policy for use throughout the Department of Defense in this area. I am attaching a copy of this policy for your information. While this overall policy was adopted because of the administrative and legal problems involved, we intend to review the situation in about one year. We are hopeful that it will be practical to issue additional guidelines at that time so as to minimize the problem of complying with two different sets of cost principles for an extended period of time.

I would like to take this opportunity to express my appreciation to you for your assistance in our study of this matter.

Sincerely yours,

Signed

PHILIP LeBOUTILLIER, JR.

Deputy Assistant Secretary of Defense
(Supply and Logistics)

Attachment

Mr. E. S. Reichardt, Jr.
Director of Contracts
Aerojet-General Corporation
Azusa, California



Prepared by: JMMalloy/rbs/30Mar60
3D774 X72026

Coordinated with:
Mr. Bannerman _____

COVERING BRIEF

CR

MAR 3 1 1960

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: The Director for Procurement Policy

Problem: To advise the Aerojet-General Corporation that we have decided not to try to amend existing cost-reimbursement type contracts so as to incorporate the new cost principles.

Background: By letter of December 17, 1959, the Aerojet-General Corporation requested that all of its contracts including those in which the company is a subcontractor to another prime contractor, be cut over to the new contract cost principles as of 1 December 1959 (the beginning of a new Fiscal Year). The company offered its services as a pilot company and provided a detailed list of contracts which totaled approximately \$85 million dollars. This Aerojet request was received at the time we were in the midst of working out our over-all policy with respect to the amendment of existing cost-reimbursement type contracts. We took advantage of the Aerojet offer to act as a pilot company and requested the field audit organizations of the Navy and Air Force to provide us with an advisory report as to the impact of the new cost principles. We also requested that Aerojet investigate the feasibility of getting its contracts amended when Aerojet was acting as a subcontractor to another prime contractor.

Cdr Mallory

The audit report mentioned above indicates that, aside from research and development expense, there is no practical difference between the return to Aerojet under the old cost principles and under the new cost principles. The auditors however could draw no sound over-all conclusions since they were unable to measure the impact of the new cost principles down the subcontract chain nor could they evaluate the impact of the new research and development cost principle. Aerojet-General, by letter dated 7 March 1960, advised that they had contacted the Douglas Aircraft Company and the Lockheed Missile Systems Division of Lockheed Aircraft Company. Both companies agreed to the modification of their contracts with Aerojet. However, Lockheed conditioned their agreement on the promise that "no adverse cost impact arose." This type of condition is not easily disposed of and raises many legal problems, all of which influenced our decision not to amend existing contracts as a matter of general policy.

110

In sum, the situation faced by Aerojet-General appears to be similar to that faced by all large companies holding substantial Government contracts. We see no basis for distinguishing the Aerojet-General situation from the others. Hence, we feel it necessary to deny the Aerojet request and provide for this company in a manner consistent with others. Since the initiation of the Aerojet request, we have issued a general policy on this subject, including a press release. Informal contact with the local Aerojet-General representative indicates a realization on the part of the company that our action would undoubtedly correspond with our general policy issuance.

Recommendation: That you sign the attached letter.

Comments: OASD (Comptroller) (Mr. Kilgore)
Army (Lt. Col. W. W. Thybony, DCS LOG)
Navy (Mr. M. E. Jones, OASD)
Air Force (Mr. George Vecchiatti, AFMFP)

Aerojet-General[®] CORPORATION

AZUSA, CALIFORNIA • TELEPHONES: LOS ANGELES, CUMBERLAND 3-6111 • AZUSA, EDGEWOOD 4-6211

A SUBSIDIARY OF THE GENERAL TIRE & RUBBER COMPANY



IN REPLY REFER TO:

920:2290

MAR -7 1960

The Honorable Philip LeBoutillier, Jr.
Acting Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

Subject: Amending Contracts to Incorporate New Contract Cost Principles Issued November 2, 1959

Reference: (a) Letter from Aerojet-General Corporation to the Assistant Secretary of Defense (Supply and Logistics), dated December 17, 1959, Serial 920:1424 ESR:lk
(b) Letter from Assistant Secretary of Defense to Aerojet-General Corporation, dated December 29, 1959, Serial: CR

My dear Mr. LeBoutillier:

In connection with Aerojet-General Corporation's offer, reference (a), to serve as a pilot company in establishing a procedure for amending contracts to incorporate the new Contract Cost Principles and in response to the request contained in reference (b), we have contacted prime contractors to ascertain their reaction to amending their subcontracts with this company to incorporate the new Contract Cost Principles.

To date, this matter has been discussed with the Lockheed Missile Systems Division and the Douglas Aircraft Company, Inc. At the Lockheed company, the matter was discussed with Mr. Roy Anderson, Manager of Finance, and Mr. Harry Kohl, Materiel Director. It was their opinion that there would be no objection by the Lockheed company to amending its subcontracts to incorporate the new Contract Cost Principles provided no adverse cost

The Honorable Philip LeBoutillier, Jr.

impact arose. Aerojet-General Corporation was advised to submit formal written requests for such amendments which could be expected to receive a favorable action by the Lockheed company.

The Douglas company representative with whom the matter was discussed is Mr. J. R. Shelton, Manager - Major Subcontracts. This gentleman stated that the Douglas company has no objection to incorporating the new Contract Cost Principles in its subcontracts. Such amendments as issued would be subject to the customary review and approval by resident government personnel under the terms of the prime contracts held by the Douglas company.

The significance of the viewpoints of these two major prime contractors is highlighted by the dollar magnitude of subcontracts which Aerojet-General Corporation is performing for them. As of January 31, 1960, the total dollar value of subcontracts being performed for the Lockheed company by Aerojet-General Corporation was \$122,114,784; while, subcontracts in performance for the Douglas company by Aerojet-General Corporation at that date totaled \$14,898,881. While these figures include some fixed-price subcontracts, the vast preponderance of the amounts stated are on a CPFF basis. Although comparable figures for the period ending February 29, 1960 are not yet available, any deviation from those reported above would be most likely to increase the amounts involved.

Aerojet-General Corporation appreciates the opportunity to report this information for your consideration and we are hopeful of rendering further assistance in your efforts to establish a procedure for amending existing contracts to include the new Contract Cost Principles.

Very truly yours,

AEROJET-GENERAL CORPORATION



B. A. Kvist
Director of Contract Administration

OC1
7560/Aerojet-Gen'l
12 Feb 1960

From: Officer in Charge, U. S. Navy Area Audit Office, Los Angeles
To: Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation, Azusa, California - Review of contractor's request for amendment of existing cost reimbursement type contracts to incorporate new contract cost principles

Ref: (a) NavCompt ltr NCT11, L10-4, Ser: 02958 of 28 Dec 1959
(b) Aerojet-General ltr 920:1424, ESR:1k of 17 Dec 1959 to Asst.Secy.Def. (S&L)

1. In accordance with request in reference (a) a review has been made of the contractor's contentions that only a negligible difference in reimbursable costs would result from the use of the new cost principles (ASPR Revision No. 50) rather than those cost principles currently incorporated in cost reimbursement type contracts. This review was conducted in conjunction with the Air Force auditor cognizant of the contractor's Sacramento divisions.

2. In reference (b) the contractor presented considerable detail concerning the contracts and subcontracts under which it is performing work for the Government. Based on the year ended 30 November 1959 the contractor's business may be summarized as follows:

Cost-Type	Cost of Sales	
	Fixed-Price (000 omitted)	Total
Prime contracts		
Navy	\$ 29,666	\$ 7,564
Air Force	163,246	469
Army	4,951	2,504
Other Government	7,196	793
Subcontracts under Government primes	<u>116,533</u>	<u>12,233</u>
Total Government	\$321,592	\$ 23,563
Commercial	<u>203</u>	<u>203</u>
Total	<u>\$321,592</u>	<u>\$ 23,766</u>

3. No sound conclusions could be reached as to the effect of the new cost principles on the reimbursement of costs to Aerojet because (a) it was not practicable to determine the effect of the new principles on the reimbursable costs of Aerojet's subcontractors, and (b) the extent and cost of the independent research and development program which Aerojet might pursue in 1960 and subsequent years is not presently known.

4. With respect to subcontractors' costs, it was determined that Aerojet now has ninety-two subcontracts issued to approximately forty subcontractors in the aggregate amount of \$38,831,700. Since the new principles appear to be somewhat more liberal than the old principles, particularly in the areas of research and development and selling costs, it would appear reasonable to assume that the subcontractors' reimbursable cost would increase. The extent of any such potential increase could not be determined unless a survey was made of all Aerojet's subcontractors.

5. With respect to Aerojet's own costs, a review of the provisions of AEFPR Revision No. 50 reveals that the only area of potential significant difference in reimbursable costs involves the contractor's independent research and development costs. In order to test the contractor's contention that the effect of the use of the new cost principles would be negligible, a comparison was made of the effect of the old and new cost principles on overhead reimbursable under cost-type contracts for the fiscal year ended 30 November 1958. The contractor's 1958 fiscal year was used because it is the most recent year for which all the information needed to make the comparison was available. The results of this comparison are summarized as follows:

Total Aerojet overhead that would be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year if costs were determined in accordance with the new cost principles	\$64,656,000
Total Aerojet overhead determined to be reimbursable under CPFF contracts and subcontracts for the 1958 fiscal year in accordance with the old cost principles	<u>64,624,000</u>
Increase in reimbursable overhead resulting from the application of the new principles - all CPFF work performed by Aerojet	\$ 32,000
Less - applicable to prime contracts with Government agencies other than Department of Defense and subcontracts	<u>9,000</u>
Increase applicable to prime contracts with the Department of Defense	<u>\$ 23,000</u>

It is believed that the 1959 fiscal year would yield comparable results except that a greater proportion of the increase would be applicable to prime contracts with other Government agencies and to subcontracts under Government primes.

6. The foregoing tabulation appears to support the contractor's contentions, since the increase in reimbursable overhead cost under Department of Defense prime contracts is negligible, i.e. approximately .05 percent. In all probability the increased cost to both this office and the contractor incident to administering contracts under two sets of cost principles simultaneously would be greater than the estimated increase in overhead cost in 1958. However, it should be noted that the increase is due entirely to the difference in the reimbursability of independent research and development costs under the new principles as compared to the old principles. In 1958 the contractor incurred \$291,000 of direct costs in its independent research and development program. In a supplement to reference (b) the contractor has proposed an independent research and development program of over \$7,000,000. This proposal was submitted by the contractor for the purpose of executing an advance agreement in accordance with the new ASPR cost principles, paragraph 15-205.35(h). Until it is known how much of this program will be approved or what cost sharing arrangements will be worked out, no conclusion can be reached as to probable effect of the new cost principles on Aerojet's reimbursable costs for the 1960 fiscal year.

7. The Director, Western District, Auditor General USAF, concurs.

L. A. COUTU



DEPARTMENT OF THE NAVY
OFFICE OF THE COMPTROLLER
WASHINGTON 25, D. C.

IN REPLY REFER TO

ACT 11

7560/Aerojet-Gen'l.

18 FEB 1960

MEMORANDUM FOR K. K. KILGORE, Office of Assistant Secretary of Defense
(Comptroller)

Subj: Aerojet-General Corporation - Report setting forth results of
review of contractor's request for amendment of existing cost-
reimbursement type contracts to incorporate new contract
Cost Principles

Encl: (1) Two copies of HAAO, LA ltr, OCL, 7560/Aerojet-Gen'l of
12 Feb 1960
(2) Two copies of HAAO, Wash. ltr, SO, A6-7, Aerojet Gen. Corp., At-
lantic Div. of 28 Jan 1960

1. The enclosures are forwarded in response to the addressee's request
for a report on the subject contractor's proposal to amend its existing
cost-reimbursement type contracts to incorporate the new contract Cost
Principles (ASPR, Sect. XV, Part 2, as revised by ASPR Revision No. 50).

J B KACILEY
Assistant Comptroller

U. S. NAVY AREA AUDIT OFFICE

WASHINGTON 25. D. C.

IN REPLY REFER TO

SO

A6-7

Aerojet Gen. Corp.

Atlantic Division

28 JAN 1960

From: Officer in Charge, U.S. Navy Area Audit Office, Washington, D. C.

