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

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

Government Position

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

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

"The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost."

Latest Suggested Revision

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

The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this dondition does not, in itself, justify allowability as a contract cost.

Current Proposal

Issue

9. Interest

Industry Position

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

Issue

10. Training and Education.

Industry Position

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

Issue

11. Plant Reconversion Cost.

Industry Position

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

Issue

12. Overtime.

Industry Position

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

Government Position

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

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

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

Government Position

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

Current Proposal

No change from the 21 August draft.

Government Position

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

Current Proposal

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

Government Position

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

Current Proposal

No change from our 21 August draft.

Issues in Items of Cost
(in Brief)

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

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

ISSUES IN ITEMS OF COST

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

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

1. Advertising Costs (a)

Contention

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

Evaluation

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

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

Recommendation

1. Disallow product and institutional advertising.

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

2. Bad Debts.

Contention

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

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

Evaluation

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

Recommendation

Continue to disallow all bad debts.

3. Compensation for Personal Services (f)

Contention

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

Evaluation

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

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

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

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

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

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

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

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

3. are allowable for tax purposes and in renegotiation.

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

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

b. That Stock Options--

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

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

3. are allowable for tax purposes.

Recommendation

Allow immediate distribution type compensation plans which may be

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

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

Contention

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

Evaluation

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

Recommendation

We recommend allowance of this element.

5. Interest and Other Financial Costs (q)

Contention

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

Evaluation

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

Recommendation

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

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

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

Contention

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

Evaluation

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

Recommendation

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

While continuing the basic policy against unnecessary overtime:

1. reduce administrative burdens on both Government and industry

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

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

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

7. Plant Reconversion Costs (cc)

Contention

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

Evaluation

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

Recommendation

Maintain the principle.

8. Rental Costs (hh)

Contention

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

Evaluation

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

Recommendation

Maintain the principle.

9. Research and Development Costs (ii).

Contention

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

Evaluation

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

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

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

Recommendation

Maintain the principle.

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

Contention

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

Evaluation

The present proposal:

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

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

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

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

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

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

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

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

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

Recommendation

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

ISSUES IN ITEMS OF COST

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

1. Advertising Costs (a)
2. Bad Debts (b)
3. Plant Rehabilitation Costs (cc)
4. Rental Costs
5. Research and Development (ii)
6. Training and Educational Costs (qq)

1. Advertising Costs (a)

Contention

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

Evaluation

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

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

Recommendation

Disallow product and institutional advertising.

2. Bad Debts.

Contention

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

Evaluation

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

Recommendation

Continue to disallow all bad debts.

3. Plant Reconversion Costs (cc)

Contention

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

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

Evaluation

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

Recommendation

Maintain the principle.

4. Rental Costs (hh)

Contention

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

Evaluation

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

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

Recommendation

Maintain the principle.

5. Research and Development Costs (ii)

Contention

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

Evaluation

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

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

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

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

Recommendation

Maintain the principle.

6. Training and Educational Costs (qq).

Contention

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

Evaluation

The present proposal:

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

(ii) allows part time technical, engineering and scientific education, including materials, textbooks, fees, tuition and, if necessary straight time compensation for attendance of classes during working hours for 156 hours per year.

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

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

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

In connection with (ii) industry objects to the limitation of 156 hours a year for the study during working hours. Basically, this sort of activity ought to be accomplished outside of working hours but instances were found in which this was not possible. This appears to be a reasonable solution.

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

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

Recommendation

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

Issues in Basic Concepts

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

Industry Contention

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

Evaluation

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

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

Recommendation

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

2. Objective

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

Industry Contention

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

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

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

Evaluation

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

Recommendation

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

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

Industry Contention

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

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

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

Evaluation

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

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

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

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

Recommendation

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

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

Industry Contention

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

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

Evaluation

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

Recommendation

Reject the contention and reevaluate the items as appropriate.

3. Application

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

Industry Contention

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

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

Evaluation

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

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

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

Recommendation

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

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

Industry Contention

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

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

Evaluation

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

Recommendation

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

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

a. Reasonableness as a standard.

Industry Contention

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

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

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

Evaluation

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

Recommendation

The concept is sound and should be maintained.

b. Allocability as a standard.

Industry Contention

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

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

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

Evaluation

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

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

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

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

Recommendation

That this approach be continued.

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

Industry Contention

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

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

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

Evaluation

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

Recommendation

Maintain the concept at this time.

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

Industry Contention

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

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

Evaluation

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

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

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

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

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

Recommendation

That this general approach be continued.

COMPARISON OF THE RESEARCH AND DEVELOPMENT PRINCIPLES

Present ASPR	September 10, 1957 Draft	June 19, 1958 Draft	Differences
General Research (undefined) Unallowable, unless otherwise provided in the contract. Pre-contract costs are not specifically covered. **Research and development specifically applicable to the supplies or services covered by the contract.** Specifically allowable. The general practice is to interpret "supplies or services" as not including research projects so that, at present, research on research is not allowed.	**Blue Sky** Allowable and allocable against production and other research. **Applied** **Development** Grouped and allowed as allocated to production in the product line. Pre-contract costs are virtually unallowable--this prevents the capitalization and amortization permissable under the 19 June draft. **August 28, 1958 Draft** Same as above except that "in cases where a contractor's normal course of business does not involve production work, the costs of independent applied research and development work...are allowable...to the extent that such work is related and allocated as a direct cost to the field of effort of the Government research and development contract."	**Blue Sky** **Applied** Grouped, allowable and allocable against production and research. Blue Sky treatment same as 10 Sept. draft. **Development** Allowed as allocable against any production contract in the same product field. Permits allocation "as incurred" or capitalized upon a contractor selected basis. Except as to the capitalization aspect, development coverage is similar.	1. Under the present ASPR, "Blue Sky" research is allowable only if a specific provision is in the contract. Under the 10 Sept. draft, "Blue Sky" stands alone as allocable against all business, whereas, in the 19 June 1958 draft, applied research has been coupled with "Blue Sky" for allocation against all business. 2. The present ASPR does not specifically cover applied research, simply providing that research and development expenses are allowable as specifically applicable to the supplies in services covered by the contract. Under the 10 Sept. draft "applied research" is coupled with development since both are said to be related to actual hardware and are allowable upon a product line basis, whereas under the 19 June draft, only development expense is so allowed. 3. The effect of the pre-contract coverage in the 10 Sept. draft and the practice under the present ASPR coverage, is virtually to disallow all expense from previous periods which means that it is not possible, as provided in the 10 June draft, to capitalize the expense and amortize it over a reasonable period. The thought behind the 10 Spet. draft and present practice is that over a period of time allowability of the expense on a current basis will achieve equity without the difficulties inherent in the capitalization of past expenses.

NUMBER 4105.34
DATE 1 July 1954

Department of Defense Instruction

SUBJECT Treatment of Deprecia on on Emergency Facilities Covered by Certificates of Necessity for Contract Pricing Purposes

I. PURPOSE

The purpose of this instruction is to restate and amend Department of Defense implementation of Defense Mobilization Order No. III-1 (former DMO-11), Amendment 1, issued by the Acting Director of Defense Mobilization, effective 21 July 1952, as amended by Amendment 2, issued by the Director of Defense Mobilization, effective 10 May 1954, with respect to the extent to which accelerated amortization may be allowed as a cost in negotiated contract pricing. The pertinent paragraphs of this amended order read as follows:

"6. For the purpose of cost computations in negotiated contract pricing, true depreciation, which includes any extraordinary obsolescence reasonably assignable to the emergency period, is allowable. Any accelerated amortization of depreciation which is in excess of true depreciation, regardless of whether such excess is included in tax amortization certificates, is not allowable as an element of cost in negotiated contract pricing.

"7. It is recognized that cost determination in negotiated contract pricing is a function of the procurement agency concerned. With respect to facilities to be used in the performance of negotiated contracts for which certificates have been or will be issued, the procurement agencies concerned will, to the extent required for the purpose of cost computations in connection with the negotiation of contract prices, have the responsibility for determining true depreciation. The Office of Defense Mobilization will, on request, furnish the procurement agency concerned with such information as it has or is readily available to it which is pertinent to the determination of true depreciation."

II. APPLICABILITY

A. The principles and procedures set forth in this instruction shall be applicable in the consideration of costs for purposes of pricing or repricing of all negotiated contracts of the Departments of the Army, Navy, and Air Force, the performance of which requires the use of emergency facilities. The term "negotiated contracts", as used herein, means all contracts, other than those awarded pursuant to formal advertising, in which costs are a factor in contract pricing;

it includes cost-reimbursement-type contracts, contracts containing price redetermination clauses, incentive-type contracts, and fixed-price contracts where estimated costs are used in negotiating firm prices. The term "negotiated contracts", as used herein, also covers subcontracts of the same types as prime contracts to the extent that the policies of the respective military departments make their representatives responsible for the approval or disapproval of prices or costs of such subcontracts. With respect to subcontracts under negotiated prime contracts the procurement agency concerned shall have no greater responsibility than heretofore.

B. These principles and prccedures shall be applicable to all negotiated contracts placed after the effective date hereof and to all existing negotiated contracts (including letters of intent) at that date where firm prices have not been finally determined or redetermined and to all existing cost-reimbursement-type contracts not completed at that date except as to predetermined overhead rates or fixed amounts of overhead which have finally been agreed upon for particular periods.

III. BASIC PRINCIPLES

A. As indicated by DMO-11, Amendment 1, "for the purpose of cost computations in negotiated contract pricing, true depreciation which includes extraordinary obsolescence reasonably assignable to the emergency period, is allowable. Any accelerated amortization of emergency facilities which is in excess of true depreciation, regardless of whether such excess is included in tax amortization certificates, is not allowable as an element of cost in negotiated contract pricing."

B. The meaning of the term "true depreciation" shall conform to the generally accepted concept of depreciation accounting which may be defined as follows: A system of accounting which aims to distribute to the cost of operations, the cost of capital assets calculated to have expired for any accounting period due to such causes as wear and tear, action of the elements, and prospective inadequacy or obsolescence. Obsolescence of facilities may be brought about by reduced economic utility of facilities without loss of productive utility, such as by technological changes affecting the demand for the products of an industry, as well as by changes affecting the economic use of individual machines. Special requirements for relocation of facilities may also result in obsolescence.

C. Obsolescence of emergency facilities due to prospective loss of economic utility after the emergency period is a special hazard in some industries. However, in some cases possible overcapacity in an industry is really represented in pre-existing facilities which are in fact obsolete; in such cases the new facilities may be expected to displace the old facilities after the emergency, and it may not be said necessarily that there is extraordinary obsolescence applicable to the new facilities during the emergency period. In cases where the

introduction of emergency facilities may cause prospective obsolescence of existing facilities after the emergency period (when such existing facilities are not already obsolete, in fact), true depreciation for emergency facilities should not include allowances for prospective extraordinary obsolescence of the existing facilities; however, in such cases extraordinary obsolescence applicable to the existing facilities, when used in military production, should be considered separately to the extent appropriate in the circumstances.

D. In the case of emergency facilities covered by Certificates of Necessity, for the purpose of depreciation computations in contract pricing, an arbitrary assignment of five years from date of completion of construction or acquisition of the respective facilities shall be made as representing the period of the emergency. The entire cost of such facilities first shall be fairly apportioned as between the emergency period and the post-emergency period; secondly, the portion of the cost of such facilities assigned to the emergency period shall be prorated over the fiscal periods thereof for purposes of determining overhead costs in any fiscal period to be allocated to the cost of performance of defense or other contracts.

E. The allocation of the cost of facilities as between the emergency period and post-emergency period shall be made with consideration of the following:

1. The estimated prospective post-emergency usefulness of the facilities in number of years of useful productive life. Consideration should be given to the post-emergency use (both civilian and military) which it is expected the facilities will have. In this connection, the character of the expected post-emergency use may be different than the emergency-period use.

2. The additional costs of special-construction features of the facilities fairly assignable exclusively to defense requirements.

3. Subject to the application of the principles outlined herein, consideration shall be given to the portion of the cost of emergency facilities certified for amortization plus so-called normal depreciation for tax purposes during the emergency period on the uncertified portion of the cost of such facilities. (See particularly paragraphs F and G of this section.)

4. The normal peacetime life of facilities having a normal peacetime utility. If Bulletin F of the Bureau of Internal Revenue is used in connection herewith, care must be exercised in its use, as its data may not be typical of any specific contractor or industry, especially in the emergency period.

It must be emphasized that this is a process of cost allocation which does not contemplate an appraisal of the resale value (other than residual salvage value) or replacement cost of emergency facilities at the end of the emergency period. Potential "use value" to the particular contractor concerned after the emergency period should be the primary basis on which loss of economic usefulness, and therefore true depreciation, is determined.

F. Certificates of Necessity have been issued in some cases providing for the amortization of emergency facilities for tax purposes during the emergency period in amounts in excess of true depreciation. It is also possible that Certificates of Necessity may have been issued in isolated cases providing for the amortization of emergency facilities for tax purposes in amounts less than true depreciation. Such variances may be attributable to the granting of other incentives than true depreciation, or to the practice of following industry-wide patterns of certification without reference to true depreciation in specific cases. The excess of tax amortization over estimated true depreciation shall not be allowable as a cost for the purpose of pricing negotiated contracts, either directly or indirectly as a factor of "contingencies" or profit allowance.

G. It is the intent of this instruction to give contractors a reasonable and properly allocable allowance to cover the estimated loss of economic usefulness of their emergency facilities in production under defense contracts. The procedures for determining such allowances must be such as will expedite determination; this requires avoidance of an impossible perfectionism. There is no intent to limit the cost allowance to depreciation that would be allowable for income tax purposes if there were no Certificates of Necessity, nor to necessarily require that the allowance be below tax amortization covered by certificates. Each case must be judged on its merits in the light of these principles. If the result obtained by the application of the principles outlined herein indicates substantial justification of the total amount of amortization and depreciation allowable for tax purposes during the emergency period, as a reasonable measure of true depreciation, such amount shall be accepted, without adjustment, as true depreciation. In those isolated cases where substantial justification can be shown for a larger amount of true depreciation than the total amount of amortization and depreciation allowable for tax purposes during the emergency period, the larger amount shall be allowable as a cost for purposes of contract pricing.

H. Contract pricing for the post-emergency period will be based upon allowing as a cost, depreciation on emergency facilities, computed by allocating the undepreciated cost of such facilities at the end of the emergency period (cost less true depreciation for that period) over the estimated remaining life of the facilities.

IV. PROCEDURES

A. Cost determination in negotiated contract pricing is a function of the procurement agency concerned. With respect to emergency facilities used in the performance of negotiated contracts for which Certificates of Necessity have been or will be issued, the procurement agency concerned shall be solely responsible for estimates of such depreciation for contract pricing purposes in the light of the principles set forth herein. The Office of Defense Mobilization will, on request, furnish the procurement agency concerned with such information as it has or is readily available to it which is pertinent to the determination of true depreciation -- such requests should be held to a minimum.

B. In order to expedite administration of the determination of true depreciation for the emergency period for a specific contractor, it will be appropriate to make over-all determinations of true depreciation of emergency facilities covered by Certificates of Necessity on a plant-wide or product-wide basis of classification of such facilities by such groupings as may be appropriate in consideration of general similarity of the facilities from the standpoint of length of useful productive life.

C. In the case of contracts to which this instruction is applicable which are in force at the effective date of this instruction, price redeterminations, cost-incentive adjustments, and cost reimbursements may continue to be made in accordance with the pricing formula established in the initial pricing negotiations, provided the contractors are agreeable, and provided there is no evidence that the contractor has been allowed more than true depreciation in pricing, either directly or indirectly. When costs of such contracts are redetermined in the light of the principles set forth herein, consideration shall be given to possible redetermination of the entire allowable costs and profit (or fees), as pricing factors, to the extent required to avoid excessive or duplicate allowances in costs or profits for such true depreciation. Allowances for contingencies and profits in initial price negotiations in some cases may have included indirect allowances for the excess of true depreciation or tax amortization over normal depreciation; in such cases no more should be allowed in total pricing for this factor than true depreciation.

D. Contractors shall be required to set forth to the authorized representatives of the procurement agencies, all the pertinent facts having a bearing on estimates of true depreciation together with their evaluation thereof. Such authorized representatives of the procurement agencies will be expected to exercise reasonable judgment in their review and evaluation of the facts in arriving at estimates of

true depreciation, in the light of the basic principles set forth herein, recognizing the impossibility of having absolutely demonstrable proof of the conclusions reached.

E. Where the emergency facilities of any contractor at one plant or at one general location are used in the performance of contracts for more than one of the military departments, one of these departments shall make determinations of true depreciation binding upon each other department. The responsible department shall be the one, if any, having plant cognizance procurement assignment; in the absence of such assignment the responsible department shall be the one, if any, having single-service audit responsibility; otherwise the responsible department shall be the one having the largest interest in effecting current procurement at the time of the determination. Similarly, each military department shall be responsible for delegating responsibility therein in a manner to avoid duplications in determinations of true depreciation within that department.

F. The following additional procedure is applicable to Emergency Facilities covered by Certificates of Necessity issued after 1 July 1954:

> "Whenever a major portion of the cost of facilities in substantial amount is to be reimbursed to a contractor as an element of product prices during a relatively short period, it will be expected in appropriate cases that consideration will be given in negotiation to protecting, by appropriate agreement, the Government's interest in the continued availability of the facilities for Defense use."

V. CANCELLATION

This Instruction cancels Department of Defense Directive 4105.34, dated 10 December 1952, and Department of Defense Directive Transmittal 54-43, dated 30 April 1954.

VI. IMPLEMENTATION

Such implementing regulations, directives, or instructions as may be necessary shall be issued within each military department, and copies shall be furnished to the Assistant Secretary of Defense (Comptroller) and the Assistant Secretary of Defense (Supply & Logistics) within forty-five (45) days from date hereof.

VII. EFFECTIVE DATE

This instruction is effective on the day of issuance.