To : Comptroller of the Navy (NCT)

Subj: Aerojet-General Corporation - Atlantic Division, Frederick, Maryland -
Review of Contractor's Request for Amendment of Existing Cost
Reimbursement Type Contracts to Incorporate New Contract Cost
Principles

Ref : (a) NavCompt (NCT) ltr NCT11, L10-4, Ser:02958 dated 28 December 1959
w/encl

1. In accordance with the reference, a review has been made of the subject Contractor's books and records for the purpose of evaluating the Contractor's contention that the difference would be negligible between costs reimbursable under the new cost principles (as published in ASPR Revision No. 50) as compared with those currently incorporated in contracts.

2. The operations of the Atlantic Division Aerojet-General Corporation are limited to research and development work and involve only five cost-type contracts with the Department of Defense. Annual sales for the fiscal year ended 30 November 1959, of \$588,870.02, are classified as follows:

Cost Reimbursable-Type Contracts

Department of Defense	\$185,378.14
U.S. Post Office Department	321,047.66
Total Cost-Type	\$506,425.80
<u>Fixed Price</u>	82,444.22
Total Sales	<u>\$588,870.02</u>

3. Review of the Atlantic Division claim, as presented under each set of costs principles, disclosed no differences in the amounts claimed, based on the Contractor's interpretation of reimbursable costs under Revision No. 50 to ASPR. The Contractor has also expressed an opinion that no change or advantage is to be found in the application of the revised cost principles.

4. Based on the foregoing review and audit of the Atlantic Division's books and records, the Auditor concurs with the opinion of the Contractor.

Copy to:

OinC, NAAO, Los Angeles


T. W. [unclear]
ACTING

ENC(2)

28 Dec 1959

CS

DEC 29 1959

Dear Mr. Reichard:

I have your letter of 17 December 1959 in which you have provided us with considerable background information in connection with your request to have all of your contracts cite the new cost principles as of 1 December 1959. This information will be very helpful in our effort to resolve the basic problems which are involved in amending existing contracts.

At the present time, we are actively studying this problem. I would like to accept your offer of Aerojet-General's services as a pilot company in our consideration of this matter. Accordingly, I have requested the Navy, as the cognizant audit agency of your home office plant, to be in touch with you as soon as possible for the purpose of evaluating the impact of the new cost principles on your existing contracts. The Air Force, which has audit cognizance of your Sacramento plant, will assist the Navy in its evaluation.

As mentioned during your recent visit to the Pentagon, the problem of securing an amendment from your prime contractor, in those instances where Aerojet-General is acting as a subcontractor, may present some substantial difficulties. You can be of further assistance to us if you would contact a few of your prime contractors to ascertain their reaction to amending their subcontracts to you, even if they themselves were not at the time out over to the new cost principles.

While we are initiating the action indicated above as soon as possible, I am sure that you appreciate that we are not yet in a position to give you positive assurance that your existing contracts will be amended as of 1 December to incorporate the new cost principles. We will, however, seek to resolve this matter at the earliest possible time. Again, may I express my appreciation for your helpful assistance in this matter.

Sincerely yours,

(Signed) Philip LeBoutillier, Jr.

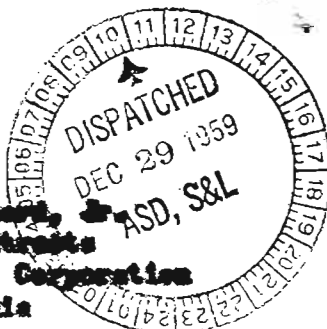
PHILIP LeBOUTILLIER, JR.
Acting Assistant Secretary of Defense

Prepared by: [Signature] / rba / 28 Dec 59

JD774 I72026
Coordinated with:

Mr. Bennerman _____

Mr. E. S. Reichard, Jr.
Director of Contracts
Aerojet-General Corporation
Azusa, California



ARTICLE ON THE DEPARTMENT OF DEFENSE
REVISION OF THE CONTRACT COST PRINCIPLES CONTAINED
IN THE ARMED SERVICES PROCUREMENT REGULATION
SECTION XV, PARTS 1, 2 AND 6

27 November 1959

By Edward T. Cook
Contract Audit Division
Office of the Comptroller
of the Navy
Washington, D. C.

DEPARTMENT OF DEFENSE PUBLISHES REVISED CONTRACT COST PRINCIPLES

By the publication of Revision No. 50 dated 2 November 1959 to the Armed Services Procurement Regulation, the Department of Defense has issued a new set of contract cost principles for use in connection with supply and research contracts with commercial organizations. The new principles will replace those now in the Armed Services Procurement Regulation and while they may be technically described as a revision of the former cost principles, they are, for all practical purposes, a new and quite different document. However, insofar as application to cost reimbursement type contracts ¹⁵ ~~are~~ concerned, they appear to reflect generally past practices rather than any extensive change in policy. The original Section XV, Part 2 has remained in effect practically unchanged for more than ten years. The text of the new principles is included in the official releases department of this issue.

Because of their use in connection with fixed price type contracts, even within the limits specified therein, the new principles will have a much broader impact on the business community than the old principles which were designed for use only in connection with cost reimbursement type contracts. The new principles will be used by both auditors and contracting officers of the military departments as guides in the preparation of advisory accounting reports and in the negotiation and administration of fixed price type contracts wherever considerations of contractors' cost data are involved. Among the situations where these principles will undoubtedly be so used are redeterminations of prices, pricing of incentive contracts, termination settlements, ^{these} and initial

pricing actions, ^{for which} where the amounts to be paid to the contractors are to be negotiated to a substantial degree on the basis of statements of cost.

The new principles will also be used, in the same manner as the old ones, in respect to cost reimbursement type contracts; that is, they will be incorporated in such agreements as the basis for determining allowable costs. As to cost-reimbursement type subcontracts, paragraph 15-204(b) limits the amounts that may be paid to prime contractors, on account of disbursement by them to subcontractors, to those amounts which are allowable under the applicable part of Section XV. It will therefore be prudent for prime contractors to incorporate the cost principles in any cost-reimbursement type subcontracts entered into by them.

The importance of the new principles should not be overlooked by any certified public accountant who has clients engaged in contract work for any of the military departments. It is suggested by the writer that any such CPAs carefully study these principles in order that they may be able to inform their clients of the probable impact on their contract negotiations and reimbursements.

The effective date of the new principles, that is, the time when it is mandatory that they be used in connection with new cost type contracts, is July 1, 1960. However, as in the case of other procurement regulations, the use of the principles is authorized commencing at once. Undoubtedly consideration will be given in the near future to whether or not existing cost-reimbursement type contracts can be amended in order to prevent a situation where two different sets of cost principles will be in effect under different contracts with the same company for the

same period of time. The necessity for determining costs under two different sets of rules could lead to considerable difficulties, particularly in the overhead area.

It may be of interest to note that the new principles do not require that contractors or prospective contractors submit their cost presentations in conformity therewith. However, contractors who prepare cost presentations in accordance with the new principles will be likely to benefit from a reduction of audit time and interference, as well as experience fewer requests for account analyses and data breakdowns as contemplated by paragraph 15-603(d). The principles do, as above indicated, require that contractors' cost presentations be evaluated by military department auditors and contracting officers under the rules set out in the document, but in respect to fixed price contracts they are clearly indicated to be guidelines. There is well worded coverage of this latter point in Part 6 of the principles.

The relative pros and cons of requiring the use of cost principles even as a guide in connection with fixed price types of contracts can be, and has been, debated at length within both the Department of Defense and Industry. While good arguments can be made on both sides of this question, the weight of evidence indicates that a real need existed for these new principles. Incidentally, they are likely to prove of considerable help to contractors in submitting their price proposals in that they will know in advance, in respect to the rather comprehensive list of cost items treated in paragraph 15-805, the attitude of the Department of Defense.

Some people have found it hard to understand why there should be a need for a set of contract cost principles published by the Department

of Defense, except possibly for cost type contracts and for settlements of terminations under fixed price type contracts. They have pointed out many times that after all accounting principles are rather well established by publications of the American Institute of Certified Public Accountants, accounting text books, the Internal Revenue Code, regulations of the SEC, etc. Also, in the fixed price area it is a price which is to be negotiated and, while cost considerations may, and frequently do, play an important part, the real objective is a mutually satisfactory total price rather than the determination of the acceptability of individual items or types of costs. What this line of argument overlooks is the vital fact that billions of dollars of defense expenditures are under types of contracts where, in the last analysis, the price is dependent chiefly upon someone's evaluation of a set of cost figures submitted by the contractor.

What then are the basic reasons for promulgation of a standard set of rules, even as a guide in the consideration of costs leading to the negotiation of fixed prices? No doubt different individuals would give somewhat different answers to this question. But the chief reasons, in the writer's mind, are: first, to fill the guidance vacuum indicated in the preceding paragraph; second, to secure greater uniformity in the consideration of cost throughout the various and rather numerous components and echelons of the Department of Defense; and third, the equalization of cost treatment among the different types of contracts so that no one type of contract will be more or less attractive to either the contractor or the Government solely because of a different approach to the acceptability of costs.

In thinking over this problem, it is important that the reader realize that we are not talking about fixed price contracts where the prices are established as the result of formal advertising. The use of cost principles under these contracts is largely limited to terminations with occasional instances of use in negotiating revised prices because of changes in work or specifications order by the Government.

As to the provisions of the new principles, the wording can and does, to a large extent, speak for itself. The first thing which will be noticed by anyone comparing the new principles with the old is the greater length of the document. As will be seen from a perusal of the text, this is due principally to the comparatively extensive treatment of each of the selected cost items in place of mere listings of examples of allowable and unallowable cost items which were used in the 1949 version.

Of particular significance to any prospective contractor is the fact that advance understandings are suggested in paragraph 15-207 in respect to any cost items which may be difficult or controversial in the case of negotiated fixed price type contracts, as well as under cost reimbursement type contracts.

The discussion in subparagraphs 15-201.2, 15-201.3 and 15-201.4 is suggested for careful study since it is in these subparagraphs that the general criteria for determining allowability are set forth. The definition of reasonableness, in subparagraph 15-201.3, should receive particular attention because this is likely to be the key to most controversial situations. The new principles bring out specifically certain aspects which have been heretofore considered but which have not been a part of

the written regulations; such as, lack of arm's length bargaining, lack of competitive restraints, and substantial increases in such items as salaries concurrent with the commencement of operations under Government contracts.

The comparatively extensive treatment of direct costs and indirect costs, in paragraphs 15-202 and 15-203 respectively, reflects an effort to deal with these fundamental aspects of contract costing in a more definitive manner than heretofore.

A brief picture of the treatment of the selected cost items covered in paragraph 15-205 of the new principles is presented in the form of an item by item chart which is printed on pages ____ and ____.

A discussion of the changes in detail as between the new principles and the older version might become rather lengthy. This is because of the greatly expanded coverage of the selected cost items. However, there is included below a brief discussion of the more significant changes:

Advertising (paragraph 15-205.1):

The former principles limited allowable advertising in trade and technical journals to ads placed for the purpose of offering financial support to the journals. This specific requirement as to financial support being the purpose of the ads is no longer included; however, this does not appear to represent a change in policy. The revised wording should eliminate the controversies which have sometimes arisen in the past when contractors were confronted with the necessity for proving that particular advertisements were placed only for the purpose of

offering financial support of the publication in question. It will be noted that ads which offer products or services for sale are unallowable. Specific provision is also made for allowance of the costs of participation in exhibits, again with the proviso that these expenses will not be allowed if products are offered for sale.

Compensation for Personal Services (paragraph 15-205.6):

This subject has been treated extensively but from the standpoint of actual practice there are few changes of significance. It may be of interest to note the limitation in (a)(1) which restricts amounts allowable to those which are permissible under the Internal Revenue Code, the provision for allowance of compensation to partners and sole proprietors where services are rendered by them in (a)(3), and the unallowability of the cost of stock options in (e). Allowance of management employee incentive compensation; i.e., "profit sharing plans", is now definitely provided for in subparagraph (a).

Depreciation (paragraph 15-205.9):

Subparagraph (f) permits allowance, under the circumstances described therein, of a use charge for fully depreciated assets without a specific contract provision.

Interest and Other Financial Costs (paragraph 15-205.17):

The disallowance of interest follows the traditional pattern but it is now extended to terminations by reason of the applicability of the new principles to these situations.

Losses on Other Contracts (paragraph 15-205.19):

The wording on this item has been amplified and strengthened in

order to make it unmistakably clear that a loss under any other contract, regardless of its type or purpose, is unallowable.

Material Costs (paragraph 15-205.22):

(b) The last sentence of this subparagraph contains specific coverage of cases where contractors are unable to take cash discounts because of circumstances under which it would not be reasonable to expect such discounts to be taken and provides that these lost discounts need not be credited to costs. This has been a controversial point on occasion in the past.

(c) The wording of this subparagraph does not contain the proviso, which was in the old principles, to the effect that inventory adjustments could not include "write-downs" of value. This inclusion was not caused by a change in viewpoint, but simply to recognize the fact that the inventory adjustments being discussed relate only to the differences between physical inventories and book inventories and therefore "write-ups" and "write-downs" of value are not involved.

(e) There is now specific provision for acceptance of charges for inter and intracompany transactions on a price basis under the circumstances outlined in the new principles. In the old principles, the pricing of such transfers was among the items suggested for specific contractual consideration in Part 5.

Precontract Costs (paragraph 15-205.30):

Specific provision has now been made for allowance of precontract costs to the extent they would have been allowable if incurred after the date of the contract. It will be observed that this item is also on the

list in paragraph 15-107 of items regarding which advance understandings are suggested. Previously, precontract costs required a specific contract provision to be allowable.

Professional Service Costs (paragraph 15-205.31):

The new principles provide that retainer fees may be allowed if supported by evidence of bona fide services available or rendered. Formerly, it had been generally held that retainer fees were allowable only where services were actually rendered.

Rental Costs (paragraph 15-205.34):

By subparagraph (b) rentals on an intercompany or interdivisional basis are limited to the normal costs of ownership.

The limitation on sale and leaseback agreements in subparagraph (c) should be noted. This now requires a contract provision for any allowance to be made in excess of normal ownership costs.

Research and Development Costs (paragraph 15-205.35):

This important subject has been treated at considerable length. First of all, definitions have been provided for basic research, applied research and development. For costing purposes, however, only two categories are established; namely, contractors' independent research and contractors' independent development. Both categories are allowable within the limitations and subject to the criteria stated.

One effect of the new principles will be to allow contractors independent research without the specific contract provision which was required under the old principles. In addition, there is provision in subparagraph (f) for costing the contractor's research and development

expenditures, from the standpoint of application of indirect and administrative expenses to such costs, in conformity with the accounting practices established by the contractor. A limitation has been included in subparagraph (g) which makes research and development costs incurred in periods prior to the award of the contract unallowable unless such expenditures are a proper part of precontract costs. The text of subparagraph (h) includes administrative guidelines and procedural suggestions with particular emphasis on advance agreements.

Taken together, all of these provisions should be of great assistance in eliminating some of the controversies of the past.

Selling Costs (paragraph 15-205.37):

Subparagraph (c) permits the allowance of salesman's or agents' fees and commissions to bona fide employees or selling agencies maintained by the contractor for the purpose of securing business. In the old principles, paragraph 15-205(d) provided that commissions and bonuses in connection with obtaining or negotiating for government contracts were unallowable. However, it is important to note the last sentence of subparagraph (b) where the factors upon which allocability of selling costs will be dependent are set out. The emphasis is on the showing of reasonable benefit to the Government.

Termination Costs (paragraph 15-205.42):

The items covered in this paragraph plus the coverage of other subjects in the new cost principles will supersede the principles which have previously been applicable to terminations in ASPR Section VIII. The change in the treatment of interest as mentioned above is important.

Training and Educational Costs (paragraph 15-205.44):

This subparagraph has been given rather extensive treatment. Except for grants and donations (which are considered contributions) the remainder of the items mentioned are allowable. However, certain limitations have been included, aimed at achieving reasonableness and these may, in some cases, have a cost sharing aspect.



HEADQUARTERS
AIR MATERIEL COMMAND
UNITED STATES AIR FORCE
WRIGHT-PATTERSON AIR FORCE BASE, OHIO

ADDRESS REPLY TO
THE ATTENTION OF:
MCI PA/1, W. 100d

26 November 1958

SUBJECT: Industry Comments on Comprehensive Cost Principles
dated 7 November 1958

TO: Headquarters USAF
Office, Deputy Chief of Staff, Materiel
Directorate of Procurement and Production
Attn: AFMPT-PR-2
The Pentagon
Washington 25, D. C.

1. The Industry comments about using comprehensive cost principles, apparently assume that all Department of Defense procurements are made in the environment of effective price competition. However, the forces of the market place and competitive restraints are not present in a substantial part of DOD procurement actions. To ignore this fundamental fact is to ignore the basic cause of the most significant pricing problems.

2. Industry's comments are in five principal areas which we will discuss individually. Based on this premise following are comments regarding the five principal areas covered in the Industry letter:

A. Recognition of all normal and legitimate costs

Industry's position on this subject indicates an apparent desire for guaranteed costs and to some extent guaranteed profit. Much has been made of the inconsistencies in the regulation where certain costs are dealt with according to function and others are dealt with according to object. Advertising is an example cited by Industry as illustrating an inconsistency which they say is objectionable. There are, however, other costs related to objectives which because of public policy and as a matter of equity should not be recognized in government pricing. An example is prosecution of claims against the government, entertainment expense or contributions to organizations seeking to influence legislation. All of these costs, from Industry's standpoint, may be proper and ordinary business expenses. However, from the Government point of view, it would not be proper to recognize these costs. The government should not be in a position of supporting payments made in prosecution of claims against itself. Industry takes a point that contractors must recover all costs incurred, somehow and somewhere.

40. Mr. Fairchild Nov 58

While Industry will attempt to recover all costs, the fact that they may not be able to do so lends incentive for management control of costs. This control would be missing completely under a provision whose primary premise is underwriting all costs. The uncertainty of cost recovery is currently present in commercial business and is one of the normal risks which Industry should expect to assume.

Industry is probably concerned regarding the use of cost data in negotiation. The intent of the regulation is to provide guide lines in evaluation of cost bases rather than rigid rules of allowance and disallowance where estimated costs are a factor in arriving at a price objective. The negotiation procedure inherent in fixed price contracting gives the contractor the opportunity to discuss allocability and a chance to justify the level of expenditures contemplated.

B. Reasonableness and Allocability as Adequate Tests and Controls

The Industry position is again based on the concept that effective competitive forces are always present in DOD procurement. This premise is not a valid one as I believe that reasonableness and allocability are tests that must be exercised on a selective basis with respect to estimated costs rather than accepting the "all cost" concept of Industry.

C. Applicability

Industry strongly opposes that the proposed provisions will result in formula pricing. Formula pricing need not necessarily result from the use of these principles. This is especially true in areas of prospective pricing where cost estimates are not the sole determinant for pricing. In those cases where cost estimates are a factor, primary concern is with the level of estimated costs and secondary concern is with the types of costs included in estimates. Analysis of prospective prices will often result in differences of opinion as to estimates. The Air Force has no fear of being wrong in this forecasting area but desires to provide the best incentive to efficiency by negotiating prices which will encourage contractors to control costs. The Air Force also hopes government negotiators must have information regarding cost estimates. The Industry spokesman states, "We oppose in principle, however, any use of cost data as a formula basis for negotiating prospective firm fixed prices". We ask this - Does not the contractor use Air Force cost data and cost estimates for preparation of his proposal? Is the government expected to ignore this information? Are negotiations to be conducted in a vacuum?

1. Effective Date

We agree with the Industry position on this point. A further comment seems necessary since this does not appear to be a matter of principle.

2. Individual Items of Cost

We are not submitting any detailed comment regarding the individual items of cost since the AEC position has been established in previous correspondence. An exception to this is in the area of research and development costs. We recommend that the separation of basic research and applied research referenced in the cost principles be maintained. General research should be handled as an entity because the separation of basic and applied research is artificial and impractical. We also recommend that the principle of sharing general research expenses with those contractors whose business is substantially all government be established. This position recognizes the mutual benefit derived by both the government and industry from general research. It also places a measure of incentive for wholly government contractors to exercise prudent control of their research programs.

This sharing arrangement is not considered necessary with contractors whose business is primarily commercial since the sharing is automatic by the normal method of allocation of general research cost to commercial and government business.

We understand that this concept has been reflected in the latest draft covering research and development dated 18 November 1958.

FOR THE COMMANDER:

PHILIP J. BLATTAU
Colonel, USAF
Chief, Pricing and Financial Division
Directorate of Procurement and
Production

1. 1st and 6 Jan 59 from AFMPP-PR, Hq USAF, Washington, D.C. to Commander, AMI, A-101 MIF, W-1 AFB, Ohio. Subject: Contract Cost Principles.

WCPFA/Mr. L.E. Todd/ep

TO: Director of Procurement and Production, Headquarters, USAF, Attn: AFMCP-PF, Washington 25, D.C.

2. The proposed Part 7 relating to applicability to fixed price type contracts is considered desirable and a marked improvement over the previous position. We believe that sufficient emphasis is contained in Part 7 relating to the evaluation of costs, where costs are a major consideration in pricing. The flexibility to be provided conforms to our present policy as expressed in ASPR Section III, Part 8. It has been our view that although cost estimates and the analysis of costs are an important part of pricing, nevertheless, the contracting officer should not be placed in a "straight jacket" regarding cost evaluation and allowance and disallowance of cost that would preclude him from otherwise negotiating a fair and reasonable price.

FOR THE COMMANDER:

B. D. LOCKBOURNE
Deputy Chief
Pricing and Financial Division
Directorate of Procurement and
Production

5/27/59

Re 15-205, 16 (a) (c) (H)

(Continuation) of the 12 May 59 draft (Page 20)

Note: - To keep you fully aware of AF developments on the cost Murphy is time-honored AF practice, and to point up the AF may well back on. Our insurance people back up Lowman (Ravens) that getting the info is no great problem - it has been done for years.

contractors, where the total costs of the benefits are paid by the contractor. Further, employees are eligible for most group insurance benefits after 1 to 3 months of service.

(a) Some group insurance plans provide for hospital and surgical benefits for the dependents of employees. The entire cost of dependent benefits is sometimes borne by the employees.

(b) *Responsibility of the Administrative Contracting Officer.* The administrative contracting officer will determine whether the group insurance benefits are reasonable in amount and necessary in connection with the performance of AF contracts. This determination will be made only after considering the wages and other fringe benefits to which the employees of a contractor are entitled. Consideration must be given to the general level of total wages and benefits for employees in similar jobs in the immediate geographical vicinity. If the contractor is engaged principally in commercial operations, there is little likelihood that the group insurance benefits will be unreasonable because of competitive reasons. However, where a contractor is primarily working on Government contracts, the restraints imposed by competition may be lacking and a careful review by the administrative contracting officer may be indicated.

10-501.31 Use and Occupancy Insurance.

(a) Use and Occupancy or Business Interruption Insurance is a form of insurance which indemnifies the contractor for certain losses incurred during a period of interruption or suspension of business operations resulting from physical damage to property essential to the conduct of business. The contractor is indemnified for loss on account of fixed charges and other expenses which accrue during such period and for loss of net profit which the contractor is prevented from earning. The amount of indemnity purchased under this form of insurance is based on the probable loss the contractor would sustain during the period of interruption or suspension of business operations. The premium charge is based on the aggregate indemnity under the policy.

(b) (1) When costs in connection with Use and Occupancy Insurance are presented for allowance, the aggregate indemnity available will be analyzed. Only that percentage of total insurance cost which is identifiable with indemnity benefits determined to be acceptable within the intent of subparagraph (2) below will be allowed.

(2) Costs of insuring those items of fixed charges and other expenses, which are allowable items of costs in AF contracts, will be considered allowable. Such fixed charges and other expenses include, but are not limited to, salaries of employees under contract and other key employees, rents, most insurance premiums, and charges for non-cancelable contracts for light, heat, or power.

(3) Costs of insuring the net profit a contractor is prevented from earning during a period of business interruption or suspension are unallowable. Similarly, the costs of insuring certain items of fixed charges such as interest, Federal income taxes, donations, and certain advertising expenses are unallowable.

10-502 Self-insurance. No implementation.

10-503 Government Property. No implementation.



ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

CR
Cdr Malloy

November 24, 1959

SUPPLY AND LOGISTICS

Dear Dan:

I met with your boys yesterday and was very appreciative of their attitude. I am not so sure we can accomplish this as of December first, but we are striving to work it out to their satisfaction.