T. P. PIKE
Assistant Secretary of Defense
(Supply and Logistics)

3–706 Coordination. When more than one Military Department contemplates the use of negotiated final overhead rates with the same contractor, the service having the preponderance of cost-reimbursement type work will, generally, sponsor and conduct the negotiation. Each Department having an interest will be notified of the pending negotiation and will be invited to participate in the negotiation. If a Department does not have a representative at the negotiation, the sponsoring Department will represent the absentee Department. The results of the negotiation will be binding upon all Departments. At the completion of the negotiation, the sponsoring Department will prepare and distribute to the other Departments a negotiation report or summary as provided for in ASPR 3–705(e). Each Military Department shall thereupon amend or supplement the affected contracts in accordance with the rates and other data set forth in the negotiation report or summary.

3–707 Cost-Sharing Rates. Cost-sharing arrangements are frequently made wherein the cost participation by the contractor is evidenced by an agreement to accept overhead rates which are lower than the anticipated actual overhead rates. In such cases, a negotiated fixed-ceiling overhead rate may be used for application prospectively, provided that in the event overhead rates developed by the cognizant audit activity on the basis of actual allowable costs are less than the negotiated rates, the negotiated rates will be reduced. Where reductions are necessary, they will be accomplished in accordance with ASPR 3–705. The Government will not be obligated to pay any additional amounts on account of overhead above the negotiated fixed-ceiling rates.

Part 8—Price Negotiation Policies and Techniques

3–800 Scope of Part. This part sets forth the price negotiation policies and techniques applicable to negotiated prime contracts and those subcontracts which are subject to approval or review within a Department. The principles in this part apply to negotiation of prices on all types of contracts and to revised prices as well as initial prices.

3–801 Basic Policy.

3–801.1 General. It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices calculated to result in the lowest ultimate over-all cost to the Government. Sound pricing depends primarily upon the exercise of sound judgment by all personnel concerned with the procurement.

3–801.2 Responsibility of Contracting Officers.

(a) Contracting officers, acting within the scope of their appointments (and in some cases acting through their authorized representatives) are the exclusive agents of their respective Departments to enter into and administer contracts on behalf of the Government in accordance with ASPR and Departmental procedures. Each contracting officer is responsible for performing or having performed all administrative actions necessary for effective contracting. The contracting officer shall exercise reasonable care, skill and judgment and shall avail himself of all of the organizational tools (such as the advice of specialists in the fields of contracting, finance, law, contract audit, mobilization planning, engineering, traffic management and cost analysis) necessary to accomplish the purpose as, in his discretion, will best serve the interests of the Government.

(b) To the extent services of specialists are utilized in the negotiation of contracts, the contracting officer must coordinate a team of experts, requesting advice from them, evaluating their counsel, and availing himself of their skills as much as possible. The contracting officer shall obtain simultaneous coordination of the specialist efforts to the greatest practical extent. He shall not, however, transfer his own responsibilities to them. Thus, the final negotiation of price, including price redetermination and evaluation of cost estimates, remains the responsibility of the contracting officer.

3–801.3 Responsibility of Other Personnel. Personnel, other than the contracting officer, who determine industrial mobilization plans and type, quality, quantity, and delivery requirements for items to be purchased, can influence the degree of competition obtainable as well as have a material effect upon prices. Failure to finalize requirements in sufficient time to allow:

(i) a reasonable period for preparation of requests for proposals;
(ii) preparation of quotations by offerors;
(iii) contract negotiation and preparation; and
(iv) adequate manufacturing lead time;

causes delinquency in delivery and uneconomical prices. Requirements issued on an urgent basis or with unrealistic delivery schedules should be avoided since they generally increase price or restrict desired competition. Personnel determining requirements, specifications, mobilization plans, adequacy of sources of supply, and like matters have responsibility in such areas, equal to that of the contracting officer, for timely, sound and economical procurement.

3–802 Preparation for Negotiation.

3–802.1 Product or Service. Knowledge of the product or service, and its use, is essential to sound pricing. Before soliciting quotations, every contracting officer should develop, where feasible, an estimate of the proper price level or value of the product or service to be purchased. Such estimates may be based on a physical inspection of the product and review of such items as drawings, specifications, job process sheets, and prior procurement data. When necessary, requirements and technical specialists should be consulted. The primary responsibility for the adequacy of specifications and for the delivery requirements must necessarily rest with requirements and technical groups. However, the contracting officer should be aware of the effect which these factors may have on prices and competition, and should, prior to award, inform requirements and technical groups of any unsatisfactory effect which their decisions have on prices or competition.

3–802.2 Selection of Prospective Sources. Selection of qualified sources for solicitation of proposals is basic to sound pricing. Proposals should be invited from a sufficient number of competent potential sources to insure adequate competition. (See also ASPR 1–302, 1–307, 3–101, 3–104, 3–105 and 12–102).

3–802.3 Requests for Proposals. Requests for proposals shall contain the information necessary to enable a prospective offeror to prepare a quotation properly. The request for proposals shall be as complete as possible with respect to: item description or statement of work; specifications; Government-furnished property, if any; required delivery schedule; and contract clauses. If a price breakdown is required, the request for proposals shall so state. Requests for proposals shall specify a date for submission of proposals; any extension of time granted to one prospective offeror shall be granted uniformly to all. Each request for proposals shall be released to all prospective offerors at the same time and no offeror shall be given the advantage of advance knowledge that proposals are to be requested. Generally, requests for proposals shall be in writing. However, in appropriate cases, such as the procurement of perishable subsistence, oral requests for quotations are authorized.

3–803 Type of Contract. (a) The selection of an appropriate contract type and the negotiation of prices are related and should be considered together. ASPR 3–402 lists some of the factors for this joint consideration. The objective is to negotiate a contract type and price that includes reasonable contractor risk and provides the contractor with the greatest incentive

for efficient and economical performance. When negotiations indicate the need for using other than a firm fixed price contract, there should be compatibility between the type of contract selected and the contractor's accounting system.

(b) In the course of a procurement program, a series of contracts, or a single contract running for a lengthy term, the circumstances which make for selection of a given type of contract at the outset will frequently change so as to make a different type more appropriate during later periods. In particular, the repetitive or unduly protracted use of cost-reimbursement type or time and materials contracts is to be avoided where experience has provided a basis for firmer pricing which will promote efficient performance and will place a more reasonable degree of risk on the contractor. Thus, in the case of a time and materials contract, continuing consideration should be given to converting to another type of contract as early in the performance period as practicable.

3–804 Conduct of Negotiations. Evaluation of offerors' or contractors' proposals, including price revision proposals, by all personnel concerned with the procurement, as well as subsequent negotiations with the offeror or contractor, shall be completed expeditiously. Complete agreement of the parties on all basic issues shall be the objective of the contract negotiations. Oral discussions or written communications shall be conducted with offerors to the extent necessary to resolve uncertainties relating to the purchase or the price to be paid. Basic questions should not be left for later agreement during price revision or other supplemental proceedings. Cost and profit figures of one offeror or contractor shall not be revealed to other offerors or contractors.

3–805 Selection of Offerors for Negotiation and Award.

(a) The normal procedure in negotiated procurements, after receipt of initial proposals, is to conduct such written or oral discussions as may be required to obtain agreements most advantageous to the Government. Negotiations shall be conducted as follows:

(i) where a responsible offeror submits a responsive proposal which, in the contracting officer's opinion, is clearly and substantially more advantageous to the Government than any other proposal, negotiations may be conducted with that offeror only; or

(ii) where several responsible offerors submit offers which are grouped so that a moderate change in either the price or the technical proposal would make any one of the group the most advantageous offer to the Government, further negotiations should be conducted with all offerors in that group.

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Whenever negotiations are conducted with more than one offeror, no indication shall be made to any offeror of a price which must be met to obtain further consideration, since such practice constitutes an auction technique which must be avoided. No information regarding the number or identity of the offerors participating in the negotiations shall be made available to the public or to anyone whose official duties do not require such knowledge. Whenever negotiations are being conducted with several offerors, while such negotiations may be conducted successively, all offerors participating in such negotiations shall be offered an equitable opportunity to submit such pricing, technical, or other revisions in their proposals as may result from the negotiations. All offerors shall be informed that after the submission of final revisions, no information will be furnished to any offeror until award has been made.

(b) There are certain circumstances where formal advertising is not possible and negotiation is necessary. In the conduct of such negotiations, where a substantial number of clearly competitive proposals has been obtained and where the contracting officer is satisfied that the most favorable proposal is fair and reasonably priced, award may be made on the basis of the initial proposals without oral or written discussion; *provided,* that the request for proposals notifies all offerors of the possibility that award may be made without discussion of proposals received and, hence, that proposals should be submitted initially on the most favorable terms, from a price and technical standpoint, which the offeror can submit to the Government. In any case where there is uncertainty as to the pricing or technical aspects of any proposal, the contracting officer shall not make an award without further exploration and discussion prior to award. Also, when the proposal most advantageous to the Government involves a material departure from the stated requirements, consideration shall be given to offering the other firms which submitted proposals an opportunity to submit new proposals on a technical basis which is comparable to that of the most advantageous proposal; *provided,* that this can be done without revealing to the other firms any information which is entitled to protection under ASPR 3–109.

(c) A request for proposals may provide that after receipt of initial technical proposals, such proposals will be evaluated to determine those which are acceptable to the Government or which, after discussion, can be made acceptable, and upon submission of prices thereafter, award shall be made to that offeror of an acceptable proposal who is the low responsible offeror.

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(d) The procedures set forth in (a), (b) and (c) above may not be applicable in appropriate cases when procuring research and development, or special services (such as architect-engineer services) or when cost-reimbursement type contracting is anticipated. Award of a contract may be properly influenced by the proposal which promises the greatest value to the Government in terms of possible performance, ultimate productibility, growth potential and other factors rather than the proposal offering the lowest price or probable cost and fixed fee.

(e) Whenever in the course of negotiation a substantial change is made in the Government's requirements, for example, increases or decreases in quantities or material changes in the delivery schedules, all offerors shall be given an equitable opportunity to submit revised proposals under the revised requirements.

3–806 Pricing Individual Contracts.

(a) Each contract shall be priced separately and independently, and no consideration shall be given to losses or profits realized or anticipated in the performance of other contracts. This prohibition shall not be construed to prevent the negotiation of fixed overhead and other rates applicable to several contracts during annual or other specific periods, or to prohibit forward pricing agreements applicable to several contracts.

(b) Contracting officers shall not rely on profit limiting statutes as remedies for ineffective pricing. Such statutes generally provide for the recapture of excessive profits, but they do not recapture the costs of inefficiency and waste which may result from failure to negotiate reasonable prices initially. Similarly, price redetermination clauses shall not be used as a substitute for the negotiation of reasonable prices at the inception of contracts.

3–807 Cost, Profit, and Price Relationships.

(a) When products are sold in the open market, costs are not necessarily the controlling factor in establishing a particular seller's price. Similarly where competition may be ineffective or lacking, estimated costs plus estimated profit are not the only pricing criteria. In some cases, the price appropriately may represent only a part of the seller's cost and include no estimate for profit or fixed fee, as in research and development projects where the contractor is willing to share part of the costs. In other cases, price may be controlled by competition as set forth in ASPR 3–805(a). The objective of the contracting officer shall be to negotiate fair and reasonable prices in which due weight is given to all relevant factors, including those in ASPR 3–101.

(b) Profit is only one element of the price proposal and normally represents a smaller proportion of the total price than do such other estimated

elements as labor and material. While the public interest requires that excessive profits be avoided, the contracting officer should not become so preoccupied with particular elements of a contractor's estimate of cost and profits that the most important consideration, the total price itself, is distorted or diminished in its significance. Government procurement is primarily concerned with the reasonableness of a negotiated price and only secondarily with the eventual cost and profit.

(c) Particularly where effective competition is lacking the estimate for profit or the proposed fixed fee should be analyzed in the same manner as all other elements of price, applying tests and considerations discussed in ASPR 3–808.4. A fair and reasonable provision for profit cannot be made by simply applying a certain predetermined percentage to the cost estimate or selling price of a product. If, for example, a factor of 10 percent were used as a flat percentage rate for estimating profit in a situation where two sources were needed to meet the requirement, the result might be grossly inequitable. If one supplier proposes to and produces at a unit cost of $1,000 and the second at a unit cost of $1,500, with a flat 10 percent factor applied to both transactions as estimated profit, the second and higher cost supplied would receive $150 profit while the lower cost supplier would receive only $100.

3–808 Pricing Techniques.

3–808.1 General. Policies set forth in this Part may be applied in a variety of ways in the evaluation of offerors' or contractors' proposals and in the negotiation of contract prices. The extent to which any particular method, or combination of methods, should be used will depend upon the judgment of the contracting officer. The following paragraphs describe several of the principal price negotiation techniques and the circumstances under which each may be used. The considerations set forth herein are equally applicable to initial and subsequent price negotiations.

3–808.2 Price Analysis.

(a) Some form of price analysis should be made in every procurement, even when competitive proposals have been submitted. The presence of effective competition, however, may make it possible to limit considerably the degree of price analysis required.

(b) One form of price analysis is the comparison of prior quotations and contract prices with current quotations for the same or similar end items. To provide a suitable basis for comparison, appropriate allowances may have to be made for differences in such factors as specifications, quantities ordered, time for delivery, Government-furnished materials, and the general level of business and prices.

(c) Rough yardsticks may often be developed (in such terms as dollars per pound, per horsepower, or other units) to point up apparent gross inconsistencies which should be subjected to additional pricing techniques, including cost analysis. Such yardsticks should be considered as an indispensable adjunct to cost analysis, since a study of a single offeror's estimated costs in sole source situations will not indicate whether the proposed

price is fair and reasonable in comparison with other products of the same kind.

3–808.3 Cost Analysis.

(a) The need for cost analysis depends on the effectiveness of the methods of price analysis outlined in ASPR 3–808.2, the amount of the proposed contract, and the cost and time needed to accumulate the information necessary for analysis. When cost analysis is undertaken, the contracting officer must exercise judgment in determining the extent of the analysis. Cost analysis is desirable whenever:

(i) effective competition has not been obtained;

(ii) a valid basis for price comparison has not been established, because of the lack of definite specifications, the novelty of the product, or for other reasons;

(iii) price comparisons have revealed apparent inconsistencies which cannot be satisfactorily explained or otherwise reasonably accounted for;

(iv) the prices quoted appear to be excessive on the basis of information available;

(v) the proposed contract is of a significant amount and is to be awarded to a sole source;

(vi) the proposed contract will probably represent a substantial percentage of the contractor's total volume of business; or

(vii) a cost-reimbursement, incentive, price redeterminable, or time and material contract is negotiated.

(b) Cost analysis involves the evaluation of specific elements of cost and the effect on prices of such factors as:

(i) allowances for contingencies;

(ii) the necessity for certain costs;

(iii) the reasonableness of amounts estimated for the necessary costs;

(iv) the basis used for allocation of overhead costs; and

(v) the appropriateness of allocations of particular overhead costs to the proposed contract.

(c) Among the several types of cost comparisons that should be made, where the necessary data are available, are comparisons of a contractor's or offeror's current estimated costs with:

(i) actual costs previously incurred by the contractor or offeror; and with its last prior estimate for the same or similar item or with a series of prior estimates;

(ii) current estimates from other possible sources; and

(iii) prior estimates or historical costs of other contractors manufacturing the same or related items.

(d) Forecasting future trends in costs from historical cost experience is of primary importance in pricing. In periods of either rising or declining costs, an adequate cost analysis must include some evaluation of the trends. Even in periods of relative price stability, trend analysis of basic labor

and materials costs should be undertaken in cases involving production of recently developed, complex equipment. In some cases, probable increases in labor efficiency, and reductions in material spoilage as a contractor's work force gains in experience with such new products can be predicted statistically. Efficiency curves may be devised to predict the reduction in the spoilage rate; learning curves may be devised to evaluate reductions in labor hours. Effective use of learning curves depends on the presence of the following elements:

(i) direct labor should represent a substantial element of the total price;

(ii) the contract price should be large enough to warrant the time spent in collecting the statistical data necessary to construct valid curves;

(iii) the proposed contract should cover production over a relatively long period;

(iv) a substantial body of historical labor cost data must be available; and

(v) the product must be a complex, non-standard item requiring a substantial amount of assembly labor (where relatively large amounts of automatic machinery are to be employed, or the product is a relatively standard item, learning curves may be of little value).

3–808.4 Profit.

(a) *General.* Where competition is adequate and effective and proposals are on a firm fixed-price basis, the contracting officer normally need not consider in detail the amount of estimated profit included in a price. However, when detailed analysis of profit is appropriate due to lack of competition or for some other reason, the factors discussed in the following paragraphs should be considered. (See ASPR 3–807 (c).)

(b) *Degree of Risk.* The degree of risk assumed by the contractor should influence the amount of profit a contractor is entitled to anticipate, For example, where a portion of the risk has been shifted to the Government through price redetermination provisions, unusual contingency provisions, or other risk-reducing measures, the amount of profit to which the contractor is reasonably entitled is less than where the contractor assumes all risk.

(c) *Extent of Government Assistance.* The Department of Defense encourages its contractors to perform their contracts with the minimum of financial, facility, or other assistance from the Government. Where extraordinary financial, facility, or other assistance must be furnished to a contractor by the Government, such extraordinary assistance should have a modifying effect in determining what constitutes a fair and reasonable profit. (See also ASPR 3–404.3 (d).)

(d) *Contribution to the Defense Effort.* The contractor's past and present performance and cooperation in such areas as engineering (including inventive, design simplification, and developmental contributions) and quality control should, in appropriate measure, affect the amount of profit.

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(e) *Character of Contractor's Business.* Recognition must be given to the type of business normally carried on by the contractor, the complexity of manufacturing techniques, the rate of capital turnover, and the effect of each individual procurement upon such business. For example, where a contractor is engaged in an industry where the turnover of working capital is low, generally the profit objective on individual contracts is higher than in those industries where the turnover is more rapid.