Best regards,

/S/
PERK

Mr. Dan A. Kimball
President,
Aerojet-General Corporation
6352 North Irwindale Avenue
Azusa, California

→ cc: Mr. Bannerman

AEROJET-GENERAL CORPORATION
6352 NORTH IRWINDALE AVENUE
AZUSA, CALIFORNIA

DAN A. KIMBALL
PRESIDENT

November 17, 1959

Hon. E. Perkins McGuire
Assistant Secretary (Supply and Logistics)
Office of the Secretary of Defense
Washington 25, D. C.

Dear Perk,

I would like to have E. S. Reichard, Jr., our Director of Contracts come in to chat with you about applying the new Cost Principles to all of our contracts beginning December 1, 1959.

I hope it will be convenient for Mr. Reichard to meet with you early in the week of November 23.

Sincerely,



AEROJET-GENERAL CORPORATION

8352 NORTH IRWINDALE AVENUE
AZUSA, CALIFORNIA

DAN A. KIMBALL
PRESIDENT

November 17, 1959

Hon. Thomas S. Gates, Jr.
The Deputy Secretary of Defense
Washington 25, D. C.

Dear Tom.

Aerojet-General Corporation believes the recently revised Contract Cost Principles, Section XV, could be applied to all of our Defense work beginning with our fiscal year starting December 1, 1959.

In this connection, we would like our people to discuss our thoughts with Mr. Perkins McGuire in the very near future.

We think beginning the uniform application of the revised Cost Principles to all of our contracts will provide the Government consistent methods of handling costs throughout our operations, rather than gradually incorporating the new regulations when new procurements take place.

Sincerely,



*See McGuire to
arrange Bf.*

*Miss Dorothy M. Kimball's Secretary
District 7-10005*

OFFICE OF THE SECRETARY OF DEFENSE
Exhibitions Board

15 November 1949

MEMORANDUM FOR THE SECRETARY OF THE ARMY

THRU: The Assistant Secretary of the Army

MEMORANDUM FOR THE SECRETARY OF THE NAVY

THRU: The Assistant Secretary of the Navy

MEMORANDUM FOR THE SECRETARY OF THE AIR FORCE

THRU: The Under Secretary of the Air Force

SUBJECT: Contract Cost Principles.

References: (a) Section XV, Armed Services Procurement Regulation.
(b) Joint Letter No. 12 dtd 5 Aug 49 re Use of Contract Cost Principles, Sec. XV, ASPR, by Audit Personnel.

1. Your attention is invited to the provisions of Paragraph 15-101 of reference (a), wherein it is provided that the Contract Cost Principles "shall be followed in connection with all cost-reimbursement type contracts..."

2. During the development of these principles, industry took the strong position that they must not be applied to contracts other than those of the cost-reimbursement type, and was assured that they would not be so applied.

3. However, in the absence of more suitable cost principles, and in order to provide uniformity from an auditing viewpoint, all auditors under the jurisdiction of the Army Audit Agency, of the Navy Cost Inspection Service, and of the Air Force Office of the Auditor General have been instructed by reference (b) to use, except in certain special circumstances set forth therein, the Contract Cost Principles as cost standards for the preparation of advisory reports to Contracting Officers in connection with fixed-price type contracts.

4. All Contracting Officers and others involved should be specifically advised that there has been no change in the application of the cost principles for purposes of determining allowable costs from that set forth in Paragraph 15-101 of reference (a), and that, therefore, the Contract Cost Principles shall not be used in negotiating prices under fixed-price contracts other than (1) for the purpose of preparing advisory reports as referred to in paragraph 3 above and (2) by the Contracting Officers to the extent they deem it advisable, as a working guide only.

C
OPY

CR

3 November 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

The program for launching the contract cost principles was carried out on schedule. The press release was distributed on Monday afternoon at 1430. We held a press interview at 1500 at which time Mr. Falvey, Commander Malloy and Mr. Kilgore answered press inquiries and supplied additional background information for over one hour. We also distributed copies of our question and answer sheet.

The press interview commenced on somewhat of a sour note in that Mr. Saythe demanded to know why Mr. McKelroy was not present. He then inquired as to why Mr. McGuire was not on hand. At several stages, Mr. Saythe interjected caustic comments or asked leading questions such as "Does this mean that the Department of Defense will continue to allow the high cost of memberships in lobbying organizations such as AIA?" The questions from the remainder of the press corps (almost exclusively from the business press) were legitimate and to the point. They were particularly interested in those particular cost elements which were new or which represented a change from the past principles. Upon the conclusion of the interview, it appeared to us that the press was well satisfied with the explanations given. A check with Mr. Cunn of our office of Public Affairs this morning elicited the comment that the press interview went off very well.

I have ascertained that our announcement did not appear on either the AP or UP wire. We have not seen any press coverage on the cost principles today.

15/
J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPL Division
Office of Procurement Policy

Cdr Malloy



DEPARTMENT OF THE NAVY
BUREAU OF AERONAUTICS
WASHINGTON 25, D. C.

IN REPLY REFER TO

Aer-CT-2
3 November 1959

Dear Pete:

I thought you might be interested in seeing your words in print. Enclosed are a couple of copies of a transcript of your speech taken by a BuAer court reporter at the ONM-sponsored Procurement Lecture Conference on 12 October 1959.

Needless to say, because of the nature of the subject, there has been a very limited and discriminating distribution consisting of several of our procurement people and the BuAer Counsel.


S. E. ROBBINS
CDR, USN

OCT 59

SCHEDULE OF ACTION - COST PRINCIPLES

<u>Action</u>	<u>Timing</u>	<u>Responsibility</u>
1. Issue Revision 50 of ASPR (Cost Principles)	2 Nov 59	ASD (S&L)
2. Issue Press Release	2 Nov 59	ASD (PA)
3. Press Interview by DOD Spokesman	2 Nov 59	ASD (S&L) and ASD (PA)
4. Advise Secretary of Defense and Deputy Secretary of Defense	28 Oct 59	ASD (S&L)
5. Advise White House	28 Oct 59	ASD (S&L)
6. Provide Advance Copy of new regulation to Congressman Hebert and Congressman Mahon	29 Oct 59	ASD (S&L)
7. Advise Departmental Assistant Secretaries (Materiel) of complete schedule	28 Oct 59	ASD (S&L)
8. Distribute Advance Copies to key offices in each Military Department	30 Oct 59	Military Depts.
9. Provide Advance Copy to GSA, AEC, and NASA	30 Oct 59	ASD (S&L)
10. Advise Industry Consultants	2 Nov 59	ASD (S&L)
11. Advise Trade Associations	2 Nov 59	ASD (S&L)

*to arrive
2 Nov
possibly
air mail*

A. 50 copies of the principles provided to each military dept.

B. Procedures for the tri-departmental administration of the R&D principle were started 22 Oct. and basic approaches were tentatively agreed to.

10/27

*ack'd down
to Messrs. Mr. Elroy
Mr. Bates
aw 10/28*

Apparently agreed to by Front Office
P

OCT 29 1959

MEMORANDUM FOR MR. JAMES P. FALVEY, DABD (SUPPLY AND LOGISTICS)

SUBJECT: Mr. Moore's Suggestion re Research and Development Treatment in New Cost Principles

To counter-balance the criticism made of the Administration that enough is not being done to encourage research and development, vis-a-vis recent Russian achievements such as Sputnik, Mr. Moore suggests that the treatment of research and development costs in the new Cost Principles should be emphasized to the press.

In this connection, it is necessary to bear in mind that we are on record */your letter of 25 September 1959 to Dr. Smuinier/* that "we do not feel that our revised Cost Principles are significantly different from our present practices with respect to the allowability of costs under cost-reimbursement type contracts." You also advised, in the same letter, that "our proposed cost principles will not have a significant effect on costs under cost reimbursement type contracts." Moreover, in regard to Question 2 in the Question and Answer Sheet we have stated that, as to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. And in response to Question 3, we state that the new Cost Principles are not going to cost us any money nor will we save any.

To adopt Mr. Moore's suggestion that the new treatment of research and development is a significant step in encouraging efforts in these areas, we would have to be prepared to come up with an item or items where we have significantly cut back on costs previously allowable, otherwise our statements to Dr. Smuinier and in response to the questions referred to above are insupportable. I do not know of any significant areas in cost type contracts where we propose to disallow items of cost that previously were allowable.

Therefore, there is a real danger in emphasizing, as Mr. Moore suggests, the significance of the new treatment of research and development costs.

As a compromise or middle-of-the-road approach, we could insert the following sentence at the beginning of the answer now prepared for Question 6:

"The new Cost Principles are in line with the national policy of encouraging research and development."

This sentence would appear sufficiently general as to avoid the danger referred to above. At the same time, it is at least questionable whether it is sufficient to accomplish anything Mr. Moore suggests be achieved.

In these circumstances, and in view of the further fact that copies of the press release and the Question and Answer Sheet have already been distributed to the military departments, I recommend that no change now be made in either document.

SIGNED

J. J. FHELAN, JR.
Acting Director for Procurement Policy

Prepared by: JJPhelan/mt/29Oct59
30774 X19391

1959

THE NUMBERS GAME

In presenting its statistical argument about the number of costs disallowed, industry is playing the numbers game. They can (as did NSIA who cited 52 items) list a number of "areas in which there is failure to recognize true costs in whole or in part," and make it appear that we are being more restrictive rather than more liberal. There are several reasons:

(1) We explain the treatment of costs in more detail in the present proposal. Thus whereas "general research unless specifically provided for in the contract" was classed as one unallowable in Sec. XV, NSIA listed several elements of R&D costs as accounting for four items of unallowables. Yet we have liberalized this element substantially. Likewise NSIA lists five such items under compensation, three under depreciation, four under insurance, three under material, three under rental, three under royalties, and four under training. In none of these items is allowability more restricted, and in several it is liberalized.

(2) We provide policy guidance on many items now included in ASPR XV, Part 5, where they are classed as for "Special Consideration."

(3) Many of the items have had to be covered more specifically and their allowability restricted because of abuse by some contractors in the absence of prescribed handling (e.g., sale and leaseback, recruiting, and training).

No doubt the source of much of the attack on this score is the fact that they have been reimbursed in the past for many of the "unallowable" costs through the mechanism of pricing under several of the types of so-called fixed price contracts.

QUESTION AND ANSWER SHEET - COST PRINCIPLES

1. Q. How do these new cost principles change what the Department of Defense has been doing in the past?

A. The Department of Defense has prescribed cost principles for cost reimbursement type contracts for many years. These principles have been prescribed for use only for cost reimbursement contracts. As to this type of contract, the new principles will not materially change our operations although they provide more definite rules and to some extent cover cost elements not previously defined. The new principles will eliminate separate cost principles which we now have for use in negotiating termination settlements. The most significant new feature of the regulation is its use with fixed price contracts. We have not had cost principles for this purpose in the past. The new regulation will be used as a guide in the negotiation of prices under fixed price negotiated contracts to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices.

2. Q. What will be the affect of the new cost principles with respect to cost recovery be a contractor for (a) cost reimbursement contracts and (b) fixed price contracts?

A. As to cost reimbursement type contracts, contractors generally can expect about the same result under the revised cost rules as they are experiencing under present practices. A definitive answer cannot be given to the question of contractor recovery in the fixed price area since the range of situations here is too complex for generalization. Since we have not provided specific guidance in the past, these new principles will, at least in some instances, result in reduced recovery by contractors for certain particular items of expense. For example, interest has previously been an allowable cost in termination situations. In the future, interest will not be allowed.

3. Q. How much money will these new cost principles cost the Department of Defense or how much will be saved?

A. As indicated previously, about the same result will be experienced in connection with cost reimbursement contracts. In the fixed price area, we expect that the new principles will ultimately result in more efficient procurement and, hence, savings will accrue in the long run. It is not possible to put a dollar sign on any such savings at this time.

4. Q. Why has the Department of Defense not promulgated cost principles for general use in the past? Why has it taken you so long to do this job?

A. The Department of Defense has had cost principles for cost type contracts and for termination settlements. The extension of cost principles to the fixed price area is a very complicated and controversial subject. It has been necessary to take into consideration the strongly held views of the many parties at interest, including those of industry. The resolution of these areas of controversy has been difficult and, hence, progress has been somewhat slow.

5. Q. What are the more important areas of cost disallowance:

A. These would include most advertising costs, bad debts, entertainment, contributions and donations, and interest on borrowings.

6. Q. How do the new cost principles treat research and development expenses?

A. A contractor's independent research costs are allowable. Independent development costs are allowable to the extent that they are related to the product lines for which the Government has contracts. We have provided for certain administrative controls and limitations to insure that these costs are reasonable.

7. Q. Are executive profit sharing plans allowable?

A. We regard compensation measured by profit sharing plans as a portion of an individual's over-all compensation. Such compensation is allowable to the extent that an individual's total compensation is reasonable in amount.

8. Q. What affect do these cost principles have on profit?

A. The cost principles do not cover the subject of profit. Our profit policies are covered fully in Section III, Part 8 of the Armed Services Procurement Regulation.

9. Q. Will this new regulation lead to "formula pricing?"

A. Formula pricing means the resolution of each item of cost by unilateral accounting decisions. We do not anticipate that the new regulation will have this result. Our over-all pricing philosophy remains in effect.

10. Q. What application will these cost principles have to contracts awarded by formal advertising?
- A. The evaluation of costs is not appropriate under contracts awarded by formal advertising. The cost principles will, however, continue to be used as a guide for terminated contracts, including terminated contracts originally awarded after formal advertising.
11. Q. What do you mean by the statement that the cost principles will be used "as a guide" in negotiating fixed price contracts?
- A. We realize that hard and fast rules with respect to costs are not appropriate for many pricing situations encountered under fixed price contracts, particularly in those instances where prices are being established for a future period. Government personnel will be expected to be guided by these principles to the extent appropriate in conducting negotiations in the fixed price contract area to the extent that the pricing action requires the evaluation of costs. Any departure from the basic policies now established will require adequate explanation and justification.
12. Q. Is this new regulation agreeable to industry?
- A. Industry has traditionally opposed any of our regulations which set forth specific costs as unallowable. Industry contends that the Government should allow all normal costs of doing business. For this reason, industry is opposed generally to most of the disallowances we have prescribed. Industry is also opposed to the utilization of cost principles in the fixed price area.
13. Q. Have the Military Departments concurred in this new regulation?
- A. Yes.
14. Q. Has the new regulation been approved by the Secretary of Defense?
- A. Yes.
15. Q. Has the Comptroller General approved this regulation?
- A. The Comptroller General has been in favor of a single comprehensive set of cost principles for some time. He has concurred in the desirability of publishing the new regulation without committing himself as to agreement on all details.

16. Q. What Congressional reaction do you expect?
- A. We expect that our new regulation will be well received by the Congress.
17. Q. How does the new regulation affect Small Business?
- A. We believe it will assist many Small Business concerns in that it is designed to foster an atmosphere of mutual understanding among contractors and contracting officers as well as provide guidance on the handling of many items not previously covered.
18. Q. Why is the new regulation not mandatorily effective until July 1, 1960?
- A. There are many details in this new regulation which will require study for both contractors and Government personnel. A longer period than usual was established in this instance to afford ample opportunity for familiarization with the new rules.
19. Q. Are these cost principles going to be used on a Government-wide basis?
- A. We expect that cost principles substantially similar to our new regulation will be adopted on a Government-wide basis.
20. Q. Will these cost principles mean more negotiated contracts?
- A. No.
21. Q. Will the new cost principles require contractors to establish new accounting systems?
- A. No. The revised cost principles are not an accounting blueprint which will require any appreciable change in the accounting systems of most Government contractors.

Office of the Assistant Secretary of
Defense (Supply and Logistics)
26 October 1959

Draft/10/23/59

**BACKGROUND DISCUSSION
SECTION XV--CONTRACT COST PRINCIPLES AND PROCEDURES
ASPR CHANGE No. 50**

Purpose

The purpose of this paper is to provide certain background information and the answers to questions which are anticipated in connection with the issuance of the new Section XV, ASPR.

Background

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

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

cost-type contracts until 1949. Section IV, "Contract Cost Principles," Armed Services Procurement Regulations, was adopted by the Department of Defense in 1949 and was applicable only to cost-type contracts.

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

Despite the apparent wealth of cost principles, the situation was recognized to be unsatisfactory. There was no set of principles applicable to the negotiation and performance of fixed-price contracts -- only to their termination. Section IV, ASPR, has been used to some degree "as a guide only" but even this use sent beyond assurances given Government contractors at its adoption and has been a constant source of conflict between contractors and the Government. Sections VIII and IV were not uniform in setting forth which costs were allowable or unallowable, so there existed the anomalous situation of certain costs being unallowable if the contract is completed, but allowable if terminated. Further, a pattern of "implementing" instructions by directive developed to the extent that the mere volume of rules was forbidding, plus the fact that such directives were inconsistent between departments, and they not infrequently altered, through change or restriction, the policy adopted by the Department of Defense. All of these factors pointed to the need

for and desirability of a single set of cost principles to be applicable to all types of contracts and all phases of the contracting process where consideration of costs was involved.

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

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

The philosophy underlying the various sets of contract cost principles likewise indicated that a change was in order. Treasury Decision 5000 in defining allowable cost stated: "The cost of performing a particular contract or subcontract shall be the sum of (1) the direct costs .. and (2) the proper portion of any indirect costs ... incident to and necessary for the performance of the contract or subcontract. (Emphasis supplied) The phrase "incident to and necessary for" was interpreted by Government auditors, including those of the General Accounting Office, in such manner as to preclude reimbursement to the contractor of a share of normal business costs where it could not be demonstrated by the contractor that the incurrence of the cost was quite

directly related to the performance of the contract. The "Green Book" referred to above contains the same restrictive language. In consequence numerous indirect costs were disallowed.

Section IV, ASPR, in defining total cost, used the phrase "... incident to the performance of the contract, ..." in an effort to get away from the restrictive interpretation of T.D. 3000; while Section VIII, ASPR, uses "... reasonably necessary to the performance of the contract." However, the cost principles contained in each of these Sections included a list of unallowable costs which, in many situations, vitiated the advantages gained from the changed language.

Characteristics

Flexibility -- Based upon past experience, it was recognized that the mere statement that a cost was allowable or unallowable, or that every contractor's system and methods for determining cost must be "strait jacketed" into a common pattern, was not the answer. The path chosen was a difficult one. It was followed to achieve the objective of providing a reasonably comprehensive and complete basis for reaching an agreement or understanding between the parties on contract costs for pricing purposes. It also furnishes restrictive safeguards and highlights areas where special care must be exercised to assure equity. Adequate details and explanations are incorporated which, it is believed, will provide intelligent users with sufficient philosophy underlying the principles to permit their application to the many varying conditions and circumstances which may be encountered. Thus, for the most part, no formulas or ready-made decisions are provided.

Advance Agreements -- Closely related to the preceding subject of flexibility is the provision for advance agreements contained in Par. 15-107. While the principles do not give specific directions for handling each problem, good contracting requires that the contract reflects a complete meeting of the minds of the contractor and the contracting officer. Thus the admonition is given that specific agreements should be reached as to the handling of any difficult problems before the fact, rather than waiting until after the costs have been incurred. Having both parties aware of the ground rules before the game is started should eliminate many disputes and simplify administration and settlement.

Avoidance of Formula Pricing -- The proposed statement should be read with the clear understanding that it constitutes only one section of the Armed Services Procurement Regulations -- that part confined primarily to establishing cost principles and standards for use where costs are a factor in determining what the Government will pay for contractual supplies or services. It is not intended that it provide all the necessary guidance, regulations, and procedures as to methods of negotiation, pricing, determination of profit margins, choice of the appropriate type of contract, or auditing. There is to be inferred no desire to encourage the greater use of contract forms other than outright fixed-price contracts, or the greater use of cost data in negotiating prices on outright fixed-price contracts. In fact, the use of other factors, such as effective competition or standards established on the basis of prices of other efficient producers or production in our own plants, are to be preferred in negotiated firm prices. Criteria to

serve these purposes are contained in other sections of ASPR, though for emphasis, some of them are repeated in Section IV. Other related sections are those concerned with taxes, patents, and Government furnished property.

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

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

Recognizes Normal Business Practice -- A significant characteristic which is apparent throughout the statement is that the principles will not ordinarily alter a contractor's normal business practices. In fact,

every effort shall be made to follow them. Safeguards have been provided, however, against any abuse of this approach, particularly where defense work constitutes the major part of a contractor's efforts, in that reasonableness of costs such as executive compensation and research development is accorded special scrutiny. Likewise, evidence of arm's length bargaining must be present in determining the allocability of such items as executive compensation, bonuses, and property rentals. Unreasonable deviations from good accounting practices are expected to be corrected by all responsible contractors.

Effect on Defense Procurement Costs -- Some charges have been made that use of the new principles will cause procurement costs to skyrocket. Though no reasons have been advanced, it is possible that this impression may have arisen from the fact that some costs are specifically allowed on which the prior Sec. XV was silent or provided for allowance only as provided for in the contract.

While only experience will provide a firm answer, it is not believed that this charge is valid. First, it is anticipated that the effect on cost-reimbursement type contracts will be minor. The minor possible increases due to changes in allowability of certain elements of costs, such as advertising and research and development, are likely to be offset by greater emphasis on the concepts of reasonableness and allocability.

Second, and more important, a substantial portion of procurement in recent years has been under incentive or fixed-price-type contracts containing price redetermination provisions. It can be safely assumed that part of this increase has been due to the fact that the rather

restrictive cost provisions of Section IV do not apply to those types of contracts, and in practice more liberal allowances have been made in pricing such contracts. In addition to obtaining reimbursement for some of these otherwise unallowable costs by this means, cost to the Government is often increased because the percentage of profit is usually higher on fixed-price contracts containing retroactive price-redetermination clauses than on cost-type contracts. Thus the advent and intelligent application of the guides provided in the proposed statement for appropriate use in fixed-price contracts may well decrease the cost of procurement by the Government.

Changes Relating to Selected Cost Elements

As indicated above, no significant changes in allowability of individual elements of cost were made. However, in Par. 15-205, the approach to each element has been changed. Rather than a mere listing as allowable or unallowable, each cost is defined, discussed where appropriate, and then generally classified as to allowability. Secondly, instead of listing certain costs as requiring further consideration as was done in the predecessor Regulation, guidance as to their handling is provided. The following paragraphs highlight and summarize a few of the more important items.

Advertising Costs -- Costs allowable under the present Sec. IV continue to be allowed. In addition costs are made allowable for participation in exhibits under certain circumstances, and for obtaining scarce material or disposing of scrap or surplus.

Bidding Costs -- While not specifically mentioned in the prior regulation, the new provision is consistent with past practice of making such costs allowable.

Civil Defense Costs -- Costs of such measures as are undertaken on the contractor's premises are allowable. Contributions for off-premises projects are unallowable for purposes consistency with the contributions provision.

Compensation for Personal Services -- The new statement is not inconsistent with the old. However the many forms in which compensation can be paid are specifically covered. This should eliminate inconsistencies in treatment of this cost which have occurred in the past. Generally the new statement makes allowable, compensation in any form, so long as it is reasonable for the services rendered. Special note is made of the necessity for evaluation of reasonableness of compensation and guides are provided for such evaluation.

Stock options are not allowed as a form of compensation.

Contingencies -- Since the new principles relate to forecasting as well as historical costing, certain classes of contingencies are allowable.

Contributions and Donations -- Continue to be unallowable.

Depreciation -- No substantial changes have been made from past practices. However, explanatory material is included stressing the influence of economic factors on depreciation rather than concern exclusively with physical life. In addition, under certain conditions a use charge may be allowed in connection with assets fully depreciated on the books of the contractor.

Interest -- Continues to be unallowable.

Material Costs -- Acceptable bases of charging for materials used are set forth.

Plant Reconversion Costs -- Generally the rule follows past practice of allowing only those costs related to the removal of Government property. However, in special circumstances where equity dictates, additional costs may be allowed if authorized before incurrence of the costs.

Rental Costs -- Factors are provided for evaluating the reasonableness of rent. In the case of sole and leaseback arrangements, rental allowance is made only to the extent that it does not exceed the amount which the contractor would have recovered as a cost had he retained legal title.

Research and Development Costs -- This cost relates to those research and development activities carried on independently by the contractor, which are not sponsored by a contract, grant or other arrangement. The policy treats research separately from development. An allocable share of a contractor's current independent research is allowable against all contracts. Development costs are allowable to the extent they are related to the contract product line, or in the case of exclusively research and development contractors, to the field of effort of research and development contracts.