(f) *Contractor's Performance.* In addition to the factors set forth in ASPR 3–101, the contractor's performance should, particularly when prices are being redetermined, be evaluated in such areas as quality of product, quality control, scrap and spoilage, efficiency in cost control (including need for and reasonableness of costs incurred), meeting delivery schedule, timely compliance with contractual provisions, creative ability in product development (giving consideration to commercial potential of product), management of subcontract programs, and any unusual services furnished by the contractor. To encourage and maintain a high degree of contractor efficiency and economy, the negotiator must recognize that good performance deserves a greater opportunity for profit than poor performance.

3–808.5 Subcontracting.

(a) The amount and quality of subcontracting may be a major factor influencing price. Since a large portion of the procurement dollar is spent by prime contractors in subcontracting for work, raw materials, parts, and components, efficient purchasing practices by a contractor will contribute heavily toward efficient and economical production.

(b) While basic responsibility rests with the prime contractor for decisions to "make or buy," for selection of subcontractors, and for subcontract prices and subcontract performance, the contracting officer must have adequate knowledge of those elements and their effects on prime contract prices. Consequently, during price negotiations, when circumstances warrant such action, the contracting officer may require the offeror or contractor to furnish adequate information, for use in evaluating the proposed price, with respect to:

(i) the purchasing practices of the prime contractor;

(ii) the principal components to be subcontracted and the contemplated subcontractors, including (A) the degree of competition obtained, (B) cost or price analyses or price comparisons accomplished, and (C) the extent of subcontract supervision;

(iii) the types of subcontracts; i. e., firm fixed-price or other (see ASPR 3–401); and

(iv) the estimated total extent of subcontracting, including procurement of purchased parts and materials.

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The evaluation of total subcontracting should not be reduced to applying arbitrary percentages of profit to subcontract prices in negotiating the prime contract price. Such elements as economies achieved through "make or buy" decisions, and the necessity of close supervision of subcontractors performing complex work (through the furnishing of engineering or other technical assistance), should be fully considered.

(c) When the prime contract is to be placed on a firm fixed-price basis, there is no need, for pricing purposes, to provide for review or approval by the contracting officer of subcontracts prior to their placement.

(d) When the prime contract is not to be placed on a firm fixed-price basis, review of subcontracts prior to placement may be desirable since the ultimate cost to the Government will depend in part on subcontract prices and performance. Prime contract provisions requiring advance notification, review, or approval of subcontracts shall be consistent with the type of contract and the conditions applicable to its use as described in Part 4 of this Section. For example, if the contract is on a firm fixed-price basis except for a clause permitting price escalation resulting from cost increases for certain materials, the prime contract may limit the contracting officer's right of review to subcontracts for materials covered by the escalation clause. In the case of cost-reimbursement type contracts, advance notification, prior consent, or approval of subcontracts is required as set forth in ASPR 7–203.8. Contract provisions requiring advance notification to the contracting officer of proposed subcontracts for materials, components, and other purchases may be appropriate both for information as to sources and prices and to provide an opportunity for review and for approval or objection by the contracting officer prior to award of the subcontracts. Such provisions are particularly necessary when:

(i) the prime contractor's purchasing policy and system or performance thereunder are considered inadequate;

(ii) subcontracts are for items for which there is no cost information or for which the proposed prices appear unreasonable, and the amounts involved are substantial;

(iii) close working arrangements or other business or ownership affiliations exist between the prime and the subcontractor which may preclude the free use of competition or result in higher subcontract prices than would otherwise be obtained;

(iv) a subcontract is being proposed at a price less favorable than that which has been given by the subcontractor to the Government, all other factors such as manufacturing period and quantity being comparable; or

(v) a subcontract is to be placed on a price redetermination, fixed-price incentive, time and material, or cost-reimbursement basis.

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The contract provisions relating to subcontracts should be consistent with the amount and character of subcontract work and with the over-all character of the prime contract, involving the Government to the minimum extent practicable in the contractor's exercise of management responsibility, but giving reasonable assurance that the Government is receiving the greatest practicable return for its expenditure. Provisions in prime fixed-price contracts relating to subcontract review may, as appropriate, be confined to one major subcontract; to certain classes of subcontracts; may set a floor above which advance approval of proposed subcontracts may be required before placement; or may be tailored to cover unusual or particular circumstances. In those instances where a contractor's purchasing system has been deemed adequate, review of subcontracts generally may not be necessary. However, contracting officers shall conduct periodic reviews of the application of the system to insure conformance therewith. In instances where subcontracts have been placed on a cost-reimbursement or time and materials basis, contracting officers should be skeptical of approving the repetitive or unduly protracted use of such types of subcontracts and should follow the principles of ASPR 3–803 (b).

(e) In cases where the prime contract reserves a right for the contracting officer to review or approve subcontracts, the prime contract shall also reserve to the Government the right to inspect and audit the books and records of such subcontractors. Whenever such first tier subcontracts are of the cost-reimbursement, price redetermination, fixed-price incentive, or time and material type, a similar right shall be reserved to the Government to inspect and audit the books and records of lower tier subcontractors; *provided,* that such a right shall not be reserved contractually below the point where a firm fixed-price subcontract intervenes.

(f) Where subcontracts are placed on a price redetermination or fixed-price incentive basis, it is particularly important in negotiating revisions of prime contract prices that there be substantial assurance that there was initial close pricing of subcontracts. Also, contracting officers should be alert to the risk of establishing firm redetermined prime contract prices while a major subcontract is still subject to price redetermination and may eventually be redetermined at a price far lower than that ascribed to it in redetermining the prime contract price, with consequent profits to the contractor far in excess of those contemplated in the prime contract price negotiation. However, in some cases, it may be appropriate to negotiate firm prime contract prices even though the contractor has not yet established final subcontract prices, *provided* the contracting officer can justify as reasonable the amount included for subcontracting as, for example, where

fairly definite cost data on subcontract prices are available. In other cases, such as where certain subcontracts are subject to redetermination and available cost data on these subcontracts are highly indefinite but other circumstances require prompt negotiation of revised prime contract prices, the contract modification which evidences the revised prime contract prices should provide for adjustment of the total amount paid or to be paid under the contract on account of subsequent redetermination of specified subcontracts. This may be done by including in the contract modification a provision substantially as follows:

> "Promptly upon the establishment of firm prices for each of the subcontracts listed below, the Contractor shall submit, in such form and detail as the Contracting Officer may reasonably require, a statement of costs incurred in the performance of such subcontract and the firm price established therefor. Thereupon, notwithstanding any other provision of this contract as amended by this modification, the Contractor and the Contracting Officer shall negotiate an equitable adjustment in the total amount paid or to be paid under this contract to reflect such subcontract price revision. The equitable adjustment shall be evidenced by a modification to this contract, signed by the Contractor and the Contracting Officer.
>
> *(List subcontracts)*"

3–808.6 Sole Source Items. When purchases of standard commercial or modified standard commercial items are to be made from sole source suppliers, use of the techniques of price and cost analysis may not always be possible. In such instances and consistent with the volume of procurement normally consummated with the contractor, the contractor's price lists and discount or rebate arrangements should be examined and negotiations conducted on the basis of the "best user," "most favored customer" or similar practice customarily followed by the contractor. Such price negotiations should consider the volume of business anticipated for a fixed period, such as a fiscal year, rather than the size of the individual procurement being negotiated.

3–809 Audit as a Pricing Aid.

(a) *General.* The audit services with the Military Departments should be utilized as a pricing aid by the contracting officer to the fullest extent appropriate when the dollar amount involved is sufficiently large to, or special circumstances exist which warrant the time and expense required for the particular type of advisory audit, special survey, or audit analysis of price or cost desired. Judicious use of audit services will expedite proper pricing. The determination as to the necessity of an audit report for pricing purposes is the responsibility of the contracting officer. When requesting audit services, the contracting officer shall state the purpose for which the report is to be used and define any specific areas of audit examination which should be given special attention.

(b) *Application.* Except for contracts containing retroactive price revision clauses, pricing techniques are concerned mainly with estimates of future costs. Therefore, audit reports for either retroactive or prospective pricing should not only establish costs accrued to a specific cut-off point

for price proposal purposes but also should include cost trends and other available information which would be of assistance to the contracting officer in price negotiation. Such audit reports will serve a useful purpose in:

(i) the evaluation of contingency allowances, overhead allocations, purchasing management efficiency, and similar cost elements;

(ii) both the initial and subsequent pricing of contracts containing price revision clauses;

(iii) establishing limitations on costs and price revision adjustments; and

(iv) establishing negotiated overhead rates for cost-reimbursement type contracts.

(c) *Conditions for Use.* Close coordination between the audit agency and procurement personnel will assist in determining the necessity of audit of price or cost proposals or the necessity of special surveys relating to contractor's accounting or purchasing systems. Some of the conditions under which the contracting officer should consider the use of audit services include:

(i) inadequate knowledge concerning the contractor's accounting policies, cost systems, or substantially changed methods or levels of operation;

(ii) previous unfavorable experience indicating doubtful reliability of the contractor's estimating, accounting, or purchasing methods;

(iii) procurement of a new product for which cost experience is lacking; and

(iv) contract performance requiring a substantial period of time.

3–810 Exchange of Information. In appropriate cases it is desirable to exchange and coordinate specialized information regarding a contractor between Military Departments, bureaus, technical services and other procuring activities since it will provide uniformity of treatment of major issues and it may aid in the resolution of particularly difficult or controversial issues.

3–811 Record of Price Negotiation. At the conclusion of each negotiation of an initial or a revised price, the contracting officer shall promptly prepare or cause to be prepared a memorandum, setting forth the principal elements of the price negotiation, for inclusion in the contract file and for the use of any reviewing authorities. The memorandum shall be in sufficient detail to reflect the most significant considerations controlling the establishment of the initial or revised price.

Draft
10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

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

Part 1 - Applicability

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

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

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

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

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

(ii) serve as the basis for --

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

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

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

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

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

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

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

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

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

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

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

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

15-201 Basic Considerations.

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

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

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

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

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

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

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

(i) is incurred specifically for the contract;

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

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

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

15-202 Direct Costs.

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

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

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

15-203 Indirect Costs

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

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

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

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

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

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

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

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

15-204 Application of Principles and Standards.

15-204.1 General.

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

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

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

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

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

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

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

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

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

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

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

15-204.2 Selected Costs.

(a) Advertising Costs.

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

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

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

(2) All other advertising costs are unallowable.

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

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

(d) Bonding Costs.

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

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

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

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

(e) Civil Defense Costs.

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

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

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

(f) Compensation for Personal Services.

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

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

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

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

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

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

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

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

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

(ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (7)c. below. (But see ASPR 15-204.1 (b).).

(5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate are unallowable.

(6) Profit Sharing Plans. For purposes of these principles, profit

haring plans are divided into two types, namely, immediate payment plans and deferred distribution plans. Immediate payment plans include those which provide for payment (of the profits being distributed) to the individual officers and employees shortly after determination of the amount due to each rather than after a lapse of a stated period of years or upon the retirement, death or disability of the individual officers and employees. Deferred distribution plans include those which provide for payment (of the profits being distributed) into a separate bank account or fund usually under the control of a trustee, for disbursement to the individual officers and employees after a stated period of years or upon their retirement, death or disability. Profit sharing plan costs under plans of the immediate distribution type are unallowable. Profit sharing plan costs under plans providing for deferred distributions will be allowable, subject to the provisions of paragraph (7) below, only in those cases and to the extent the distributions of benefits are to be made upon or after retirement, disability or death of the covered officers and employees.

(7) Deferred Compensation. a. As used herein, deferred compensation includes all remuneration, in whatever form, for services currently rendered, for which the employee is not paid until after the lapse of a stated period of years or the occurrence of other events as provided in the plans, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension, annuity, stock bonus, and profit sharing plans, (ii) contributions to disability, withdrawal, insurance, survivorship, and similar benefit plans, and (iii) other deferred compensation, whether paid in cash or in stock.

b. Deferred compensation, including profit sharing plan costs allowable under (6) above, is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all

other compensation paid to the employee, reasonable in amount; (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payments; and (iv) for a plan which is subject to the Bureau of Internal Revenue, it falls within the criteria and standards of the Internal Revenue Code and the regulations of the Bureau of Internal Revenue. (But see ASPR 15-204.1(b).)

c. In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible future abnormal forfeitures shall be effected according to the following rules:

(i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and

(ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the

contractor either as to an equitable adjustment or a method of determining such adjustment.

d. In determining whether deferred compensation is for services rendered during the contract period or is for future services, consideration shall be given to conditions imposed upon eventual payment, such as, requirements of continued employment, consultation after retirement, and covenants not to compete. Similar consideration should be given to the cost of past service credits of pension and annuity plans.

(8) Fringe Benefits. See (o).

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

(10) Training and Education Expenses. See (qq).

(11) Insurance and Indemnification. See (p).

(g) Contingencies.

(1) A contingency is a possible future event or condition arising from presently known or unknown causes, the outcome of which is indeterminable at a present time.

(2) In historical costing, i.e., costing as related to past events or experience, contingencies are not allowable.

(3) In connection with estimates of future costs, contingencies fall into two categories:

(i) those which may arise from presently known and existing conditions, the effects of which are foreseeable within reasonable limits of accuracy; e.g., anticipated costs of rejects and defective work; in such situations where they exist, contingencies of this category are to be included in the estimates of future cost so as to provide the best estimate of performance costs, and

(ii) those which may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation, and other general business risks. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately, including the basis upon which the contingency is computed in order to facilitate the negotiation of appropriate contractual coverage (see, for example, (p), (t), and (mm) below).

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

(i) Depreciation.

(1) Depreciation is a charge to current operations which distributes the cost of a tangible capital asset, less estimated residual value, over the estimated useful life of the asset in a systematic and logical manner. It does not involve a process of valuation. Useful life has reference to the prospective period of economic usefulness in the particular contractor's operations as distinguished from physical life.

(2) Normal depreciation on a contractor's plant, equipment, and other capital facilities is an allowable element of contract cost; provided that the amount thereof is computed

(i) upon the property cost basis used by the contractor for Federal income tax purposes (see Section 167 of the Internal Revenue Code of 1954); or

(ii) in the case of nonprofit or tax-exempt organizations, upon a property cost basis which could have been used by the contractor for Federal income tax purposes, had such organizations been subject to the payment of income tax; and in either case

(iii) by the consistent application to the assets concerned of any generally accepted accounting method, and subject to the limitations of the Internal Revenue Code of 1954, including --

(A) the straight line method;

(B) the declining balance method, using a rate not exceeding twice the rate which would have been used had the annual allowance been computed under the method described in (A) above;

(C) the sum of the years-digits method; and

(D) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the use of the property and including the current year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in (B) above.

(3) Depreciation should usually be allocated to the contract and other work as an indirect cost. The amount of depreciation allowed in any accounting period may, consistent with the basic objectives set forth in (1) above, vary with volume of production or use of multi-shift operations.

(4) In the case of emergency facilities covered by certificates of necessity, a contractor may elect to use normal depreciation without requesting a determination of "true depreciation" or may elect to use either normal or "true depreciation" after a determination of "true depreciation" has been made by an Emergency Facilities Depreciation Board. The method elected must be followed consistently throughout the life of the emergency facility. Where an election is made to use normal depreciation, the amount thereof for both the emergency period and the post-emergency period shall be computed in accordance with (2) above. Where an election is made to use "true depreciation," the amount allowable as depreciation:

(i) with respect to the emergency period (5 years), shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board; and

(ii) after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility over the balance of its useful life (but see (5) below); provided the remaining undepreciated portion of such cost shall not include any amount of unrecovered "true depreciation."

(5) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for current and immediately prospective production.

(6) No depreciation, rental, or use charge shall be allowed on the contractor's assets which have been fully depreciated when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against Government contracts or subcontracts. Otherwise, a

mutually agreed upon use charge may be allowed. (But see ASPR 15-204.1(b).) In determining this charge, consideration should be given to cost, total estimated useful life at time of negotiation, and effect of any increased maintenance charges or decreased efficiency due to age.

(j) Employee Morale, Health, and Welfare Costs and Credits. Reasonable costs of health and welfare activities, such as house publications, health or first-aid clinics, recreational activities, and employee counseling services, incurred, in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relations, employee morale, and employee performance, are allowable. Such costs shall be equitably allocated to

all work of the contractor. Income generated from any of these activities shall be credited to the costs thereof unless such income has been irrevocably set over to employee welfare organizations.

(k) Entertainment Costs. Costs of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see (j) and (pp)).

(l) Excess Facility Costs. Costs of maintaining, repairing, and housing idle and excess contractor-owned facilities, except those reasonably necessary for current and immediately prospective production purposes, are unallowable. The costs of excess plant capacity reserved for defense mobilization production shall be the subject of a separate contract.

(m) Fines and Penalties. Costs resulting from violations of, or failure of the contractor to comply with, Federal, State, and local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing from the contracting officer.

(n) Food Service and Dormitory Costs and Credits. Food and dormitory services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accommodations or similar types of services for the contractor's employees at or near the contractor's facilities. Reasonable losses from the operation of such services are allowable if they are allocated to all activities served. Where it is the policy of the contractor to operate such services without cost to the employee, reasonable costs of such operations are allowable if they are allocated to all activities served. (But see ASPR 15-204.1(b).) Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for

the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated to all activities served.

(c) Fringe Benefits. Fringe benefits are allowances and services provided by the contractor to its employees as compensation in addition to regular wages and salaries. Costs of fringe benefits, such as pay for vacations, holidays, sick leave, military leave, employee insurance and supplemental employment benefit plans, are allowable to the extent required by law, employer-employee agreement, or an established policy of the contractor.

(p) Insurance and Indemnification.

(1) Insurance includes (i) insurance which the contractor is required to carry, or which is approved, under the terms of the contract, and (ii) any other insurance which the contractor maintains in connection with the general conduct of his business.

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

b. Costs of other insurance maintained by the contractor in connection with the general conduct of his business are allowable subject to the following limitations:

(i) types and extent of coverage shall be in accordance with sound business practice and the rates and premiums shall be reasonable under the circumstances;

(ii) costs allowed for business interruption or other insurance shall be limited to exclude coverage of profit, interest, and any other items of cost unallowable under this Part;

(iii) costs of insurance or of any contributions to any reserve covering the risk of loss of or damage to Government-owned property are allowable only to the extent that the Government shall have required or approved such costs;

(iv) contributions to a reserve for an approved self-insurance program are allowable to the extent that the types of coverage, extent of coverage, and the rates and premiums would have been allowed had insurance been purchased to cover the risks; and

(v) costs of insurance on the lives of officers, partners, or proprietors are allowable to the extent that the insurance represents additional compensation (see (f) above).

c. Actual losses which could have been covered by permissible insurance (through an approved self-insurance program or otherwise) are unallowable unless expressly provided for in the contract, except;

(i) costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound business practice, are allowable; and

(ii) minor losses not covered by insurance, such as spoilage, breakage and disappearance of small hand tools, which occur in the ordinary course of doing business, are allowable.

(2) Indemnification includes securing the contractor against liabilities to third persons and other losses, not compensated by insurance or otherwise. The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract, except as provided in (1)c above.

(q) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and pro-

fessional fees paid in connection with the preparation of prospectuses, costs of preparation and issuance of stock rights, and costs related thereto, are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in (oo) below. (But see (x).)

(r) Labor Relations Costs. Costs incurred in maintaining satisfactory relations between the contractor and its employees, including costs of shop stewards, labor management committees, employee publications, and other related activities, are allowable.

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

(t) Maintenance and Repair Costs.

(1) Costs necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see ASPR 15-204.2(i)):

(i) normal maintenance and repair costs are allowable;

(ii) extraordinary maintenance and repair costs are allowable, provided such are allocated to the periods to which applicable for purposes of determining contract costs. (But see ASPR 15-204.1(b).)

(2) Expenditures for plant and equipment which, according to generally accepted accounting principles as applied under the contractor's established policy, should be capitalized and subjected to depreciation are allowable only on a depreciation basis.

(u) Manufacturing and Production Engineering Costs. Costs of manufacturing and production engineering, including engineering activities in connection with the following, are allowable:

(i) current manufacturing processes such as motion and time study, methods analysis, job analysis, and tool design and improvement; and

(ii) current production problems, such as materials analysis for production suitability and component design for purposes of simplifying production.

(v) Material Costs.

(1) Material costs include the costs of such items as raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing material costs consideration will be given to reasonable overruns, spoilage, or defective work (for correction of defective work, see the provisions of the contract or proposed contract relating to inspection and correction of defective work). These costs are allowable subject, however, to the provisions of (2) through (5) below.

(2) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to the cost of the material involved or be allocated (as credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to circumstances beyond his control, such lost discounts need not be so credited.

(3) Reasonable adjustments arising from differences between periodic physical inventory quantities and related material control records will be included in arriving at the cost of materials, provided such adjustments (i) do not include "write-downs" or "write-ups" of values and (ii) relate to the period of performance of the contract.

(4) When the materials are purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to the contract. If material is issued from stores, any generally recognized method of pricing such material is acceptable if that method is consistently applied and the results are equitable. When estimates of material costs to be incurred in the future are required, either current market price or anticipated acquisition cost (if reasonably certain and determinable) may be used, but the basis of pricing must be disclosed.

(5) Costs of materials, services, and supplies sold or transferred between plants, divisions or organizations, under a common control, ordinarily shall be allowable to the extent of the lower of cost to the transferor or current market price. However, a departure from this basis is permissible where (i) the

item is regularly manufactured and sold by the contractor through commercial channels and (ii) it is the contractor's long-established practice to price inter-organization transfers at other than cost for commercial work; provided that the charge to the contract is not in excess of the transferor's sales price to its most favored customer for the same item in like quantity, or the current market price, whichever is lower.

(w) Organization Costs. Expenditures, such as incorporation fees, attorneys' fees, accountants' fees, brokers' fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (q) above).

(x) Other Business Expenses. Included in this item are such recurring expenses as registry and transfer charges resulting from changes in ownership of securities issued by the contractor, cost of shareholders' meetings, normal proxy solicitations, preparation and publication of reports to shareholders, preparation and submission of required reports and forms to taxing and other regulatory bodies; and incidental costs of directors and committee meetings. The above and similar costs are allowable when allocated on an equitable basis to all classes of work.

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

(1) This item consists of the premium portion of overtime, extra pay shift and multi-shift payments to employees. Preferably such premiums should be separately identified and handled as indirect costs to be allocated to all work of the contractor. However, where it is the normal practice of the contractor to handle these premiums as direct costs, such practice is acceptable if it does not result in the Government absorbing a disproportionate share of costs. The same considerations govern their inclusion in or exclusion from the base for overhead

distribution. Such premiums, when allowable, shall be equitably allocated in light of (i) the amount of such premium costs allocated to non-Government work being concurrently performed in the contractor's plant and (ii) the factors which necessitate the incurrence of the costs.

(2) Overtime, extra pay shift and multi-shift premium expenses may arise in two distinct ways in connection with the contract: (i) by initial agreement between the contractor and the contracting officer that known conditions warrant the use of such premium labor; and (ii) to meet unexpected conditions or emergencies arising in the course of the contract, not contemplated by the contracting parties.

(3) The allowability of overtime, extra pay shift and multi-shift premiums will be determined as follows:

(i) to the extent that the contractor and the contracting officer initially agree that such premiums are necessary in view of known conditions, and the contracting officer so authorizes in writing, such costs are allowable; and

(ii) with respect to unexpected conditions or emergencies arising in the course of the contract, such costs are --

(A) unallowable if the contractor is already obligated to meet the contract delivery schedule without additional compensation therefor;

(B) allowable to the extent authorized in writing by the contracting officer, in the case of cost reimbursement type contracts; and

(C) allowable to the extent authorized in writing by the contracting officer prior to final pricing, in the case of fixed-price redeterminable or incentive type contracts.

(z) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. In accordance with the clauses of the contract relating to patents, costs of preparing documents and any other patent costs, in connection with the filing of a patent application where title is conveyed to the Government, are allowable. (See also (ii) and (jj) below.)

(aa) Pension Plans. See (f) above.

(bb) Plant Protection Costs. Costs of items such as (i) wages, uniforms, and equipment of personnel engaged in plant protection, (ii) depreciation on plant protection capital assets, and (iii) necessary expenses to comply with military security requirements, are allowable.

(cc) Plant Reconversion Costs. Plant reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same condition existing immediately prior to the commencement of the military contract work, fair wear and tear excepted. Reconversion costs are unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal.

(dd) Precontract Costs. Precontract costs are those incurred prior to the effective date of the contract directly pursuant to the negotiation and in anticipation of the award of the contract where such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract. (But see ASPR 15-204.1(b).)

(ee) Professional Service Costs - Legal, Accounting, Engineering, and Other.

(1) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (2) and (3) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see (w) above).

(2) Factors to be considered in determining the allowability of costs in a particular case include:

(i) the past pattern of such costs, particularly in the years prior to the award of Government contracts;

(ii) the impact of Government contracts on the contractor's business (i.e., what new problems have arisen);

(iii) the nature and scope of managerial services expected of the contractor's own organizations; and

(iv) whether the proportion of Government work to the contractor's total business is such as to influence the contractor in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Government contracts.

Retainer fees to be allowable must be reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, defense of anti-trust suits, and the prosecution of claims against the Government, are unallowable. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with patent infringement litigation, are unallowable unless otherwise provided for in the contract.

(ff) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the sale or exchange of plant, equipment, or other capital assets, including sale or exchange of either short or long term investments, shall be excluded in computing contract costs (but see (i) (2) above as to basis for depreciation).

(gg) Recruiting Costs. Costs of "help wanted" advertising, operating costs of an employment office necessary to secure and maintain an adequate labor force, costs of operating an aptitude and educational testing program, travel costs of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment are allowable. Where the contractor uses employment agencies, costs not in excess of standard commercial rates for such services are also allowable. Costs of special benefits or emoluments offered to prospective employees beyond the standard practices in the industry are unallowable.

(hh) Rental Costs. (Including Sale and Leaseback of Facilities).

(1) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement. Application of these factors involves comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

(2) Charges in the nature of rent between plants, divisions, or organizations under common control are unallowable except to the extent such charges do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(3) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal costs, such as depreciation, taxes, insurance, and maintenance, borne by the lessor, which would have been incurred had the contractor retained legal title to the facilities.

(ii) Research and Development Costs.

(1) Research and development costs (sometimes referred to as general engineering costs) are divided into two major categories for the purpose of contract costing -- (i) general research, also referred to as basic research, fundamental research, pure research, and blue-sky research and (ii) related research or development, also referred to as applied research, product research, and product line research.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below. Reasonableness of the cost should be determined in light of the pattern of the cost of past programs, particularly those existing prior to the placing of Government contracts.

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production

engineering (see (1) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below, under any production contract to the extent that the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line. Such costs are unallowable under research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

(6) The reasonableness of expenditures for independent research and development must be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Where such expenditures are not subject to the restraints of commercial product pricing, there must be assurance that these expenditures are made pursuant to a planned research program which is reasonable in scope and is well managed. The costs should not exceed those which would be incurred by an ordinarily prudent person in the conduct of a competitive business. (See ASPR 15-204.1(b).)

(jj) Royalties and Other Costs for Use of Patents.

(1) Royalties on a patent or amortization of the cost of acquiring by purchase a patent or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable, unless:

(i) the Government has a license or the right to free use of the patent;

(ii) the patent has been adjudicated to be invalid, or has been administratively determined to be invalid;

(iii) the patent is considered to be unenforceable; or

(iv) the patent is expired.

(2) Special care should be exercised in determining reasonableness where the royalties may have been arrived at as a result of less than arm's length bargaining; e. g.:

(i) royalties paid to persons, including corporations, affiliated with the contractor;

(ii) royalties paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Government contract would be awarded; or

(iii) royalties paid under an agreement entered into after the award of the contract.

(3) Special care should also be exercised with respect to royalties paid to unaffiliated parties, including corporations, upon patents the cost of which, or the cost of research and development work thereon, were substantially recovered through Government grants or charges against Government contracts or subcontracts.

(4) In any case involving a patent formerly owned by the contractor, the amount of royalty allowed should not exceed the cost which would have been allowed had the contractor retained title thereto.

(5) See ASPR 15-204.1(b).

(kk) Selling Costs.

(1) Selling costs arise in the marketing of the contractor's products

and include costs of sales promotion, negotiation, liaison between Government representatives and contractor's personnel, and other related activities.

(2) Selling costs are allowable to the extent they are reasonable and are allocable to Government business (but see ASPR 15-204.1(b)). Allocability of selling costs will be determined in the light of reasonable benefit to the Government arising from such activities as technical, consulting, demonstration, and other services which are for purposes such as application or adaptation of the contractor's products to Government use.

(3) Notwithstanding (2) above, salesmen's or agents' compensation, fees, commissions, percentages, or brokerage fees, which are contingent upon the award of contracts, are allowable only when paid to bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business.

(ll) Service and Warranty Costs. Such costs include those arising from fulfillment of any contractual obligation of a contractor to provide services, such as installation, training, correcting defects in the products, replacing defective parts, making refunds in the case of inadequate performance, etc. When not inconsistent with the terms of the contract, such service and warranty costs are allowable. However, cate should be exercised to avoid duplication of the allowance as an element of both estimated product cost and risk.

(mm) Severance Pay.

(1) Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by contractors to workers whose employment is being terminated. Costs of severance pay are allowable only to the extent that, in each case, it is required by (i) law, (ii) employer-employee agreement, (iii) established policy that constitutes, in effect, an implied agreement on the contractor's part, or (iv) circumstances of the particular employment.

(2) Costs of severance payments are divided into two categories as follows:

(i) actual normal turnover severance payments shall be allocated to all work performed in the contractor's plant; or, where the contractor provides for accrual of pay for normal severances such method will be acceptable if the amount of the accrual is reasonable in light of payments actually made for normal severances over a representative past period, and if amounts accrued are allocated to all work performed in the contractor's plant; and

(ii) abnormal or mass severance pay is of such a conjectural nature that measurement of cost by means of an accrual will not achieve equity to both parties. Thus accruals for this purpose are not allowable. However, the Government recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, allowability will be considered on a case-by-case basis in the event of occurrence.

(nn) Special Tooling Costs. The term "special tooling" means property of such specialized nature that its use, without substantial modification or alteration, is limited to the production of the particular supplies or the performance of the particular services for which acquired or furnished. It includes, but is not limited to, jigs, dies, fixtures, molds, patterns, special

taps, special gauges, and special test equipment. The cost of special tooling, when acquired for and its usefulness is limited to one or more Government contracts, is allowable and shall be allocated to the specific Government contract or contracts.

(oo) Taxes.

(1) Taxes are charges levied by Federal, State, or local governments. They do not include fines and penalties except as otherwise provided herein. In general, taxes (including State and local income taxes) which the contractor is required to pay and which are paid or accrued in accordance with generally accepted accounting principles are allowable, except for:

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see (q));

(iii) taxes from which exemptions are available to the contractor directly or available to the contractor based on an exemption afforded the Government except when the contracting officer determines that the administrative burden incident to obtaining the exemption outweighs the corresponding benefits accruing to the Government; and

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

(2) Unadjudicated taxes otherwise allowable under (1) above, but which may be illegally or erroneously assessed, are allowable; provided that the contractor prior to payment of such taxes:

(i) promptly requests instructions from the contracting officer concerning such taxes; and

(ii) takes all action directed by the contracting officer, including cooperation with and for the benefit of the Government, to (A) determine the legality of such assessment or, (B) secure a refund of such taxes.

Reasonable costs of any such action undertaken by the contractor at the direction of the contracting officer are allowable. Interest and penalties incurred by a contractor by reason of the nonpayment of any tax at the direction of the contracting officer or by reason of the failure of the contracting officer to assure timely direction after prompt request therefor, are also allowable.

(3) Any refund of taxes, interest, or penalties, and any payment to the contractor of interest thereon, attributable to taxes, interest, or penalties which were allowed as contract costs, shall be credited or paid to the Government in the manner directed by the Government, provided any interest actually paid or credited to a contractor incident to a refund of tax, interest or penalty shall be paid or credited to the Government only to the extent that such interest accrued over the period during which the contractor had been reimbursed by the Government for the taxes, interest, or penalties.

(pp) Trade, Business, Technical and Professional Activity Costs.

(1) Memberships. This category includes costs of memberships in trade, business, technical, and professional organizations. Such costs are allowable.

(2) Subscriptions. This item includes cost of subscriptions to trade, business, professional, or technical periodicals. Such costs are allowable.

(3) Meetings and Conferences. This item includes cost of meals, transportation, rental of facilities for meetings, and costs incidental

thereto, when the primary purpose of the incurrence of such costs is the dissemination of technical information or stimulation of production. Such costs are allowable.

(qq) Training and Educational Costs.

(1) Costs of preparation and maintenance of a program of instruction at noncollege level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees during regular working hours, and

(i) salaries of the director of training and staff when the training program is conducted by the contractor; or

(ii) tuition and fees when the training is in an institution not operated by the contractor;

are allowable.

(2) Costs of part-time technical, engineering and scientific education, at an under-graduate or post-graduate college level, related to the job requirements of bona fide employees, including only:

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

(iv) tuition charged by the educational institution, or in lieu of tuition, instructors' salaries and the related share of indirect cost of the educational institution to the extent that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution; and

COST PRINCIPLES

ADVERTISING

Draft as of 21 August 1958

Unallowable except for advertising in trade and technical journals and "help wanted" advertising.

Industry

Institutional, product and special advertising is a legitimate and necessary cost of doing business and should be allowed subject to the test of reasonableness and allocability.

Special Working Group Recommendation

To liberalize the advertising principle to include the cost of exhibits sponsored by the government as well as advertising for scarce materials or disposing of scrap or surplus materials.

Recommended Army Position

Concur with the Special Working Group recommendation, except that the cost of participation in exhibits sponsored by the government should be allowable only if incurred pursuant to a Department of Defense invitation for such participation.

12/3/58

15-204.2 Listing of Costs.

(a) Advertising Costs.

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

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

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

(iii) costs of participation in exhibits sponsored by the Government for the purpose of developing military applications of products.

(iv) advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.

(2) In connection with this element, special care must be exercised in determining reasonableness. Reasonableness can be determined by an analysis of significant deviations in scope from past advertising programs; the presence or absence of competitive restraints.

(3) Except as provided in (iii) and (iv) above, all advertising which offers products for sale is unallowable.

COST PRINCIPLES

CONTRIBUTIONS AND DONATIONS

Draft as of 21 August 1958

Unallowable.

Industry

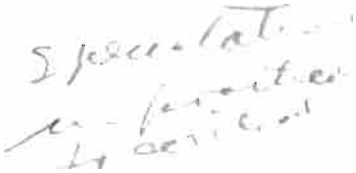
The making of contributions is essential to the conduct of business and the failure to do so adversely affects the contractor's standing in the community and hence his employee relations. Some contributions aid in the development of technical education and scientific research. Support of charitable, scientific and educational institutions is a normal cost of doing business and recognized as such for tax purposes.

Special Working Group Recommendation

To allow the cost of reasonable contributions to established non-profit charitable organizations of a community type.

Recommended Army Position

Nonconcur in the recommendation of the Special Working Group since contributions are not obligatory upon a contractor but are voluntary expenditures not necessary for performance of government contracts. The allowance of contributions and donations would put contractors in the position of being able to give away the taxpayers money.



12/3/58

CONTRIBUTIONS AND DONATIONS

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

The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost.