Amortization of such costs incurred in prior periods are not allowable. This treatment is considered to be equitable in that the Government will pay its share of current costs regardless of any direct benefit derived, but in exchange therefor, will not bear any share of the cost of the contractor's past research even though its contracts

benefit therefrom.

Finally, safeguards are provided to assure reasonableness of costs through approval of the contractors research and development program and cost sharing arrangements under appropriate circumstances.

Selling Costs -- Such costs are allowable but special care is directed to assure consideration of their proper allocability; i.e., reasonable benefit is derived to the Government therefrom.

Severance Pay -- This represents another of the several difficult elements of cost on which guidance has not previously been provided. Costs arising from severance pay in connection with normal employee turnover are allowable. Abnormal or mass severance pay is of such a conjectural nature that any accrual therefor is not allowable. However, the Government recognizes responsibility for its fair share of such costs in the event of occurrence and will consider allowability on a case by case basis.

Termination Costs -- While the aggregate of principles included in Part 2 are applicable to termination situations, such terminations give rise to the incurrence of costs, or the need for special treatment of costs. These special provisions have been eliminated from Sec. VIII, where they appeared previously, and incorporated in Part 2.

Training and Educational Costs -- Costs of routine training and education related to job requirements are allowable. As a means of assuring reasonableness of a contractor's training program, cost of extraordinary programs are shared with the contractor through disallowance of such items as salaries and subsistence paid to full time, post-graduate employee students.

CR

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

SUBJECT: Publication of Our New Regulation on Contract Cost Principles

We are now in the final stages of publication of our new procurement regulation dealing with cost principles which we recently discussed with you. It will be published on 2 November 1959, at which time we also plan to issue a rather comprehensive press release. I have separately forwarded a memorandum to Mr. McElroy (Tab A attached) to alert him to our plans and to provide him with a copy of the press release. A copy of the press release (Tab B) is attached for your information. In addition, I am providing you with a copy of our Action Schedule (Tab C) which indicates the important corollary actions which we are taking.

Attachments

Tab A
Tab B
Tab C

Prepared by: JMMalloy/jm/23 Oct 59
3D774 X-72026

Coordinated with: Mr. Bannerman



CR

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

22 Oct 59

SUPPLY AND LOGISTICS

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE ARMY (LOGISTICS)
THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

SUBJECT: Contract Cost Principles

As I indicated at one of our recent meetings, I am anxious that each of you be closely informed of our activities in connection with publication of the new cost principles. I am attaching a schedule of the various actions which we contemplate in this connection. There is also attached a copy of a press release which we expect to issue on 2 November 1959. In addition to the actions listed on the attached schedule, I have instructed Commander Malloy of my staff to be in close touch with his counterpart in each of the services so as to keep him fully informed of our activities.

I am sure that you will agree that the public relations aspects and the timing of our various actions is very important to this exercise. I solicit your assistance in assuring that we will have no breakdown in this regard nor any premature disclosure of either the cost principles or our specific plans in connection with their issuance.

Attachments

1. Action Schedule
2. Press Release

Prepared by: JMMalloy/jm/22 Oct 59
3D774 X-72026

Coordinated with: Mr. Bannerman _____

CR

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Publication of Our New Regulation on Contract Cost Principles

We have now completed our work in connection with the publication of a revision to the Armed Services Procurement Regulation dealing with contract cost principles. The regulation is being printed by the Government Printing Office and will be distributed to the public on 2 November 1959, at which time we plan to issue a press release. A copy of the press release is attached for your information.

You will recall that we discussed this new regulation at some length approximately a year ago. During your recent absence, I provided Mr. Gates with information as to our current plans. We can expect some adverse industry comment. Congressional reaction should be favorable.

Attachment
Press Release

Copy to:
Mr. Gates

Prepared by: JMMalloy/jm/~~300~~
23 Oct 59 3D774 X-72026

Coordinated with: Mr. Bannerman _____

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)
FROM: Director for Procurement Policy

Problem: To provide an advance copy of the new Cost Principles to Congressman Mahon for information.

Discussion: The attached letter to Congressman Mahon is designed to afford him with an advance copy of the new Cost Principles. We have no commitment to clear our principles with the House Appropriations Committee prior to their publication. We feel, however, that we should give the Committee an advance copy as a matter of courtesy in view of its sustained interest in this subject.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)
General Counsel

CR

Dear Mr. Floete:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

The Department of Defense has been developing a revision to our Procurement Regulations with respect to Contract Cost Principles for a considerable period of time. However, as I am sure you will recognize, this is a highly complicated and controversial subject and one which generates a wide variety of different views as to the treatment which should be afforded each detailed cost element. As a result, the obtaining of a degree of agreement on this set of Cost Principles has been a slow process.

The Department of Defense has been under considerable pressure from several Congressional Committees to promulgate a comprehensive set of Cost Principles without further delay. For my own part, I am convinced that it is more important for us to promulgate our current proposals without further refinement. We will, of course, look forward to any changes which may be necessary after we have had experience with these Principles.

We have afforded ample opportunity for Industry to provide comments and suggestions with respect to this new Regulation. While we expect that Industry will remain quite critical of the new Cost Principles, it is my feeling that our present effort is the proper course of action for us to take. I feel sure that you will desire to incorporate these Contract Cost Principles into the Federal Procurement Regulation. In this connection, we have been in consultation at the Staff level with the Atomic Energy Commission and the National Aeronautics and Space Administration who have both indicated substantial agreement with our new Regulation.

Sincerely yours,

Inclosure

Contract Cost Principles

Honorable Franklin G. Floete
Administrator
General Services Administration

Prepared by: JMMalloy/jm/19 Oct 59
3D774 X-72026

Coordinated with:

Mr. Bannerman _____

Mr. Kilgore _____

Copy to: Mr. Pilson
Mr. Kilgore

7m-100 y

200 59

COVERING BRIEF

CR

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide an advance copy of the Cost Principles to the General Services Administration for information and for possible use in connection with the Federal Procurement Regulation.

Discussion: The General Services Administration has been aware of our continuing efforts over the past several years to resolve the problems which have accompanied our efforts to promulgate a comprehensive set of Cost Principles. They have not taken an active part in this project, preferring to await the outcome of our efforts. The Department of Defense is the primary user of Cost Principles in Government although both AEC and NASA will have use for Cost Principles. Use by other Government agencies, including GSA, will be insignificant. The purpose of this letter is to advise Mr. Floete of the results of our efforts.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

CR

Dear Mr. Johnson:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I am advised that members of the NASA staff have reviewed earlier drafts of our new Regulation and have expressed the view that these Cost Principles could be used by NASA. In view of the fact that both NASA and the Department of Defense have many common contractors, purposes, and interests, I think it very desirable that our approach to costs under Government contracts be parallel to the maximum practicable extent.

Sincerely yours,

Inclosure
ASPR Revision
Contract Cost Principles

Mr. John A. Johnson
General Counsel
National Aeronautics and
Space Administration
1520 H Street, NW

Prepared by:
JMMalloy/jm/19 Oct 59
3D774 X-72026

Coordinated with:
Mr. Bannerman _____
Mr. Kilgore _____

Copy to:
Mr. Pilson
Mr. Kilgore

59

CR

COVERING BRIEF

TO: The Assistant Secretary of Defense (Supply and Logistics)

FROM: Director for Procurement Policy

Problem: To provide an advance copy of our Contract Cost Principles to the National Aeronautics and Space Administration for information.

Discussion: We have been providing NASA with a copy of each new draft of the Cost Principles as they were being developed. NASA has been waiting for us to take the lead in this effort. They feel that our Principles as currently developed will be completely satisfactory to NASA. We have had one meeting with NASA representatives at which time they recommended that we change our research and development principle to eliminate the definition of basic research and applied research. The affect of this revision would not change the substance of our research and development principle. They were concerned more with the precedent that our definitions would have in fields beyond contract cost principles. After a full discussion, it was agreed that the definitions were necessary to enable DOD personnel to completely understand this cost principle. NASA representatives indicated that their suggestion was, from their point of view, desirable although not essential. We feel that our present proposal will be completely satisfactory to NASA and will be used by them upon publication.

Recommendation: That you sign the attached letter.

Concurrence: Assistant Secretary of Defense (Comp) (Mr. Kilgore)

12-2-59

CR

Dear Mr. Luedecke:

I am inclosing an advance copy of a Revision of the Armed Services Procurement Regulation on the subject of Contract Cost Principles. We expect that this Revision will be distributed officially by the Government Printing Office on 2 November 1959.

I am aware of the fact that our respective Staffs have been working together on many of the earlier drafts of this Regulation. I am advised that the new Cost Principles which we have adopted, after an extended period of review and consultation with the many interests involved, are, with few exceptions, agreeable to the Atomic Energy Commission. I think it very desirable that the many Government agencies with a primary interest in this project be substantially in agreement as to the treatment of costs under Government contracts.

Sincerely yours,

Inclosure
ASPR Revision
Contract Cost Principles

Prepared by: JMMalloy/jm/19 Oct 59
3D774 X-72026

Mr. A. R. Luedecke
General Manager
Atomic Energy Commission

Coordinated with:
Mr. Bannerman _____
Mr. Kilgore _____

Copyh to:
Mr. Pilson
Mr. Kilgore

Procurement Lecture Conference

12 Oct 1959

"Revised ASPR Section XV -

Contract Cost Principles"

Speaker, CDR John M. Malloy (OSD)

P R O C E E D I N G S

[The meeting convened at 8:25 o'clock, a.m.,
Monday, 12 October 1959, GSA Auditorium, Washington, D. C.]

CAPT. FAGAN: Good morning. This is the fourth of our procurement talks, and the first three--the first two particularly--we have called quite controversial subjects. The third one was on auditing, and the use of auditors.

This morning, we are going to hear about cost principles. I got exposed to procurement from BuShips beginning in 1948, and one of the hottest subjects at that time was cost principles.

I had heard of Section 15 before I got there, but I had no idea what it was. I thought it was a revenue code, and then I got to BuShips and found that Section 15 had to do with cost type contracts, and that sort of thing, but there was considerable debate as to whether or not it was theoretical; whether it applied to fixed type contracts as well as cost type contracts.

In 1948, some ten or eleven years ago, cost principles were quite a discussion, quite an issue. I got back in Washington, here, in 1956 and found out that the subject hasn't changed a bit or had the solution apparently toward the subject.

FOR OFFICIAL USE ONLY

among other things my boss has told me to keep my mouth shut and such other direct admonitions.

I would like to take up with you today, and try to describe, some of the objectives which we are trying to accomplish by putting out a so-called comprehensive set of contract cost principles. I will give you some of the important highlights of the new principles themselves.

I think some of the history of this exercise might be of interest to most of you. I don't think that too many of you realize the number, the great number, of people in government outside of the Navy Department--if you will--who are interested in and have a voice in what kind of contract cost principles we will have, and I think maybe I can give you a little on that.

I also would like to give you my own personal evaluation as to these principles as a set of contract cost principles, and as to the effect they will have when published for what they are worth, and then after lunch to the extent we have time I would be glad to tell you the current status of the project.

First of all, I think that you have to be in the proper frame of mind to consider objectively this very controversial kind of a regulation, and because I think--and I speak with some actual degree of experience with respect to this--we sometimes think emotionally

5

Let's get into it then, and try to set forth some of the objectives which we are seeking to obtain by putting out a comprehensive set of cost principles; that is, a set of principles which will be used in one way or another as the basic groundrules whenever costs are a factor in procurement, and you will notice that my words are rather carefully chosen--whenever costs are a factor in procurement--and that is not to say that costs always should be a factor. But, first, we have I think the obligation to up-date the contract cost principles which we have in the book now.

These were published in 1948. They are rather sketchy. A lot of new things have come on the horizon since these were published. We have been in the process of revising them for the past six years, and so you'd expect that we would need some up-dating and this, of course, has to be one of the objectives.

We are also seeking to obtain some uniformity of treatment of these various elements of cost, and this uniformity of treatment has to do with uniformity within the Department of Defense first among the three Services, and then--if you will--sometimes a little uniformity among the Navy bureaus doesn't hurt, and that is one of the things that might be accomplished here with these contract cost principles.

FOR OFFICIAL USE ONLY

7

Now, a few things that this is not designed to do. It is not designed to be an accounting blueprint. It has many, many, references in it indicating that there is no need for any major revision of a contractor's accounting system to accommodate these cost principles.

Now, there will be some but not very major for a contractor who is already doing business with the Government. Some of our definitions will cause a kind of tightening up for some contractors, and for others who have a very loose arrangement there would be more practical effects, but it was not set out to be an accounting blueprint and we don't believe that that will be the effect of these principles we published; that is, that there will be any accounting revolution, you might say, on the part of our contractors.

We are not seeking here to throw into the Potomac the pricing philosophy which we hold so dearly. You will see somewhat later our attempt to emphasize our pricing philosophy, and maybe some of the reasons why we feel that this emphasis is necessary at this time.

Now, another thing that this is not designed to be is it is not designed to be a document which will guarantee to contractors a certain recovery of costs just because we have a list of contract cost principles that are listed as allowable. It is no guarantee that we

FOR OFFICIAL USE ONLY

price contract situation depends on a lot of things including the power and strength of the negotiating parties and what not.

Now, what should be the Department of Defense policy on anything like interest, and is there any difference in the situation where you meet the problem of interest? Now, that is one of the things we are trying to come upon. There are differences in application of such things as interest and any other cost, individual costs, research if you will, training if you will, contributions and donations. There are differences existing today as between Navy Bureaus, Army, technical services, individual offices in the Air Force. There are different philosophies, actually, in the military departments and I can cite you one specific case which is known maybe to a lot of you, and this was hammered home to me by Congressman Bates one day when he was then a member of the Hebert Committee, and he was saying that he--and, incidentally, he was one of the greatest friends we had down there--and I say had because he is no longer on the Committee.

He said, "I can't understand for the life of me, sympathetic as I am with the Department of Defense, I can't understand for the life of me why the Air Force says that a profit sharing plan, or a bonus if you will,

contractual situations, and that they should be incorporated into contracts in all but fixed price situations.

So, what we have in the package today is a rather delicate balance of the conflicting points of view and, of course, you have industry who like no part of anything unallowable. Industry, strangely enough, if you read their material closely, can be said to be very much in favor of a comprehensive set of contract cost principles.

Now, that may cause some raised eyebrows on the part of the more sophisticated and experienced with this exercise in the audience, but I maintain that it is so. Industry would love to have a comprehensive set of cost principles. Under certain conditions, of course, they have expressed themselves as being in favor of this but what they want is a set of cost principles not near as detailed as we have which, in effect, would have everything allowable. They won't like any unallowable. This is almost tantamount to being un-American to have an unallowable. They would like to have everything allowable, and industry as a whole with their trained negotiators they start from up here in order to get here. They argue for everything being allowable so that they can get a better cost recovery, and some people think that

situation where we traditionally feel that we should be very conservative, moving down the line to the re-determinable contract, redeterminable after the fact. Now, we don't use many of those in the Navy but I am rather surprised at the extent of their use in some of the other Services particularly in the Army.

If you have an after the fact re-determinable contract of \$100,000,000, do you have a situation pretty close to a cost reimbursement type contract? Yes, and how about the next one down the line our old friend and incentive contract, fixed price incentive contract? The contract clause, itself, says there will be a negotiation of costs, and this is done after the fact. This is a retrospective application. We know what has been incurred; what is the Department of Defense policy here. You don't have to be guessing, you do have a negotiation but not something that is out in the wild blue yonder, a situation that calls for and requires a certain degree of precision, not a completely boxed in type of precision, but precision nonetheless, and as you move down the spectrum you come to the other family--the other wrinkles in the family--of redeterminable contracts and in many of these you need contract cost principles.

You need something. Anyway, we start off with that, you need something and we hope that we are providing

anything further and shouldn't care anything further about the use of cost principles and that is not intended to prescribe the use of these principles when you would not, yourself, even today want to look at the breakdown of costs. So, to go on:

"When, pursuant to ASPR so and so costs are to be considered in the negotiation of fixed price type contracts, the appropriate part of this Section 15 shall be used as a guide in 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 3, part 8."

Again, a throwback to pricing and an abundance of caution if you will and to go on:

"In the case of negotiated termination settlements, Section 8 Part 3."

So that, then becomes the punch line for the use of cost principles in the fixed price contract area. Now, what do you do; how are you guided in a case where you are in an argument with the contractor over a specific item of cost?

Now, we sometimes talk rather loosely--we procurement people--about how we use costs in negotiating price and you sometimes get the idea that we really are not much interested, that we go through no real approach and get a price that is real tight and close, and that we

contractually bound.

Well, we tried our hand at expressing this and this is some change from earlier drafts, some loosening up if you will.

"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 analysis in respect to some cost elements 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."

It is a little ~~weak~~, I think. Will it do any good at all, that kind of language? I think it will. Will it do the most good? You have a difference of opinion. Some, of course, feel the contractor should be required to the maximum extent we can, using all of our powers, to prepare his account analysis, and cost breakdowns, strictly in accordance with the contract cost principles because this makes the audit job easier; makes the consideration of costs and pricing easier. We have not adopted, here, the rather stringent approach.

Well, I have spent a great deal of time on the applicability because they are really at the heart of this whole exercise. I recall speaking with Jim Bannermann the other day, and he was recalling this whole

cost principles--will serve as a basis for the resolution of the issue. You see the difference?

In the latter instance, you would be pretty well bound in an argument with a contractor to resolve it the way the book says. As here written, there is obviously a need to follow the policy laid down by your bosses. They say you will use these as a guide. They didn't say, however, that you will have to use it every time. They didn't say that you have to throw common sense out the window. They didn't say that you would abandon overall bargaining. You can, I think, depart from these but when you do, when you depart from the guidance that has been laid down by your superiors, it is only right that you have a pretty good story.

You shouldn't depart on some whim of your own. You ought to be willing to stand up and be counted. We have other language here which will, I hope, not get us into the straightjacket of having to examine each and every minor item of cost and where we don't follow the blueprint exactly have to fill the file with that much justification. We don't intend this, and I think that there is enough flexibility here to prevent it, absent some bad approach--if you will--by those who might be looking over your shoulder including the procurement types who do that sort of work, and the audit types. But, absent

different from that which I have described to you this morning.

We have made it more flexible. We have fixed it up here and there, but in its basic elements it is not too different from that which was developed about three years ago, and which the majority of procurement types decided was then a feasible project having described the use to which these principles would be put.

Well, now, let's get into the principles in slightly more detail. We, of course, have here much more detail than we have in the book today. I think the present Section 15 has what, five or six pages, something like that. I would guess that the new cost principles in terms of pages--which is a rather bad way to measure--but in terms of pages maybe 25 or 30 pages. That gives you some idea. You have considerably more guidelines in many, many, areas.

We have, for example, tried our hand at defining reasonableness, and allocability.. Sort of foundation words, wouldn't you say? Foundation words with respect to the current Section 15, and yet not defined in the ASPR today. They are probably not susceptible of precise definition, particularly the one on reasonableness. But I think you will find that they

sit down and do these things in advance? Mass movement of personnel; pre-contract costs; there are a list of seven or eight areas which are suggestive in this new set of cost principles, suggestive of advance understandings and when you have reached advanced understandings in the cost reimbursement area they will be incorporated into the contract.

In the fixed price area, this will be put in the contract file. Now, others would have us put-- others meaning, more specifically, the General Accounting Office--would have us put these advanced understandings as a part of the contract regardless of the type of contract, but as now set up it would be in the contract file except in cost reimbursement type situations as to the individual items of cost that are, we will say, in the allowable category.

I have indicated that compensation will include all facets of compensation regardless of how determined, which really boils down to the real severe argument within the Department of Defense as to whether bonuses based on profit sharing plans would be allowable. That one reached the level of the Secretary of Defense himself last year about this time, and he decided that the total compensation was the key.

Research is a particularly difficult individual

with the applied following the pattern for development and we have become rather substantially convinced that any attempt to draw the line between basic research and applied research is fraught with all kinds of complications, so we have dropped that concept.

We have, now, lumped applied research and basic research together and we have said--and we call this, then, independent research, so independent contractor's research is a reimbursable element of cost through overhead.

Now, subject to what? Subject to these advance agreements that I indicated that we would agree with them in advance on these things, which provides one check on it and provided in the principles themselves also are several methods by which we can come at the problem of paying less than what the contractor wants to put into it.

This could be a dollar sharing. For every dollar he puts, we will put a dollar in. This can take the form of a review of individual research programs and decisions as to which one we will support; things that we are doing today for the most part, and we have an agreement to have a three Services approach to the research expenses to be reimbursed through overhead for the major big large contractors.

We have not figured out how to do this yet. I

fun debating that one if you like. I don't have the time to develop it here. Let me say only that most people agree that interest should be unallowable. Whether they are right or not is another question, but even in industry the feeling of the people who have tried to analyze this concept abstractly differ. We have it as unallowable.

Contributions and donations, another friend, unallowable; bad debts, unallowable; stock options, unallowable; just a few. These I don't think are of any surprise. Now, about the final package with respect to cost reimbursement type contracts. Is it more liberal? Will a fellow get more under these new principles than under the old? That is rather important when we start worrying about whether we can amend current contracts or not.

We can not provide a completely definite answer on this. I will give you my personal opinion. Contractors have been giving us the business saying when you publish those terrible new contract cost principles don't forget that you have got to provide a mechanism to give us an equitable adjustment as to increase in prices, to make these things equal--the old versus the new.

I don't think this is factual, however, my

overall result will be advantageous in the fixed price area. I don't think it will make a hoot and a damn's worth of difference in the termination area.

Sure, the new principles for termination contracts may be a little bit tighter in that, for example, I have indicated interest is allowable today in terminated contracts and not allowable in the new principles. By and large, I don't think it will have a very great effect in termination.

We have had six years' history of this exercise. We have met with industry innumerable times. We had a rather unique meeting in October of last year where the twelve industry associations interested in this exercise got together and nominated a spokesman who came before a meeting which I am sure a lot of you attended, which was primarily for the benefit of the decision making Assistant Secretaries of the military departments, and in the Pentagon, to listen to both sides of the controversial items.

The industry spokesman said his piece, and he didn't pull any punches, and the Government spokesman said his piece, and there was a verbatim transcript of that. Incidentally, I think there are still a few copies of that available for any students in the audience, but subsequent to that meeting we received further written comments. The written comments on that, and I am not

and interest, and these other things, allocated to our contract. This is what really departs us from industry.

Other people have an interest. The General Accounting Office, they have been hammering us for years to get out a set of cost principles applicable across the board. They have written very strong letters. They are, as you know, a very potent force. They could well get the Congress so excited that they would hold hearings, and try to develop contract cost principles by law. This has been threatened, but I have never considered it to be a very serious matter. It is something, though, that is on the horizon.

We have met with the Comptroller himself within the past month, have discussed this with him, and we have just a few days ago received his written comment. Our approach to him was that it is better, we think, to get out something now than to spend any further time in refinements and hence we are going to publish his comments. It was about two and a half pages, but really it was in the nature of a nit-pick. He says:

"It isn't abundantly clear that your test of reasonableness which you have over in the front of your document, and which you speak of two or three, or four times elsewhere, it isn't absolutely clear that the test of reasonableness applies to each and every individual element of cost."

it will undoubtedly appear in the Federal Procurement Regulations.

Well, as to a personal evaluation of this whole thing, the following are at least my views for what they are worth. I think that this whole exercise is necessary. I think that the present set could be improved. It isn't the way I would personally write it in all respects. I suppose anybody could say that, however. This is such a controversial area.

The thing that bothers me is that we started with a good premise, and we varied from it. We started with a good premise that we would say all costs are allowable unless there is a damn good reason why they shouldn't be, some overriding public policy reason like entertainment. We couldn't have a set of cost principles that said entertainment was an allowable cost because of public reasons, but we shouldn't make certain costs across the board unallowable because they are hard to administer. We have done some of that. I think this isn't good.

I think that we have, in the package we have now, the best results that we could hope to get. I think that, as I have said, that it is essential that we have a comprehensive set of cost principles. It is management's duty to provide guidance in this area. I can't, myself, quarrel with the basic theory that a cost is a cost

a crutch to avoid criticism rather than doing a good job of overall bargaining.

We are worried, sincerely, about the possibilities of misuse of these contract cost principles by certain audit elements and by the General Accounting Office. I said certain audit elements and, of course, didn't mean the Navy audit elements. But, if you will be honest in your own evaluation, I think you must have as a basic worry the use to which those who have the job of criticizing us, of second guessing us, what use will they put to this document.