COST PRINCIPLES

INTEREST

Draft as of 21 August 1958

Unallowable (however represented).

Industry

The cost of money for whatever purpose and however evidenced is an essential cost of doing business, government or commercial, and therefore should be allowed. Otherwise commercial business would be required to bear the cost of financing government work.

Special Working Group Recommendation

To remain unallowable, except to add a statement in Section III of the ASPR to indicate that the extent of a contractors total investment in the performance of the contract will be taken into consideration in the fixing of the amount of fee or profit to provide consistency in ASPR with the 80%-20% withholding policy.

Recommended Army Position

Concur in the recommendation of the Special Working Group.

12/3/58

INTEREST ON BORROWINGS

Proposal: Maintain unallowability of interest as a COST, but revise profit policy appearing in ASPR 3-808.4 by adding a new subparagraph (d) and relettering the remaining subparagraphs. The inserted paragraph will read:

"d. Extent of the Contractor's Investment.

The extent of a contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee or profit."

COST PRINCIPLES

PLANT RECONVERSION COSTS

(Plant reconversion costs are those incurred in the restoration or rehabilitation of the contractors' facilities to approximately the same condition existing immediately prior to the commencement of the military contract work, fair wear and tear excepted.)

Draft as of 21 August 1958

Unallowable except for the cost of removing government property and the restoration or rehabilitation cost caused by such removal.

Industry

Plant reconversion costs should be allowable including the cost of removing government property and restoration or rehabilitation cost caused by such removal to the extent authorized by advance negotiated agreement.

Special Working Group Recommendation

Normally unallowable, but to liberalize this principle by allowing additional cost by mutual agreement where equity so dictates in special circumstances.

Recommended Army Position

Concur in the recommendation of the Special Working Group.

PLANT RECONVERSION COSTS

(cc) Plant Reconversion Costs. Plant reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same condition existing immediately prior to the commencement of the military contract work, fair wear and tear excepted. Reconversion costs are normally unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent mutually agreed upon. Whenever such costs are given consideration, care should be exercised to avoid duplication through allowance as contingencies, as additional profit or fee, or in other contracts.

COST PRINCIPLES

DIRECT COSTING

Draft as of 21 August 1958

A direct cost is any cost incurred or to be incurred solely for the benefit of a single cost objective of the contract.

Special Working Group Recommendation

Addition of an additional sentence inadvertently omitted and necessary to avoid duplication of charges under certain circumstances.

Recommended Army Position

Concur in the Special Working Group recommendation.

12/3/58

DIRECT COSTING

In order to take care of a concept which had been inadvertently omitted and to avoid duplication of charges under certain circumstances, we recommend addition of the following sentence at the end of 15-202(a):

15-202(a) Add:

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

COST PRINCIPLES

RENTAL COSTS

Draft as of 21 August 1958

Allowable if rates are reasonable in light of such factors as the type, life expectancy, condition and value of the facilities leased, options available and other provisions of the rental agreement. Also requires a comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

Industry

The ultimate test should be the rental value of comparable properties, and not comparisons to costs which the contractor would have sustained as owner.

Special Working Group Recommendation

Same as 21 August draft except to include "market conditions in the area" as a test of reasonableness of rental costs.

Recommended Army Position

Concur in the recommendation of the Special Working Group.

(hh) Rental Costs. (Including Sale and Leaseback of Facilities). Revise paragraph (1) of the principle to read as follows:

(1) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as market conditions in the area, the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement. Application of these factors involves along with other considerations comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

COST PRINCIPLES

COMPENSATION

Draft as of 21 August 1958

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.

Special Working Group Recommendation

To recognize that in the determination of the reasonableness of total compensation, contracting officers, as a practical matter, can only cope with the unreasonableness or out of line situation. The following addition is proposed:

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

Recommended Army Position

Concur in the Special Working Group recommendation.

12/3/58

COMPENSATION

Take care of the past service pension credit problem by deleting the phrase "for services currently rendered" from 15-204.2(f)(6)a, and insert at the beginning of paragraph b(1):

"Except for past service pension costs, it is for services rendered during the contract period."

To take care of the gigantic problem incident to an examination of ALL compensation plans, introduce the concept of management by exception by inserting a new sentence in paragraph (b) as follows:

"b. Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. In the administration of this principle, particular attention should be given to remuneration which is obviously out of line. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following:

COST PRINCIPLES

APPLICABILITY

Draft as of 21 August 1958

Proposed that the cost principles be applicable to all types of contracts as follows:

a. Cost-Reimbursement Type Contracts

As a contractual basis for termination of costs.

b. Fixed-Price Type Contracts

As a basis for submission of cost data and price analyses by contractors, the evaluation of cost data by contracting officers to the extent that costs become a factor, the resolution of cost questions in retrospective pricing, and as a guide for the resolution of cost questions in forward pricing.

c. Audit Reports

As a basis for the preparation of advisory audit reports.

d. Contract Terminations

Unilateral determinations in contract terminations.

Industry

Strongly protests the application of detailed cost principles to fixed-price contracts on the basis that formula price fixing would result and negate the advantages of competitive and negotiated prices.

Special Working Group Recommendation

The military departments have objected also to the applicability of cost principles to fixed-price contracts. It is contended that formula pricing would result, and that the traditional concept of negotiating fair and reasonable prices would be lost. It is proposed

that the cost principles be revised to provide for a separate applicability treatment for fixed type contracts consistent with the current pricing principles in Part 8, Section III, ASPR. A new Part 7, Section XV would be added providing:

a. That the pricing policy in Part 8, Section III would be governing and followed in the negotiation of fixed-price type contracts. In brief, this philosophy provides that prices not separate elements of cost plus profit are to be negotiated.

b. When cost principles are being considered in fixed-price type contracts, the cost principles will be used to provide general guidance in establishing a fair and reasonable price. This would be particularly applicable to incentive and redeterminable contracts. Even in these situations, the use of the cost principles would be flexible.

Recommended Army Position

Concur in the Special Working Group recommendation.

(v) straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year where circumstances do not permit the operation of classes or attendance at classes after regular working hours;

are allowable.

(3) Costs of tuition, fees, training materials and textbooks (but not subsistence, salary, or any other emoluments) in connection with fulltime scientific and engineering education at a post-graduate (but not under-graduate) college level related to the job requirements of bona fide employees for a total period not to exceed one school year for each employee so trained, are allowable. In unusual cases where required by military technology, the period may be extended.

(4) Maintenance expense, and normal depreciation or fair rental, on facilities owned or leased by the contractor for training purposes are allowable to the extent set forth in (t), (i), and (hh) above, respectively.

(5) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions (see (h) above).

(rr) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. These costs are allowable. When such costs can readily be identified with the items involved, they may be directed costed as transportation costs or added to the cost of such items (see (v) above). Where identification with the materials received cannot readily be made, inbound transportation

costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent, equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, should be treated as a direct cost.

(ss) Travel Costs.

(1) Travel costs include costs of transportation, lodging, subsistence, and incidental expenses, incurred by contractor personnel in a travel status while on official company business.

(2) Travel costs may be based upon actual costs incurred, or on a per diem or mileage basis in lieu of actual costs, or on a combination of the two, provided the method used does not result in an unreasonable charge.

(3) Travel costs incurred in the normal course of over-all administration of the business and applicable to the entire business are allowable. Such costs shall be equitably allocated to all work of the contractor.

(4) Travel costs directly attributable to specific contract performance are allowable and may be charged to the contract in accordance with the principle of direct costing (See ASPR 15-202).

(5) Necessary, reasonable costs of family movements and personnel movements of a special or mass nature are allowable, subject to allocation on the basis of work or time period benefited when appropriate. (But see ASPR 15-204.1(b).)

Draft
21 August 1958

Proposed Amendments to Draft Dated 10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

15-000 Scope of Section. This Section contains general cost principles and standards for use in connection with (i) the determination of historical costs, (ii) the preparation and presentation of cost estimates by prospective contractors, contractors and subcontractors in negotiated procurement and in termination for convenience of the Government, and (iii) the audit of cost in the negotiation and administration of contracts, and (iv) the evaluation of cost data in procurement and contract administration.

Part 1 - Applicability

15-101 Scope of Part. This Part prescribes the use of the cost principles and standards set forth in the several succeeding Parts of this Section in contracting and subcontracting and delineates the nature of such use under different circumstances.

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

(i) As a contractual basis, by incorporation by reference in the contract, for determination of:

(A) reimbursable costs under cost-reimbursement type contracts including cost-reimbursement type subcontracts thereunder and the cost-reimbursement portion of time and materials contracts;

(B) terminations when the amounts thereof are determined unilaterally by the contracting officer;

(C) costs of terminated cost-reimbursement contracts.

(ii) As a basis for:

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

(B) audit reports prepared by the Audit Agencies in their advisory capacity of providing accounting information respecting negotiated pricing, repricing and termination.

(iii) By Contracting Officers in the evaluation of cost data, as follows:

(A) In Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed or substantially completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contract, redetermination of price after completion of the work, negotiation of final overhead rates, or negotiation of a settlement agreement under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. Accordingly, ASPR, Section XV, Part 2, shall serve as the basis for evaluation of cost data. However, the finally agreed price or settlement represents something other than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the

evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

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

to be performed, or a target price under an incentive contract.

(iv) As the basis for the resolution of questions of acceptability of individual costs whenever such questions become issues.

15-101.2 "Allowable" and "Unallowable" in Connection with Fixed-Price Type Contracts. As used in ASPR, Section XV, Part 2, the words "allowable," "unallowable," and the like, shall, in connection with any fixed-price type contract, mean "acceptable," "unacceptable," and the like.

Negotiation Requirement

Modify 15-204.1(b) to read as follows:

(b) The extent of allowability of the selected items of cost covered in ASPR 15-204.2 has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in the case of contractors whose business is predominantly or substantially with the Government. In order to avoid possible subsequent disallowance based on unreasonableness or non-allocability, it is important that prospective contractors, particularly those whose work is predominantly or substantially with the Government, seek agreement with the Government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Such agreement may be initiated by the contracting officer. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. Included are such elements as:

(i) compensation for personal services (ASPR 15-204.2(f));

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

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

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

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

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

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

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

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

Compensation for Personal Services

Modify 15-204.2(f) to read as follows:

(f) Compensation for Personal Services.

(1) General. a. Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses, incentive awards, employee stock options, employee insurance, fringe benefits, and contributions to pension, annuity, stock-bonus and plans for incentive compensation of management employees. Except as otherwise specifically provided in this paragraph (f), such costs are allowable to the extent that the total compensation of individual employees is reasonable for the services rendered and are not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

b. Compensation is reasonable to the extent that the total amount paid or accrued, is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following:

(i) Compensation paid to owners of closely held corporations, partners, sole proprietors, or members of the immediate families

thereof, or to persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that such compensation is reasonable for the actual personal services rendered rather than a distribution of profits.

(ii) Any change in a contractor's compensation policy resulting in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the ratio of Government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in Government policy.

(iii) The contractor's business is such that his compensation levels are not subject to the restraints normally occurring in the conduct of competitive business.

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

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

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

(3) Cash Bonuses and Incentive Compensation. Incentive compensation for management employees, cash bonuses, suggestion awards, safety awards, and incentive compensation based on production, cost reduction, or efficient performance, are allowable to the extent that the overall compensation is

determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see ASPR 15-204.1(b).) Bonuses, awards and incentive compensation when any of them are deferred are allowable to the extent provided in (6) below.

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

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

(ii) accruals for the cost of stock prior to the issuance of such stock to the employees shall be subject to adjustment according to the possibilities that the employees will not receive such stock and their interest in the accruals will be forfeited.

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

(5) Stock Options. The cost of options to employees to purchase stock of the contractor or of an affiliate is unallowable.

(6) Deferred Compensation. a. As used herein, deferred compensation includes all remuneration, in whatever form, (for services currently rendered)

for which the employee is not paid until after the lapse of a stated period of years or the occurrence of other events as provided in the plans, except that it does not include normal end of accounting period accruals. It includes (i) contributions to pension, annuity, stock bonus, and profit sharing plans, (ii) contributions to disability, withdrawal, insurance, survivorship, and similar benefit plans, and (iii) other deferred compensation, whether paid in cash or in stock.

b. Deferred compensation is allowable to the extent that (i) it is for services rendered during the contract period; (ii) it is, together with all other compensation paid to the employee, reasonable in amount; (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payments; and (iv) for a plan which is subject to approval by the Internal Revenue Service, it falls within the criteria and standards of the Internal Revenue Code and the regulations of the Internal Revenue Service. (But see ASPR 15-204.1(b).).

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

give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible future abnormal forfeitures shall be effected according to the following rules:

(i) abnormal forfeitures that are foreseeable and which can be currently evaluated with reasonable accuracy, by actuarial or other sound computation, shall be reflected by an adjustment of current costs otherwise allowable; and

(ii) abnormal forfeitures, not within (i) above, may be made the subject of agreement between the Government and the contractor either as to an equitable adjustment or a method of determining such adjustment.

d. In determining whether deferred compensation is for services rendered during the contract period or is for future services, consideration shall be given to conditions imposed upon eventual payment, such as, requirements of continued employment, consultation after retirement, and covenants not to compete.

(7) Fringe Benefits. See (o).

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

(9) Training and Education Expenses. See (qq).

(10) Insurance and Indemnification. See (p).

(ii) Research and Development Costs.

(1) Research and development costs are divided into two major categories for the purpose of contract costing — (i) basic research, also referred to as general research, fundamental research, pure research, and blue-sky research and (ii) applied research and development, also referred to as product research and product line research.

(2) Basic research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent basic research (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below and subject also to their being allocated to all of the work of the contractor.

(3) Applied research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of or improvements in useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering. Costs of a contractor's independent applied research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable, subject to (6) below, under any production contract to the extent that such applied research and development are related to the product lines for which the Government has contracts and such costs are allocated as indirect costs to all production work of the contractor on such contract product lines. Costs of independent applied research and development are unallowable under research and development contracts. However, in cases where a contractor's normal course of business

does not involve production work, the costs of independent applied research and development work (that which is not sponsored by contract, grant or other arrangement) are allowable, subject to (6) below, to the extent that such work is related and allocated as an indirect cost to the field of effort of the Government applied research and development contracts.

(4) Independent research and development projects shall absorb their appropriate share of the indirect costs of the department where the work is performed.

(5) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

(6) In addition to the definition of reasonableness provided in ASPR 15-201.3, the reasonableness of expenditures for independent research and development should be determined in light of the pattern of the cost of past programs (particularly those existing prior to the placing of Government contracts), with due consideration to changes in science and technology. Such expenditures must be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the Government. Where such expenditures are not subject to the restraints of commercial product pricing, there must be assurance that these expenditures are made pursuant to a planned research program which is reasonable in scope and is well managed. The costs should not exceed those which would be incurred by an ordinarily prudent person in the conduct of a competitive business. (See ASPR 15-204.1(b).)

(y) Overtime, Extra-Pay Shift and Multi-Shift Premiums. Overtime, extra-pay shifts, and multi-shift work is allowable to the extent approved pursuant to ASPR 12-102.4, or authorized pursuant to ASPR 12-102.5.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON 25

B-124125

Honorable Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)

Dear Mr. McGuire:

In response to your letter of October 22, 1957, we are pleased to send you our preliminary views on the September 10, 1957, draft of Armed Services Procurement Regulations, Section XV, Contract Cost Principles.

We note from your letter that the Department of Defense subscribes to the view that it would be advantageous to have cost principles which are applicable to all types of negotiated contracts. This is a position in which we concur and one which we feel will foster an atmosphere of mutual understanding among contractors and contracting officers of the various agencies. It should ultimately lead to more effective negotiation and administration of Government contracts. We recognize that this is a difficult undertaking, and we are pleased to learn that differences of opinions within the Department of Defense have been largely resolved.

We prefer to review and comment on the cost principles after industry comments have been analyzed and accepted suggestions have been incorporated in the proposed principles. There are, however, a few comments we would like to make at this time concerning the over-all philosophy of the cost principles. We hope these comments will be helpful to you.

We have long had an interest in the objective of establishing cost principles for use on all types of negotiated contracts within the Department of Defense as evidenced by our letters to the Secretary of Defense on May 31, 1955, December 16, 1955, and March 11, 1957. We understand that the adoption of uniform cost principles for Government-wide use is now being considered. We also endorse this objective, and our comments which follow give recognition to the possibility of the proposed cost principles being adopted for Government-wide application.

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Paragraph 15-000, Scope of Section, contains a concise statement of the three basic uses for cost principles, namely:

(i) the determination of historical costs

(ii) the preparation and presentation of cost estimates by contractors and subcontractors, and

(iii) the review, audit and evaluation of cost data in the negotiation and administration of Government contracts and subcontracts thereunder

We believe that this paragraph properly expresses the appropriate use of the cost principles; however, subsequent paragraphs, and in particular paragraph 15-101, appear to deemphasize the importance of the cost factor in contract pricing, and thus the importance of the cost principles. We visualize the cost principles as a vehicle to provide a basis for mutual understanding by contractor and Government representatives as to the ground rules for a highly important factor in contract negotiation and administration. Deemphasis of the relative importance of the cost factor, particularly in a statement of the cost principles, would almost surely impair efforts to obtain a more realistic evaluation of this important factor in contract pricing.

Particular attention is invited to the following portion of paragraph 15-101(c) of the September 10, 1957, draft of the contract cost principles.

> "To the extent that costs are a factor in forward pricing, ASPR, Section XV, Part 2, shall apply to the development and evaluation of cost data. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives

for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while Part 2 will be used to develop and evaluate cost data, it will not control negotiation of prices for work to be performed in the future (e.g., negotiation of a firm fixed-price contract an intermediate price revision covering, in whole or important part, work which is yet to be performed, or a target price under an incentive contract). Nevertheless, when the question of acceptability of a specific item of cost becomes an issue, Part 2 will serve as a guide for the resolution of the issue."