You might say, "Sure, it is helpful to me, but in the long run it isn't going to help me if the other fellow can beat me over the head with it on and off so badly that I don't get my work done, so it forces me to go to cost price contracts or price all my negotiations on a formula basis."

I don't think that the dangers inherent here are insurmountable. I think they can be overcome, and we will try to insure that they won't take place. I think that the principles will, at times, give industry a handle against us. I think that it will be sometimes more difficult to negotiate an individual element of cost if industry can point to a set of principles that says allowable and now allow it when you are trying to

I think it is the closest ~~that~~ it has ever been. We have in mind that even when it is published it will not be mandatorily effective until the first of January--excuse me--until the first of July next year. We obviously don't want to have something that has the potentially disruptive effect of these to come in, we will say, in April or May, or March for that matter and so we have skipped over into the first of July for mandatory use. They will, of course, be for use as a guide in the interim period.

We will be issuing, when these are published, there will be an official Department of Defense press release issued. There will be a lot of yakety-yak about it. We will attempt to distribute advanced copies throughout the military so that you don't first see these principles in the hands of the contractors, a situation which sometimes happens.

Well, I have covered a lot of territory here this morning. I hope that I have given you at least some food for thought, and at least I have exposed some of my own personal views; whether you like them or not is beside the point, and I will say it has been a pleasure to talk to you and I will be glad to duck your questions as best I can. Thank you.

[Applause]

CH

MEMORANDUM FOR THE SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

Approximately one year ago, Assistant Secretary McNeil, the Material Assistant Secretaries of the Military Departments, and I discussed with you certain issues within Department of Defense and with industry concerning the proposed comprehensive cost principles applicable to all types of negotiated contracts in which costs are a factor in pricing.

Due to the inherently controversial nature of these cost principles, achieving even reasonably close agreement between all parties concerned has been a slow process. We have given industry more than the customary opportunities to present their views. These have included written comment on the 10 September 1957 draft, an open discussion meeting on 15 October 1958 followed by a second written comment, and finally a detailed discussion with four industry representatives on 1-3 April 1959.

Our current proposal is the result of thorough consideration of industry and military department views. Outlined below are its most significant provisions, primarily from the standpoint that they represent a change from present policy or practice, or are opposed by industry.

1. Applicability -- The principles will be incorporated by reference in cost-reimbursement type contracts and will form the basis for determination of costs thereunder. They will also serve as guidance in the evaluation of costs in pricing negotiated fixed-price type contracts where such evaluation is required in the establishment of prices.

2. Advance Agreements -- In order to avoid disagreements with respect to costs during or after performance of a contract, the principles encourage the negotiation of advance agreements as to the handling and the degree of allowability of certain items of cost, particularly in connection with firms or separate divisions thereof whose work is primarily with the Government. Industry has some reservations concerning this provision, but we believe it is entirely reasonable and will work to the benefit of all concerned.

3. Compensation — As decided in our above-mentioned discussion, compensation of contractor officers and employees is allowable if reasonable. Thus, compensation dependent upon or measured by profits is not, per se, unallowable.

4. Research and Development Costs — In line with national policy of encouraging research and development, we propose to provide for acceptance as allowable costs, our share of a contractor's independent research. We will treat his independent development costs similarly to the extent that they relate to product lines for which the Government has contracts. Restrictions are provided, however, to limit these costs to reasonable amounts and to prevent unwarranted duplication of efforts in the same area by different contractors. In return for our support of current research programs, we will not accept similar costs incurred by the contractor in the past, even though we may receive some of the benefits thereof.

5. Minor Costs Disallowed — Industry has long objected to our disallowance of certain items which it considers to be normal and proper costs of doing business. We maintain the position that, for reasons of public policy, equity, or absence of benefit to the Government, we should disallow certain costs. Among these are contributions and donations, interest, bad debts, and product and institutional advertising.

We believe that to try further to resolve the remaining differences with industry would serve only to delay this much needed guidance and deprive us of the benefits which are expected to flow from it. We anticipate that the issuance of these cost principles will result in greater uniformity of treatment of contractors, more effective and economical audit of contractors' costs, and a more orderly procurement process.

One possible hurdle, yet to be overcome, is discussion of the principles with the Comptroller General. While it is within the authority of Department of Defense to issue such regulations without reference to the General Accounting Office, we recognize its interest. Based upon comments of the Comptroller General on earlier drafts and informal staff discussion, we know that he favors a much more rigid application of the principles to all contract pricing — an approach which industry and many of us fear will remove bargaining from the negotiation process and result in formula pricing. The possibility exists that he may be critical of our effort. However, Mr. McNeil and I plan to discuss the matter with him on 23 July to point out the reasons why we believe we are proposing the best possible solution at this time.

My position, concurred in by Mr. McNeil and the military departments,

Wash. D.C.

Concurrence:

3

CH

3 March 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Discussion of Contract Cost Principles Before the Committee on Government Activities Affecting Costs and Prices.

I am attaching a copy of the memorandum which we have received from Mr. Saulnier, requesting that the contract cost principles be discussed prior to issuance before the Committee on Government Activities Affecting Costs and Prices. I think that it would be most unfortunate if we let the contract cost principles become involved in the anti-inflation exercise. I suspect that none of the individuals on this Committee have the necessary background to evaluate the pros and cons of the proposed contract cost principles. We can only look forward to another delaying action. I strongly recommend that we take whatever informal steps that may be appropriate to allow us to take no action on Mr. Saulnier's request.

As a generality, it is my view that the revised cost principles are slightly more liberal than those currently appearing in Section IV. The research and development principle is potentially the most inflationary, but even here it is not possible to predict the impact of our revision since its impact in actual fact may well be diminished by our administration of the principle. You may be able to use the following quotation from the industry letter of 7 November 1958 in any discussion which you might have with Mr. Saulnier.

"To what extent is the Government, in these proposed regulations, refusing to bear its fair share? It would disallow 23 items entirely, of which only 18 are disallowed by the provisions of the present Section IV of ASFR. It would partially disallow 20 other items, of which only 6 are disallowed by the present ASFR. It would subject 19 other items to special tests or reviews (not "principles") which would, by definition or tests applied, lead to still more partial or total disallowances. Of these 19 items, 3 are disallowed and 7 are subject to "special consideration" under the present ASFR. The proposed new regulations also suggest advance negotiation of 9 items of which 7 are on the list for "special consideration" under the present ASFR. Elsewhere in the document, however, advance negotiation is stated as a requirement of cost allowance in 6 additional cases. The identification of the above statistics are included in the attachment hereto.

"These figures demonstrate conclusively that the new regulations would not only subject cost data to substantially more detailed and lengthy analyses and reviews, with added costs to both Government and contractors, but that the negotiation process would likewise be lengthened. They also show that contractors must expect to recover substantially less of their costs than they have heretofore obtained under cost reimbursement type contracts, and to the extent the proposed regulations are applied to other types of contracts, contractors must expect disallowances of cost equivalent to the new measure of disallowances under cost type contracts. If applied to terminations, the allowable recovery would also be much less than under the provisions of Section VIII of AFPR. It is impossible to predict the measure of such non-recoveries under the new regulation, but they would deprive a substantial portion of profits."

1 Incl.
Copy memo fm Mr. Sealster

J. N. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division
Office of Procurement Policy

Prepared by: Cdr JN Malloy/rhs/
3/3/59
3D 774 172026

Coordinated by: Mr. Bannerman _____

m. Termination Costs

As stated in paragraph 2 of this bulletin, the new principles apply to both advertised and negotiated cost-reimbursement type and fixed-priced type contracts terminated for the convenience of the Government. The separate set of cost principles set forth in ASPR Section VIII for terminated contracts is therefore not effective with respect to those contracts to which the new cost principles apply. To cover the special considerations involved in terminations, such as treatment of common cost items, initial costs, settlement expenses, etc., a separate paragraph 15-205.42 entitled "Termination Costs" has been included in the new principles to indicate the extent of allowability of these items. The prior provisions in ASPR Section VIII with respect to the treatment of interest expense and product advertising as allowable costs of terminated contracts have been eliminated from the new principles.

n. Training and Educational Costs

The brief mention of training of personnel as an example of allowable costs under the old principles has been replaced by an expanded statement to clarify any questions regarding the allowability of training and educational costs paid to outside institutions, to company training personnel, or to employees receiving the training. The new principles set forth the specific items of allowable costs applicable to (1) training and educational activities designed to increase the vocational effectiveness of bona fide employees; and (2) part-time education, at an undergraduate or post-graduate college level, related to the job requirements of bona fide employees. Excluded from allowable costs are (1) grants, scholarships and fellowships, donations of facilities or other properties to educational institutions, (ASPR 15-205.44(e)); (2) straight time compensation for part-time education during working hours which is in excess of 156 hours per year per employee, (ASPR 15-205.44(b)(v)). With respect to full-time undergraduate and post-graduate college education, the new principles provide only for the allowability of certain costs in connection with full-time scientific and engineering education at a post-graduate level not normally exceeding one year.

6. CROSS REFERENCE INDEX TO THE NEW AND OLD PRINCIPLES

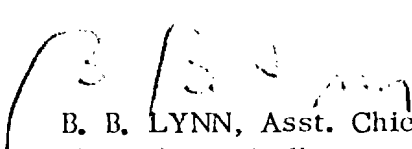
The attached Appendix A sets forth selected costs and the corresponding paragraph references covering the treatment of these items in the new and old principles.

FOR THE CHIEF, U. S. ARMY AUDIT AGENCY:

Appendix A

DISTRIBUTION:

D


B. B. LYNN, Asst. Chief
U. S. Army Audit Agency
for Policies and Plans

termination situations.

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 contracts. Accordingly, the policies and procedures of ASPR, Section 3, part 8, and that is of course the specific ASPR containing our pricing policies, 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 or criteria, or standards, may furnish 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.

You see, there, our attempt to remove ourselves from any potential straightjacket which may be forced on us as a result of publication of a comprehensive set of contract cost principles. Here, we have specifically referred back to the policies, our pricing policies. We have said they will be controlled, and we have put in some of the language from the termination section that I at least thought was pretty good.

Now, we have still the problem of differentiating

between retrospective pricing and prospective pricing, where you are looking back to a cost that you have incurred. It seems to me you have one situation where you are looking ahead, and guessing that you have another situation, so we try to get at that kind of a break in this fashion.

First, as to these two among the different types of fixed price type contracts, the need for consideration of course varies considerably as indicated below. First, retrospective pricing and settlements in negotiating firm fixed price or settlements for work which has been completed at the time of negotiation; that is, final negotiations under fixed price incentive contracts, re-determination of price at the completion of work, or negotiation of a settlement under a contract terminated for the convenience of the Government.

The treatment of cost is a major factor in arriving at the amount of the price of 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.

If you were to sit down, yourself, in all honesty and try to attack that problem I wonder what you'd write. That is what we wrote. The type of language was written some three years ago, and I take no personal credit whatsoever for it. The section on forward pricing:

"The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs can not 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 the work; the extent of competitive pricing, and the contractor's record for efficiency, economy, and ingenuity.

Available cost estimates must be present to bargain for total price, to equitably distribute a risk between the contractor and the Government and provide incentive for efficiency and cost reduction.

In negotiating such a price, it is not possible to identify the treatment of specific cost elements since bargaining is on a total price basis. Thus, while cost data

is often a valuable aid it will not control the negotiation of prices for work to be performed or a target price under an incentive contract."

Does that, I wonder, give you enough room to operate in in the manner in which you have become accustomed, and in the manner in which you would prefer to remain accustomed? I think it does.

Now, we come to the punch line of the document which goes on this way:

"When, pursuant to ASPR 15-6 or 2, costs are to be considered in the negotiation of fixed price type contracts."

If I might stop there, that is rather important. "When costs are to be considered." Now, this doesn't intend to say, doesn't mean to say, and I hope won't be construed to say, that costs are always a factor in negotiating prices. Very often, under the right competitive situation as we all know we don't care what the man has in his cost. We are not interested. We don't want any breakdown. We, I think, all believe quite sincerely that the very best price that we can obtain is one which is established in the marked place under competitive conditions.

That is how the water gets out, and when we are satisfied that competitive conditions are correct and that they have taken the water out, we don't care