Our examinations of contract activities have disclosed serious weaknesses in the procurement procedures stemming from inadequate consideration of the cost factor in contract pricing. These have included failures to obtain periodic cost data needed to exercise repricing options, failure to obtain the latest available cost data at the time of price negotiations, inadequate analysis or verification of cost data and recognition of cost trends, and failure to properly examine future cost estimates and related supporting data. Further, our reviews have disclosed failures on the part of both the Government and prime contractors to obtain cost data or other information as to the basis for the price where awards were made without competition to suppliers at firm fixed prices. Various measures have been adopted to improve these conditions; however, we feel that inadequate consideration of the cost factor in contract pricing is a continuing problem. Therefore, we strongly suggest that the foregoing paragraph be rephrased to emphasize the importance of cost as a pricing factor rather than to subordinate it.

When prices are determined by negotiation rather than simply by comparison of competitive bids, as in the case of formally advertised contracts, the actual or estimated cost of performing the work should normally be a very important factor in appraising the reasonableness of a proposed price. Hence, a thorough analysis and evaluation of such cost data are essential to sound contract negotiations, whether it be a negotiated firm fixed-price, redeterminable fixed-price, or a cost-type contract or subcontract. We understand that the cost principles are intended to be guides for preparing cost proposals and negotiating prices; therefore we suggest that the document be written with particular emphasis on

the importance of costs and appropriate evaluation thereof in the process of negotiating contract prices.

We would also suggest some reconsideration of the statement that treatment of specific cost elements is not possible because the bargaining is on a total price basis. Certainly, so far as Government negotiators are concerned, there should be a full showing of all factors considered in arriving at the price and the files should show the basis for acceptance of the price. When competitive forces are not present to assure a reasonable price, one of the major considerations is the actual or estimated cost of production and the record should reflect the negotiator's treatment of it in arriving at a price acceptable to the Government. The quoted statement seems to encourage failure to adequately consider cost and to document the decisions made. This weakens contract negotiations and impairs subsequent administrative and other reviews of the activity.

We note that part 2 is to be incorporated in contracts to provide a contractual basis for ascertaining reimbursable costs under cost-reimbursement-type contracts and the cost-reimbursement portion of time and material contracts and unilateral determinations under terminated fixed-price contracts. We recommend that these principles also be incorporated by reference in negotiated contracts which provide for repricing during or after performance. Controversies over what types of cost are to be recognized in the negotiation of a price could be substantially minimized by an advance understanding by the contracting parties of the cost principles to be followed. The principles would then have official standing by contract stipulation and their use would be required in the submission of cost data and in the evaluation and negotiation of the contract prices.

We recommend that subparagraph (iii) of paragraph 15-201.4 (page 6) be deleted. The provisions of this subparagraph appear to be so broad as to qualify almost any cost of a contractor as allocable to Government work, whether or not there is any relationship to the work. The provisions of subparagraphs (i) and (ii) seem to be broad enough to recognize any cost appropriately assignable to Government work, particularly if the phrase "or other equitable relationship" were added to subparagraph (ii).

We note that the cost principles relating to indirect costs provide in paragraph 15-203(d) (page 8) that the contractor's established practices, if in accord with generally accepted accounting principles, shall be acceptable. We

believe that a further qualification should be added that the results of the allocation must be equitable to both contracting parties when viewed and tested against the contractor's activity under the contract.

Subparagraph 15-204.1(b) (page 9) recognizes that the extent of allowability of certain costs should be agreed to in advance of the contractor's incurring of such costs. It provides that such agreement should be incorporated in cost-reimbursement-type contracts but would only be made a part of the contract file in the case of negotiated fixed-price-type contracts. We believe that it would be extremely helpful if such agreements were to be incorporated in any type of contracts where there are pricing or repricing or cost-reimbursement determinations to be made subsequent to the award.

In considering the application of the cost principles on a Government-wide basis, some of the agencies may consider it desirable to make special arrangements and to have an advance agreement concerning the extent to which "home office" expenses are to be applied to GOCO contracts (Government-owned, contractor-operated) and similar management-type contracts, particularly where the operations under the contracts are sufficiently autonomous so as to require little or no assistance from the "home office." We recommend that the cost principles specifically recognize that these circumstances require limited acceptance or nonacceptance of "home office" expense.

Pending your receipt and consideration of comments from industry, we will withhold comments relating to the "Selected Costs" contained in "Application of Principles and Standards" (paragraph 14-204). However, our review of the document would be facilitated by a further explanation of the treatment of compensation for personal services, and depreciation, and representatives of our Office will communicate with your staff on these matters. We shall, of course, be glad to discuss any other matters with you or members of your staff should you so desire.

Sincerely yours,

Comptroller General
of the United States

COPY

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.

Memo for S/D 18 June 58

5829

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.

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Tab B, attached, represents an identification and evaluation of 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
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

(concurred 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 pl[illegible].

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 d be unallowable only if subsequently found unreasonable which would not

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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 Developmen

Industry Position

Under the ~~proposed cost principles~~ draft of 10 Sept 1945 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).

TAB C

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

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.

TAB D

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

November 7, 1958

The Honorable E. Perkins McGuire
Assistant Secretary of Defense
(Supply & Logistics)
The Pentagon
Washington 25, D. C.

Subject: Comprehensive Cost Principles

Dear Mr. Secretary:

Pursuant to the suggestion made by you at the joint DOD-Industry conference on Cost Principles held at the Pentagon on 15 October 1958, this letter is submitted to amplify and explain further the industry views expressed at the conference, and to comment also in some cases upon contrary views expressed by government spokesmen. It has been prepared after the receipt of written comments from each industry spokesman, and after a detailed review at a conference on 6 November among industry spokesmen or representatives of the associations who participated in the preparation of the industry statements on 15 October. This document represents the unanimous views of these people.

You and the other Assistant Secretaries have before you the task of deciding upon issues on which wide differences seem to exist between government and industry viewpoints as expressed at the 15 October conference. In preparing the industry statements for the conference, the views of the conferees (which included managers, controllers, and professional accountants) were remarkably in accord with each other. It is difficult to believe that this consensus of so many different interests and viewpoints can be as wholly wrong as the government spokesmen would lead one to believe, for these industrial and professional views are based upon years of actual experience. We shall, therefore, try to show you where we think we are truly apart, where implementations negate apparent intentions with which we are in accord, and why we think a complete and exhaustive review of the proposals outstanding are essential. In considering these, we know you will show the same thoughtfulness and patience which has characterized your handling of this complex problem to date.

The responsibility which you and the other Assistant Secretaries bear in making these decisions is of the utmost gravity, as they affect the cost recoveries and profit potentials of every company engaged in defense contracting - not, as in the past, just those which undertake cost reimbursement type contracts. At the same time, however, this obligation to decide also provides a unique opportunity - to cut through past disputes, to reassert principles basic to our economic system, and to reaffirm that the prime objective of our Government is to be fair and equitable in carrying out its business transactions. We feel that you agree with us in this fundamental principle. For example, the definition of allocability included in the latest draft (paragraph 15.201.4) does in fact express a fair and reasonable approach. The problem lies, however, in that much of the remainder of this draft of "Cost Principles" completely negates this definition. To correct this defect, you must make "fairness" a concept more

fundamental than "reasonableness," or than "applicability," or than "allocability," even though each of these three is of real importance and significance. You must also be ready to separate principle from interpretation, and to require the clear subordination of interpretation to policy. This can be done, we submit, without taking precipitate action, without conclusively binding the DOD or contractors finally as to any specific element of cost, and without now attempting to perfect every interpretation. This is, we sincerely believe, the only fair and practical way to issue comprehensive cost principles soon which will not evoke a storm of protest, criticism and bitterness from many sources.

There are other compelling reasons for such a reconsideration of the general aspects of these proposed regulations even at this late date. When they are made effective, they will have virtually the same effect as the enactment of new legislation, for they will change the ground rules from what they have ever been before. If made applicable to current contracts to any extent, the regulations, as proposed, would materially revise the basis under which every present contractor agreed to perform his obligations. Undoubtedly they would also cause greatly added costs of administration and of audit and negotiation both to contractors and to the Government, and would force extensive delays in placing original contracts or definitizing necessary actions under other contracts. Any regulations must, therefore, deal fairly with the entire spectrum of types of contracts, whether now in existence or placed in the future. They may well become a precedent for later extension to all non-defense Government procurement. Surely, then, a self-imposed time schedule must yield to the necessity for being right.

We strongly urge that the whole body of general principles of cost determinations be stated separately and apart from any official interpretations or detailed instructions. We recognize that interpretations and instructions are essential in the management and control of Government personnel, but these personnel should all perform their work within the framework of policies and principles determined at the Secretarial level. Thus the general would govern the specific, whereas in the proposed document, the specific governs the general. A clear way to draw this distinction, and to enforce it, would be to leave interpretations and instructions out of ASPR, confining it to principles and policy - and making this the limit of a contractor's obligation through incorporations by reference into specific contracts. Auditors' manual would be an adequate place for detailed interpretations or instructions, provided these were approved by a central source to assure conformity to principle and policy, and uniformity among the several Services.

While many particular differences between Government and industry were disclosed at the 15 October conference, and others remain which were not discussed there, the fundamental differences relate to the basic approach to be taken, mentioned above, and to seven other factors, which are: 1) recognition of all normal and legitimate costs, 2) reasonableness and allocability as adequate tests and controls, 3) applicability, 4) effective date, 5) requirements of public interest, 6) advance understandings, and 7) individual items of cost. We believe that all differences as to particulars would be readily resolvable if ways can be found to reach agreement on the first five of these points. We shall, therefore, devote most of the balance of this statement to them.

I. RECOGNITION OF ALL NORMAL AND LEGITIMATE COSTS

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

conduct of its business. Then the Government might properly say that although it will accept such costs, they must be appropriately and fairly allocated among the contracts in question and other work of the contractor, in accordance with accepted principles and an established method of accounting; that the Government will accept such costs only in so far as they are not unreasonable in amount, and are not objectionable from the established standards of public policy. This would provide a uniform and positive approach to the problems of cost analysis, in marked contrast to the proposed regulations, which confuses principle with practice, and policy with instruction.

Contrast this, however, to what has been actually done. The Government's draft, in Section 15-201.1, shows that the Government starts from the premise we have proposed above (if one word - "allowable" - is eliminated), but then the balance of the proposed regulations whittle away at this to such an extent as to render Section 15-201.1 meaningless. This, we believe, is because that in the proposed regulations, some costs are dealt with according to their functions, and others according to their objects. The distinction here is as between, one the one hand, the purpose of the goods or services purchased, and, on the other, the kind of goods or services purchased. This distinction is considered to be as between the function of the cost (its purpose) and the object of expenditure (the kind of thing purchased). Among professional accountants, it is a basic principle of cost determination that all costs incurred by a contractor should be judged for validity according to the function performed by the goods or services they represent. It is unfair to disallow reimbursement of cost incurred for a valid function merely because they are costs of an "object of expenditure" which Government auditors or other critics deem to be generally objectionable by its nature.

A single example of the distinction being drawn is illustrated by the problems of advertising. If costs incurred to buy advertising may fairly be associated with performance of a Government contract because of the nature of the results sought or achieved by the advertising, then these costs should not be deemed invalid for reimbursement merely because of the tradition that "it is not necessary to advertise to get Government business."

The Government's own internal accounting practices, developed since the endorsement by the Hoover Commission in 1948 of the accounting distinctions between "functions" and "objects," are utilizing more and more the approach we advocate. An example is "performance budgeting."

It is axiomatic that contractors must recover all of the costs they incur somehow and somewhere. If they do not, it is only a question of time when their funds, capital and credit will be exhausted, their business insolvent and closed, and the employment they have provided lost forever. This is why management must, and always will, exercise judgment in incurring costs. Obviously, if fairness is the overriding consideration, the Government should bear its fair share of all of these costs - not just of some of them. To the extent that it fails to do so, it is not only seeking or demanding special favors for itself, but is asking its suppliers to handicap themselves when they go out in the market place to compete with other companies for commercial or other non-Government business, because they would have to recover Government-disallowed costs from commerical prices.

To what extent is the Government, in these proposed regulations, refusing to bear its fair share? It would disallow 23 items entirely, of which only 18 are disallowed by the provisions of the present Section XV of ASPR. It would partially

disallow 20 other items, of which only 6 are disallowed by the present ASPR. It would subject 19 other items to special tests or reviews (not "principles") which would, by definition or tests applied, lead to still more partial or total disallowances. Of these 19 items, 3 are disallowed and 7 are subject to "special consideration" under the present ASPR. The proposed new regulations also suggest advance negotiation of 9 items of which 7 are on the list for "special consideration" under the present ASPR. Elsewhere in the document, however, advance negotiation is stated as a requirement of cost allowance in 6 additional cases. The identification of the above statistics are included in the attachment hereto.

These figures demonstrate conclusively that the new regulations would not only subject cost data to substantially more detailed and lengthy analyses and reviews, with added costs to both Government and contractors, but that the negotiation process would likewise be lengthened. They also show that contractors must expect to recover substantially less of their costs than they have heretofore obtained under cost reimbursement type contracts, and to the extent the proposed regulations are applied to other types of contracts, contractors must expect disallowances of cost equivalent to the new measure of disallowances under cost type contracts. If applied to terminations, the allowable recovery would also be much less than under the provisions of Section VIII of ASPR. It is impossible to predict the measure of such non-recoveries under the new regulation, but they would aggregate a substantial portion of profits.

At the 15 October conference, the propriety of industry's position has been recognized from time to time by Government spokesmen, but these sixty-two departures from "principle" into "instruction," from "function" into "object," were justified - to the extent they were specifically discussed - on one or more of the following grounds: statutory prohibition, public policy (whether expressed officially, unofficially or merely implied), or unallocability to Government contracts. Implicit also were disallowances or limited allowances provided for solely because of supposed difficulties in measuring reasonableness, allocability or equality of treatment between competing contractors.

An examination of the disallowed or partially disallowed items, however, discloses only one - "contingent fees for securing government orders," which is forbidden by statute governing expenditure of DOD funds. Statutory prohibitions, therefore, have created none of the disagreements.

Public policy is a subject we shall discuss more fully later. Allocability should be a wholly separate question from allowability. If no allocability can be shown or reasonably implied, industry does not expect recovery from the Government. It does not, however, wish to be foreclosed from even the opportunity to prove or show allocability, and any disallowances on a premise of total unallocability are, therefore, objectionable. It is the height of accounting by "object" rather than by "function."

Equality of treatment among competing contractors is, of course, required by the paramount test of fairness. It is not accomplished, however, by total or partial disallowance. Rather it must be realized through a recognition of all normal and legitimate costs and judicious price negotiations. One company is not superior to another because it may not have incurred a cost that the other company has - the test should be, what is the best overall price to the Government for what it is buying? Competition is hampered - not encouraged - by arbitrary cost disallowances.

Neither is disallowance a solution to difficulty of measurement or control. Ways acceptable to both industry and government can be found to provide equitable measurements for allowing the costs of such things as contributions, the maintenance of excess facilities, interest, grants to educational institutions, advertising, civil defense, reconversions, applied research and development, and many other kinds of costs proposed to be disallowed or specially reviewed. Let us recall Commander Malloy's admonition at the start of the 15 October conference that "any problem can be solved by reasonable men who are in possession of the facts and who are motivated to a common purpose". So far as we know, a specific joint effort to agree on such measurements has never been undertaken, face to face. If the concept advocated at the outset of this statement were adopted, these determinations need not be made before cost principles are issued - because they would each be interpretations and instructions for auditors and not a portion of the "principles" in ASPR.

In concluding discussion on this point, let us be sure that the Government does not conclude that industry is seeking a blank check. If such an impression has been left, please re-read the first paragraph of this Section I, and consider the tests and limitations therein suggested.

II. REASONABLENESS AND ALLOCABILITY AS ADEQUATE TESTS AND CONTROLS

Government spokesmen at the 15 October conference, on several occasions, justified specific instructions, limited allowances or disallowances on the grounds that "reasonableness" and "allocability" are not sufficient, definable or usable tests. Such a position is not only contrary to the experience of industry, the opinions of every professional accountant who certifies to the accuracy and propriety of corporate books and records, the history of Anglo-Saxon and American jurisprudence, but also to the words of the proposed regulations themselves. "Reasonableness" or "allocability" as tests are used 49 times throughout the 10 September 1957 draft, as amended by the 21 August 1958 draft. They were also used by almost every Government spokesman at the 15 October conference.

One Government spokesman at the 15 October conference quoted excerpts from an article by Dr. Howard Wright in THE FEDERAL BAR JOURNAL of April-June, 1958 as proof that "generally accepted accounting principles" are not a suitable base for cost determination. This was curious, however, because this phrase or its equivalent was used 19 times throughout the DOD draft. He failed also to quote Dr. Wright's conclusion and recommendation, in the same article, as to what the primary cost accounting principle applicable to Government contracts should be. This is quoted from pages 167 and 168 of the JOURNAL, as follows:

> ". . . . Cost principles used in contract pricing if they are to apply in many situations should, in my opinion, be based on the following assumptions:
>
> (1) Cost is something to be determined, not negotiated;
> (2) Competition in the market place will create equity;
> (3) The Government should recognize its share of the operating costs of the supplier;
> (4) The Government will not exercise its sovereign rights in a contractual situation.

Based on these assumptions, the author would propose the following as the primary cost accounting principle applicable to Government contracts:

> 'All costs incurred solely for the benefit of the Government contract shall be charged directly thereto; all cost incurred solely for the benefit of other classes of work shall be charged directly to such classes of work. Other costs incurred benefit both classes of work and shall be allocated to each in proportion to the benefits derived or reasons for incurring.'"

Obviously, Dr. Wright's position is much closer to that of industry than it was portrayed to be.

These are, therefore, usable tests recognized by all parties to the present discussions. All that remains to resolve these differences, then, is to agree on the kinds of tests to be applied in utilizing such terms as "reasonableness", "allocability", "standard accounting principles", and "consistently applied." We believe a joint effort can also resolve these problems. As requested, there is included in the attachments hereto recommended tests of "reasonableness". This has been drafted carefully and has recognized agreements with much that is contained in the DOD proposed definition (Section 15-201.3).

The use of "reasonableness", "allocability" and like concepts as tests are wholly consistent with accounting by "function", and the separation of "principles" from interpretations and instructions, as heretofore recommended. When recognized as adequate tests, they also go far to justify the recognition of all normal and legitimate costs, as we have urged.

III. APPLICABILITY

In preparing a single set of comprehensive cost principles and providing that they will be applicable clear across the procurement spectrum from cost reimbursement type contracts on one side to price analyses submitted with bids for firm fixed price negotiated contracts, including termination or change order repricing claims against any type of contract, however placed initially, the Department of Defense has made the fundamental assumption that cost allowability is an identical problem throughout this spectrum and in each of the covered types of transactions. We agree that a cost is a cost wherever incurred. Because the proposed regulations arbitrarily exclude certain normal or legitimate costs from consideration, the Government's proposals of areas of applicability become impractical and patently unjust.

If "fairness" is the ultimate test, as we have recommended, then it must be conceded that there is nothing fair about both retaining the unilateral right to cancel a contract for the Government's convenience, and then - when that right is exercised - changing the ground rules of allowable costs of termination even though the initial contract may have been placed through advertised bidding, or on a negotiated firm fixed price, or at a time long before the new regulations were even promulgated! Yet in the absence of language to the contrary, this is a sure result of the presently proposed language. Similarly, it is not fair to require

a contractor to certify that something less than legitimate costs, actually incurred, are "total costs." Such costs do not become a "profit" merely because they are "disallowable" under arbitrary Government regulations. This is another inevitable result of blindly accepting these proposed regulations.

It is also interesting to contemplate the regulation's effects upon the "growing-in-popularity" incentive type contract. Consider the incentive contractor who, against a $1000 target cost, is to be paid $100 profit, or a total of $1100. It actually performs the contract with total costs of $950 but which, under these regulations, might well result in allowable costs of only $900. If the incentive profit division is 80% to the Government and 20% to the contractor, the contractor would receive a price of $1020, thus being required to give $80 of the "savings" back to the Government, even though he had already actually paid out $50 of that $80 as costs incurred. On his basis of costs, he would have received a price of $1060 and a profit of $110. Thus his absolute and actual profit is reduced from the target of $100, or from the deserved profit of $110, to $70, but the Government would report to a Renegotiation Board that he had received a profit of $120! This simple example, we submit, clearly demonstrates the unfairness of applying to incentive contracts any cost principles which do not recognize all normal and legitimate costs of doing business.

We cannot emphasize too strongly that experience of the last decade indicates that to the extent that costs are rigidly decided to be allowable or unallowable, formula price fixing is automatically involved. Despite the sincere instructions in this draft that costs shall be only one factor of pricing, the draft actually requires that many costs called "unallowable" be eliminated from the submission from the outset. Thus such costs will never be considered in negotiation, and will never become a factor in pricing. To this degree, formula pricing has already occurred. In this atmosphere, an increased use of formula pricing will be an inevitable result of putting regulations out in this format and of this character. The Hoover Commission, in 1955, recognized this in its recommendations for revisions in ASPR, Section XV, when it recommended cost principles only for cost reimbursement type contracts, and that there only be "guidelines for auditors" as to everything else.

Are "costs a factor" in any negotiation before such costs are incurred? They are not then costs, but only estimates of what costs will be - and one may argue, but never decide, as to which is the most accurate of different estimates. A final meeting of the minds occurs on price, not on costs - and this necessitates each party taking a risk of being wrong. This, however, is nothing to fear, or to be ashamed of, for this has been the trading technique of centuries, and has provided the highest incentives to efficiency. To go to or toward rigid formula pricing is to diminish or remove such incentives.

Implication exist that these proposed regulations may broadly apply to subcontractors and vendors. There is no privity of contract between the Government and a subcontractor on any tier below the prime contractor itself. There can be no assurance, therefore, that a prime contractor can, even in the best of faith, in all cases obtain necessary goods or services from subcontractors under contracts containing Government clauses or incorporating by reference Government cost or other regulatiions. Nor can it always require its subcontractors so to contract with their vendors and suppliers. This has been the repeated experience in many instances where such attempts have been made. Also it is impossible to predict

or anticipate at the time of initial negotiations, all such problems which may arise with subcontractors. Thus, if applied to subcontractors' costs, this regulation would appear in some cases to have the effect on the prime contractor of forcing it to accept not only the disallowances of some of its own costs, but also of some of its subcontractors' costs. In other cases, it would deny the availability of subcontractors to primes, thus forcing the use of second-best sources.

For these reasons, and those advanced at the 15 October conference, we strongly urge, at the very least, that this regulation not apply to fixed price negotiations, or to the preparation of cost estimates or price analyses in negotiated procurements or terminations, and that its use in such circumstances be specifically negated; and that it not apply to any determinations of costs or prices under any contract or subcontract in which it is not specifically accepted by the contractor. If, however, the regulations are redrafted on the principle of recognizing all normal and legitimate costs, reasonable in amount and fairly allocated, then their applicability could be expanded. We oppose in principle, however, any use of cost data as a formula basis for negotiating prospective firm fixed prices.

IV. EFFECTIVE DATE

The regulations as proposed are completely silent on when and how they will be made effective. This is a matter, however, which cannot be left undecided.

If the regulations are applied, in any way, to contracts in being, the Government should be prepared to negotiate equitable adjustments of price. This applies to contracts placed by advertised bids as well as by negotiation, for the applicability to termination settlements and pricing change orders affects these contracts, too. We see no other way of being fair in making these regulations effective. To say that they shall apply only to contracts negotiated after a certain date, or executed after such a date, will not suffice - for then a contractor is left with two different sets of cost accounting rules to apply - one as to old contracts, and one as to new. This would continue until all present contracts are run out, which could be years ahead. Experience under ASPR, Section XV has shown that auditors and negotiators would try to apply the new regulations to existing contracts, whether the contractors had agreed to accept them or not. This would only cause confusion, more delay, and more friction between Government and business.

To be fair, then, the Government must be prepared to pay for taking away rights to cost recovery. Parenthetically, but also of importance, it must also be prepared to accept and pay indefinitely for materially longer times for cost and price presentations, audits, and negotiations, and substantial delays in completing procurement and pricing actions. It just takes longer to isolate, review, audit, discuss and decide about over 60 elements of cost than it does 18, or none. This will cost money to both the Government and the contractor in higher administrative costs and time delays.

V. REQUIREMENTS OF PUBLIC INTEREST

At the 15 October conference, it was pointed out that Government officials "must weigh rather carefully and rather heavily the public interest factor." Several

spokesmen alluded to this, and to "public policy" or such phrases, directly or by implication. For example, one said, "are based not necessarily on public policy stated in law, but on public policy which we derive from many sources, from committee hearings, for example, personal conversations, and formal memos from the various members of the legislative branch."

We are sure that few of us in industry can appreciate the extent or the nuances of pressures of many kinds which must be placed upon you and your staff, directly or indirectly - including those from industrialists! As citizens, we want the public interest protected, and public officials placed under pressure to protect them. At the same time, however, we want to be sure it is public interest, or that it is public policy - and not merely some individual's concept of it, that causes a decision to be made adverse to the interests of industry, and ultimately to the Government itself.

In this area of cost principles, of allowable or unallowable costs for contracts, etc., we do not know of any official or clearly identified legislative expression of public policy. We do know of an expression of policy by an agency of Congress - the Hoover Commission - which we have already quoted and endorsed. We know of some individual rulings of the General Accounting Office on cost allowability - but each of necessity is narrowly restricted to the facts of the particular case, and is not unchangeable, overriding policy, nor should these be deemed to be the establishment of policy. The same is true of rulings by the Boards of Contract Appeals.

The proposed regulations depart from and are more restrictive then all of these, in one way or another. Where, then, is the public policy or public interest dictating such action? We fear that it is in the minds of staff personnel, overly concerned with the attitudes or expressions, however well considered or not, of vocal or powerful legislators or other Government officials. Let us recognize that public policy in this field does not exist, and will not exist until you and the other Assistant Secretaries make your decisions identifying the official public policy of the Defense Department on which you are relying. It is our belief that you have not been restricted in your decisions by any official of the Government, even though certain members of Congress and of the Administration may be impatient to have you reach decisions. This is why we have put forth, successively, such efforts to try to apprise you of industry's sincere and objective views on these problems.

We may be considered by some to be biased, but we believe very deeply that the welfare of our country's 20,000 defense contractors, large and small, is important not only to defense, and maintaining our armed might, but also to the overall economy and welfare of our cities, towns, states and nation. These will be hurt by these proposed regulations - not vitally, but significantly - and their profits, already below those of other industry, will be still less. Before the action is taken, therefore, we request that you weigh very carefully whether any public policy requires or makes desirable the infliction of this hurt.

VI. ADVANCE UNDERSTANDINGS (Section 15-204.1(b))

Industry welcomes any opportunity to agree in advance on cost principles, cost allowances or any other points of potential controversy which might arise during or after contract performance. If the intentions of this section as we were given to understand on October 15 is truly to make available to contractors

the privilege of taking up questionable items in advance and will not be deemed to be a requirement, we believe it to be desirable. However, the language of the section does not make this sufficiently clear and we are fearful that the good intentions at the Secretarial level may not be carried out in the field.

Such agreements to be practical, can be on a contract-by-contract basis as to only three of the cost elements listed. These are: (v) pre-contract costs (ASPR 15-204.2(dd)); (vii) royalties (ASPR 15-204.2(jj)); and (ix) travel costs, as related to special or mass personnel movement (ASPR 15-204.2(ss)(5)). All others must of necessity be treated uniformly and on an overall basis. No forum is provided for such overall negotiations, nor is any basis provided for effecting agreements binding for all Government end-use work, whether as a prime or subcontractor. The latter is especially burdensome for small businesses doing business as subcontractors to many large primes.

Comparisons to custom under Part 5 of the present ASPR, Section XV are invalid, as such discusssions have often been with auditors and not contract officers, and not always embodied in formal contracts or agreements. Nor are such overall agreements favoritism to contractors, for no special advantages are sought - only uniform treatment of these kinds of indirect costs.

This section, then, should be deleted in its entirety, for the reasons outlined at the 15 October conference. If retained, however, it should affirm that failure to negotiate in advance does not lead to disallowance, that initially negotiated amounts or clauses may be reopened on showing of necessity or changed circumstances, and it should provide a forum in which contractors might negotiate these factors on an overall basis.

VII. INDIVIDUAL ITEMS OF COST

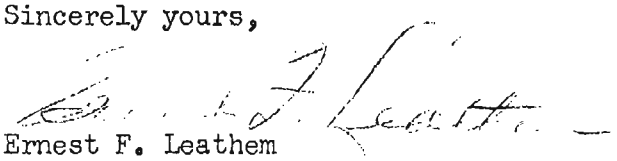
We could extend our remarks at the 15 October conference and debate further on each individual item discussed. This would be unnecessary if you accept our basic premises, as heretofore outlined, for then you would not issue, as an ASPR, any statement on allowances, disallowances, or review requirements for individual elements of cost. If, on the other hand, you should decide to continue the present format and approach implicit in the outstanding drafts, then, though in overall disagreement, and in addition to the comments herein above expressed, we would want to be heard on individual items as completely as possible. Towards this purpose, we have prepared and attached an illustrative list, with only a minimum of justification, stating industry's position both on those items discussed at the 15 October conference, and on those items not discussed but as to which disagreements still exist. We shall, of course, be glad to amplify these in writing or in person to any extent you or the other Assistant Secretaries may wish.

Apart from these items, it was apparent at the 15 October conference that considerable redrafting of the proposed regulations is necessary to clearly express the matters on which there is no disagreement except as to semantics. When your overall decisions are reached, we hope that their implementation, as well as these corrections, can be made the basis of a joint drafting effort by a very few persons from Government and industry who are not committed to the old words and the old

cliches. Such a procedure has been expeditious on other subjects - it should be on this one, too.

In conclusion, may we express again our appreciation for your sincerity and patience in hearing us out on these difficult issues. You have an opportunity to make a unique and lasting contribution to the health and welfare of our defense effort and the industries which are participants in it. We hope that we have helped to show you how that can be done.

Sincerely yours,



Ernest F. Leathem
Associate Chairman
October 15, 1958 Conference

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ATTACHMENTS

I. TEST OF REASONABLENESS

We propose the following:

(a) In evaluating estimates or actual costs of performance of specific contracts, the application of the test of reasonableness requires a flexibility in understanding and the exercise of sound judgment in dealing with the specific item after consideration of all influencing or related factors.

(b) Evaluations of reasonableness, of necessity, involve consideration of 1) the function of the cost, 2) the amount of the cost, and 3) circumstances under which it was incurred.

(c) These elements may then be tested against one or more of the following factors as appropriate:

1) Whether the cost is recognized as an ordinary type of expense in the conduct of the contractor's business.

2) Whether the cost makes a functional contribution to the conduct of the contractor's business.

3) Whether the cost was incurred in accordance with established policies and practices of the contractor.

4) Whether the level of the cost is consistent with the prior history or experience of the contractor with regard to the cost, adjusted for changed conditions.

5) Whether the cost is compatible with the prevailing level of comparable costs incurred in similar concerns, in the same geographic area, or in industry in general.

6) Whether the cost exceeds that which would be incurred by an ordinary prudent person in the conduct of competitive business giving recognition to the circumstances under which it was incurred.

(d) In the negotiation of fixed price contracts, the presumption of reasonableness, of costs, as such, is not applicable inasmuch as the controlling element in such negotiation is the overall price.

(e) As to allowability of costs under cost reimbursment type contracts, the presumption of reasonableness shall be accepted unless the cost is patently unreasonable either as to type or amount when measured by applying the appropriate factors of those listed in (c) above. Prior to making a determination of unreasonableness, the contractor shall be given the opportunity to submit data sustaining the reasonableness of the cost. The burden of proof shall be regarded as having been met if the evidence submitted sustains the reasonableness of the cost under the circumstances in which it was incurred.

II. ADVERTISING - Section 15-240.2(a)

Industry recognizes that some forms of advertising are seldom, if ever, properly allocable to Government contracts, but these are far narrower than the areas of advertising, and other types of costs, absolutely excluded and made unallowable by this section. It protests, therefore, such absolute exclusions and wants the right to present its case in negotiations to show whether and to what extent its advertising is of benefit to the Government, is reasonable in character and amount, and is fairly allocable to Government contracts. This is especially necessary in view of the breadth of definition given to advertising in this section and the artificial distinction drawn among varying advertising media.

Here, as in all specific elements of costs, we recommend that there be no exclusions by definition, and that the tests of allowability should be defined, and not the tests of unallowability. This would relieve cost elements of the stigma of unallowability in general.

III. COMPENSATION FOR PERSONAL SERVICES - Section 15-204.2(f)

The 21 August 1958 revisions to this section are a great improvement, but a few needs for clarification remain, as pointed out specifically by the industry spokesman at the 15 October conference. As no serious disagreement seems to have evolved at the 15 October conference, this seems to be purely a drafting problem. It would be helpful, however, to reduce the quantity of needless reviews by shifting the burden from the contractor (to prove reasonableness) in part to the Government (to allege unreasonableness).

IV. RESEARCH AND DEVELOPMENT - Section 15-204.2 (ii)

We propose the following specific language to substitute for this clause:

> "1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which 1) normally follows basic research, but may not be severable from the related basic research, 2) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and 3) represents efforts to 'advance the state of the art'. Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale.
>
> "2. Development is the systematic use of scientific knowledge which is directed toward the production of or improvements in useful products to meet specific performance requirements, but exclusive of design, manufacturing, and production engineering.
>
> "3. A contractor's costs of independent research as defined in (1) above (not sponsored by a contract, grant or other arrangement,) shall

be allowable as indirect costs, provided they are incurred pursuant to a broad planned program reasonable in scope, with due regard to expansion when justified by changes in science and technology, and which is well managed. Such costs should be charged off as incurred, and not capitalized, and shall be equitably allocated to all the work of the contractor, but in appropriate cases, such allocations may be made separately for each of acontractor's organizational segments.

"4. Cost of contractor's independent development, as defined in paragraph (2) above (which are not sponsored by a contract, grant, or other arrangement), are allowable to the extent that such development is related to the product line for which the government has contracts and provided such costs are reasonable in amount and are allocated as indirect costs to all work of the contractor on such contract product lines. Such costs may either be allowed as incurred, or capitalized and amortized over a reasonable period, but the method of recovery chosen by the contractor must be uniform and consistently applied.

"5. If provided for under the contractor's accounting system, independent research and development costs may, but are not required to include amounts representing appropriate shares of indirect or administrative costs."

This supports the basic industry position that applied research should be grouped with basic research, and not with development (which Mr. Holaday's comments supported). These costs should be recoverable against the base of all contracts of any type to the proportion which Government business bears to total business or in accordance with other acceptable methods of allocations. Development should be recoverable against all types of contracts, included within the product line toward which the development is directed.

On study we believe this clause will be seen to provide the overall controls sought by Messrs. Munves, Golden and others at the 15 October conference. On the other hand, the proposed language in the 21 August 1958 draft would exclude entirely all applied research cost recovery unless it was related to production work in contract product lines. This is impractical because such research begins long before such a relationship can be identified. Also it excludes any recovery of that portion allocable to research and development contracts. This is manifestly unfair, especially to those companies whose Government work is largely, but not wholly, on that form of contract. Moreover, the requirement for applying departmental overhead to R&D jobs should be permissive and not mandatory since the proposed draft would force a contractor to perform his accounting in a prescribed way.

V. CONTRIBUTIONS AND DONATIONS - Section 15-204.2(h)

It is contrary to every instinct of humanity and fails completely to recognize industry's public and community responsibilities to deny acceptance of its expenditures for contributions and donations as normal and legitimate costs. The fear of the Government seems to be excessive gifts or improper objects of giving. These certainly can be defined, and tests of reasonableness established which are acceptable to both industry and Government. Every other branch of the Government recognizes such expenditures as costs, except the Defense Department and GAO.

incurred costs. Such management cannot ignore the fact that by their very nature defense contracts often generate more requirements for working capital than any other kind of business.

Finally, this is another instance in which all that industry seeks is an opportunity to make its case in negotiations freely conducted, and not to be foreclosed arbitrarily from such negotiations.

VII. PLANT RECONVERSION COSTS - Section 15-204.2(cc)

Industry believes that there are circumstances not within the limited allowability provided in this section, and that these should be left open for negotiation. This is another instance of unreasonable and arbitrary disallowance in an area where adequate controls upon allowability should be readily devisable, or could be negotiated in advance on a case-by-case basis. This matter can be resolved by a joint drafting committee.

VIII. OVERTIME COMPENSATION - Section 15-204.2(y)

Industry's recommendations are limited to requesting a clarification between overtime premium pay and shift premium pay, both in ASPR, Section XII and any new Section XV.

This matter can be resolved by a joint drafting committee.

ITEMS NOT DISCUSSED AT 15 OCTOBER 1958 CONFERENCE

IX. RENTAL COSTS - Section 15-204.2(hh)

The provisions of this section, both as to normal rentals and lease-back rentals, are unrealistic and inequitable in that the tests of reasonableness are much too narrow. The ultimate test should be the rental value of comparable properties, and not comparisons to costs which the contractor would have sustained as owner. For example, the actual owner is entitled to a profit, to be included in his rental, and not just a bare cost recovery.

Full recovery of actual lease or lease-back costs have been maintained and allowed in decisions of the Armed Services Board of Contract Appeals.

It would be unfair as to present lease or contractual commitments which cannot be altered to disallow now legitimate costs incurred thereunder. This is a typical example of the injustice of changing rules in mid-stream.

X. CIVIL DEFENSE COSTS - Section 15-204.2(e)

It is unrealistic, and a detriment to the perfection of civil defense plans for a community or area as a whole (which certainly must be done under threats of A or H bomb damage), to deny allowability to reasonable expenditures undertaken off or away from the contractor's premises, and for contributions to local civil defense funds and projects. The latter usually consist of employee time and

This is a very small percentage of total costs for most contractors, but is a very vital one in maintaining external and community relations.

VI. INTEREST - Section 15-204.2(g)

The Government spokesman at the 15 October conference took a position contrary to all fact when he said that interest "is not a price paid for something used in production." It is incredible for anyone to think that a business can be run or a Government contract produced without money, and that there is not a price to be paid for money. The simple fact is that interest is a vital cost of doing business. Indeed, this cost of capital ranks with the cost of material, the cost of labor, the cost of overhead, etc., as the fundamental costs of conducting any business operation.

The most frequently presented arguments against interest recovery hinge primarily upon the thesis that the Government should not favor those companies which engage in substantial borrowing over those companies which rely primarily upon equity capital. The proponents of such a thesis are ignorant of the peculiar set of economics in military business as opposed to the acceptable economics of ordinary commercial business. This separate set of economics must dictate to the sophisticated and competent management of a military company that the best interests of their stockholders are served by engaging in an optimum amount of borrowing to finance the working capital requirements of military sales. This "leverage approach" is not used for the purpose of pyramiding the earningson stockholders' equity, but rather because of the cyclical, expandable and contractible, nature of military business. Since most borrowings are of the short-term or V-Loan nature, which too is expandable and contractible, management can to some extent insulate the company's financial status against the cyclical hazards inherent in military business. To do otherwise, i.e., to rely solely or primarily upon additional stockholders' capital for the financing of military sales, would, by an professional investor standards, represent poor management policy. Very simply, to have committed the corporation to a broadened stockholder capital base and to be faced subsequently with a contraction in its military sales would result in a diluted and weakened corporate status. Indeed, the corporation would at that time look like an "uninvested" investment trust.

If, however, the financing of this business was pursued intelligently via optimum borrowings, rather than additional stockholder capital solely, the corporation would have its stockholder capital reasonably undiluted after both the military sales and the aforementioned borrowings have been contracted and its financial status, although reduced, would still be one of a going business. It is for the Government's protection that these military contractors remain going businesses, following any contraction periods, since it might have to call upon these contractors again in the event of a sudden outbreak of hostilities. Financing solely through stockholders' capital will result in the virtual destruction of these companies following a contraction period because stockholders will have descended upon these corporations and divided the swelled cash purses. However, if these corporations remain financially sound and flexible with an undiluted equity base during any interim contraction periods, they will retain the capability of meeting any new military requirements at short notice.

Therefore, the granting of interest recovery by the Government is <u>not</u> a subsidy for weakly managed and weakly financed corporations, but instead represents compensation to the well managed and well financed corporation for very properly

XV. FINANCING COSTS OTHER THAN INTEREST - Section 15-204.2(q)

Financing and refinancing costs are an inevitable part of the costs of doing business. These costs should not be shoved over entirely against commercial business. Government should bear its fair share.

Does anyone really believe that financing is not required to do business with the Government?

XVI. MAINTENANCE AND REPAIR COSTS - Section 15-204.2(t)

Industry recommends an unqualified allowance of such costs, and hence, the deletion of subparagraphs (1)(i) and (ii).

XVII. MATERIAL COSTS - Section 15-204.2(v)

Technical revisions are required in subsections (2), (3) and (4) to assure that the contractor is entitled to recover its full costs of materials, and to recognize varying acceptable accounting practices. As to subsection (5), the allowability of prices in interdivisional transactions is too narrowly defined and needs extensive revision, especially to recognize the fact that competitive costs exist as to wholly Government end-use components as well as to commercial components.

XVIII. ORGANIZATION COSTS - Section 15-204.2(w)

True costs of organization are an inescapable cost and should be allowable if amortized on a reasonable basis. Without them, the contractor would not exist to undertake contracts for the Government.

XIX. PATENT COSTS - Section 15-204.2(z)

This section is unduly restrictive in its wording, and could be materially improved by a joint drafting committee. The Government certainly should not, directly or by implication, disallow the costs of obtaining and protecting patents to which it wants or claims license rights and, in addition, it should bear its allocable share of patent costs incurred by the contractor.

XX. PROFESSIONAL SERVICES COSTS - Section 15-204.2(ee)

The success of a suit against the Government, or of defending a suit brought by the Government, is proof of the contractor's inherent rights. The professional costs of defending these rights should, in all fairness and equity, be allowable.

Technical corrections and changes are also desirable in the tests of reasonableness and allowability contained in subsections (1) and (2) of this section.

equipment (trucks, mobile radios, etc.) rather than cash, and are closer to plant protection costs than to charitable contributions.

The limitation that expenditures must be made at the suggestion or requirement of civil defense authorities is not only unrealistic, but a direct violation of management's right and duty to protect its properties.

This item is of insignificant dollar value in most companies, but is illustrative of a number of items where partial disallowance is accomplished by definition.

XI. CONTINGENCIES - Section 15-204.2(g)

As to "historical contingencies," industry requests that they not be categorically disallowed, but left open for negotiation. The proposed regulation, in subparagraph (2), is based on the erroneous assumption that because the event giving rise to the cost is in the past, then the actual cost can be definitely known. This is not true in many normal business situations. One typical example is warranty expense.

XII. DEPRECIATION - Section 15-204.2(i)

This section is replete with technical changes requiring the type of language revisions which could be accomplished by a joint drafting committee. The principal matter of substance which, in fairness, should be revised is subsection (5) in order to recognize the national interest in maintaining stand-by defense facilities, even though these are not necessary to current or "immediately prospective" production.

XIII. EXCESS FACILITY COSTS - Section 15-204.2(l)

Limiting the allowance of excess facility costs to "current and immediately prospective purposes" is too restrictive and does not serve the Government's best interests. We feel that those facilities "reasonably necessary for stand-by production purposes" should be the criteria.

XIV. INSURANCE AND INDEMNIFICATION - Section 15-204.2(p)

Industry's objections to this paragraph are technical but vital. These are based upon the premises that (1) the portion of business interruption insurance which is disallowed cannot be avoided by contractors as a normal and legitimate business cost and should be allowed in full, (2) actual losses incurred through an approved self-insurance program or otherwise should be allowed without being contingent upon contractual coverage since these cannot be foreseen in advance of occurrence, and (3) the contractor should not be prohibited from purchasing insurance covering the insurable risk that a contractor has in Government property unless there is a complete relief of liability granted to the contractor.

XXI. RECRUITING COSTS - Section 15-204.2(gg)

We would prefer to see the subject of "special benefits or emoluments" dealt with affirmatively. As presently written the use of "standard practices in the industry" as a criteria for allowance would be most difficult if not impossible to administer and determine. Therefore we recommend changing the last sentence in this paragraph to read: "Reasonable costs of special benefits or emoluments offered to prospective employees are allowable."

XXII. ROYALTIES - Section 15-204.2(jj)

This section needs material revisions and deletions. The determination of the unenforceability of a patent (see subsection (iii)), or of its invalidity (see subsection (ii)), are judicial functions, which under no circumstances should ever be left to the determination of a contracting officer.

Royalty payments are usually based upon contractual obligations freely negotiated at arms length. There is no reason why it is not enough to subject them to ordinary tests of reasonableness.

XXIII. SELLING COSTS - Section 15-204.2(kk)

The philosophy that selling and distribution expenses are generally unnecessary in securing Government business, and hence are unallowable, fails to recognize the many indirect benefits the Government gains from a contractor's sales, distribution and sales engineering functions. The paragraph as written would permit an allocation of only those expenses which consist of "technical, consulting, demonstration and other services" for purposes of adaptation of the contractor's product to Government use. This is an unwarranted limitation and this category of expense should be fully allowable, subject only to tests of reasonableness and allocability.

XXIV. TAXES - Section 15-204.2(oo)

This section requires technical revisions to bring it into accord with recent court decisions, and to permit a contractor to protect property against tax lien enforcement, and to protect its interests in a timely manner when the Government fails to meet date deadlines.

XXV. TRADE, BUSINESS AND PROFESSIONAL ACTIVITY COSTS - Section 15-204.2(pp)

Here again, exclusions by definition occur. One omits from allowability membership costs in service organizations which in fact are required to preserve a corporation's status in its plant communities. The other places overly narrow qualifications (i.e., "dissemination of technical information or stimulation of production") upon meeting and conference expense allowability.

XVI. ADDITIONS NEEDED FOR TERMINATION SETTLEMENTS

Recognition should also be given in the Cost Principles to the following additional types of costs which are experienced by contractors under termination claims:

Common claims of subcontractors
Costs continuing after termination
Initial costs (including high start-up costs)
Interest on borrowings
Loss of useful value of special machinery and equipment
Preparatory expenses
Settlement expenses
Special leases
Subcontract settlements

XXVII COST ELEMENTS MADE WHOLLY UNALLOWABLE

Item	Paragraph of Proposed Cost Principles	Made Unallowabl by Present ASPR Section XV
Bad debts	(Sec. 15-204.2(b))	yes
Stock options	(Sec. 15-204.2(f)(5))	
Historical contingencies	(Sec. 15-204.2(g)(2))	yes
Contributions and donations	(Sec. 15-204.2(h))	yes
Entertainment	(Sec. 15-204.2(k))	yes
Excess facility costs	(Sec. 15-204.2(l))	
Interest	(Sec. 15-204.2(q))	yes
Bond discounts	(Sec. 15-204.2(q))	yes
Costs of financing and refinancing	(Sec. 15-204.2(q))	yes
Legal and professional fees paid in preparation of prospectus	(Sec. 15-204.2(q))	yes
Costs of preparation and issuance of stock rights	(Sec. 15-204.2(q))	yes
Losses on other contracts	(Sec. 15-204.2(s))	yes
Organization costs	(Sec. 15-204.2(w))	yes
Reorganization costs	(Sec. 15-204.2(w))	yes
Costs of raising capital	(Sec. 15-204.2(w))	yes
Legal, accounting and consulting services (of certain types)	(Sec. 15-204.2(ee)(3))	yes
Federal income taxes	(Sec. 15-204.2(oo)(1)(i))	yes
Taxes in connection with financing, refinancing or refunding	(Sec. 15-204.2(oo)(1)(ii))	yes
Special assessments	(Sec. 15-204.2(oo)(1)(iv))	
Taxes for which exemptions are available etc.	(Sec. 15-204.2(oo)(1)(iii))	
Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships	(Sec. 15-204.2(qq)(5))	
Losses from sales or exchanges of capital assets	(Sec. 15-204.2(ff))	yes
Contingent fees for securing government orders		yes

XXVIII COST ELEMENTS MADE PARTIALLY UNALLOWABLE

Advertising Costs	(Sec. 15-204.2(a))	yes
Civil defense costs	(Sec. 15-204.2(e))	
Depreciation on idle or excess facilities	(Sec. 15-204.2(i)(5))	
Use charge in fully depreciated assets	(Sec. 15-204.2(i)(6))	yes
Fines and penalties	(Sec. 15-204.2(m))	
Insurance on lives of officers, partners or proprietors	(Sec. 15-204.2(p)1(v))	yes
Patent costs	(Sec. 15-204.2(z))	
Reconversion costs	(Sec. 15-204.2(cc))	
Costs of special benefits or emoluments offered to new employees	(Sec. 15-204.2(gg))	
Applied research and development costs	(Sec. 15-204.2(ii))	

Item	Paragraph of Proposed Cost Principles	Made Unallowable by Present ASPR Section XV
Accruals for mass or abnormal severance pay	(Sec. 15-204.2(mm)(2)(ii))	
Commissions and bonuses	(Sec. 15-204.2(f))	yes
Unrecovered true depreciation	(Sec. 15-204.2(i)4(ii)	yes
Insurance	(Sec. 15-204.2(p)	
Deferred maintenance	(Sec. 15-204.2(t)1(ii)	
Material costs - credits	(Sec. 15-204.2(v)2)	
" " - writeups or writedowns	(Sec. 15-204.2(v)3)	yes
Lease-back costs	(Sec. 15-204.2(hh)(3))	
Memberships	(Sec. 15-204.2(pp)(1)	
Training and educational costs	(Sec. 15-204.2(qq)(1,2&3)	

XXIX COST ELEMENTS FOR WHICH SPECIAL TESTS OR REVIEWS ARE REQUIRED

Item	Paragraph of Proposed Cost Principles	Made Unallowable By Present ASPR Sec.XV	Special Consideration Required by ASPR Sec.XV
Bidding costs	(Sec. 15-204.2(c))		
Compensation for personal services	(Sec. 15-204.2(f))		yes
Future contingencies	(Sec. 15-204.2(g)(3))	yes	
Emergency depreciation or amortization	(Sec. 15-204.2(i)(4)		
Use charge on fully depreciated assets	(Sec. 15-204.2(i)(6))		yes
Insurance	(Sec. 15-204.2(p))		yes
Costs of materials transferred between plants or affilitates	(Sec. 15-204.2(v)(5))		yes
Overtime, extra-pay shift and multi-shift premiums	(Sec. 15-204.2(y)		yes
Pre-contract costs	(Sec. 15-204.2(dd))		yes
Professional service costs	(Sec. 15-204.2(ee)(1) and (2))		
Recruiting costs	(Sec. 15-204.2(gg))		
Rental costs	(Sec. 15-204.2(hh)(1) and (2)		
Research and development costs	(Sec. 15-204.2(ii))	yes	
Royalties	(Sec. 15-204.2(jj))		yes
Selling costs	(Sec. 15-204.2(kk))	yes	
Severance pay	(Sec. 15-204.2(mm))		
Unadjudicated taxes	(Sec. 15-204.2(oo)(2))		
Meeting or conference expense	(Sec. 15-204.2(pp)(3))		
Travel costs	(Sec. 15-204.2(ss)(5))		

XXX ITEMS ON WHICH ADVANCE NEGOTIATION IS REQUIRED AS A REQUIREMENT OF COST ALLOWANCE

Contingencies	(Sec. 15-204.2(g))
Insurance and indemnification (losses not covered by insurance - Sec. 15-204.2(p)(1)c) (Indemnification - Sec. 15-204.2(p)(2))	
Patent Costs	(Sec. 15-204.2(z))
Professional service costs	(Sec. 15-204.2(ee)(3))
Rental Costs	(Sec. 15-204.2(hh)(3))

MACHINERY & Allied Products INSTITUTE BULLETIN

REPUBLIC 7-6512 1200 EIGHTEENTH STREET, N.W. • WASHINGTON 6, D.C

No. 3569 November 17, 1958

GOVERNMENT CONTRACTS

CONTRACT COST PRINCIPLES: MAPI Files Statement Supplementing Its Presentation During DOD Hearings on Proposed Set of Comprehensive Contract Cost Principles

As indicated in Bulletin 3560, MAPI participated in a joint government-industry conference at the Department of Defense on October 15, regarding the proposed set of comprehensive contract cost principles. Supplementing our oral presentation a written statement has been submitted to Assistant Secretary of Defense Perkins McGuire, the text of which is reproduced in this bulletin.

The MAPI statement of November 14 stands firm on the proposition advanced and documented by MAPI since 1956, namely, that under no circumstances should contract cost principles of the type embodied in ASPR, Section XV, be applied to fixed-price contracts. This position is spelled out fully in the MAPI statement in terms of current public policy on the subject supporting the MAPI position, pertinent regulations of the Department of Defense which would be in conflict with any single set of cost principles, and the need, in our view, of a complete reappraisal of the concept that a single set of cost principles be uniformly applicable in government prime and subcontracting. The Institute has consistently reasoned and argued that the result of the current DOD proposal would be to convert fixed-price contracting into formula pricing as employed in cost-reimbursement type situations.

Our other specific recommendations are summarized on page 12 of the letter to Secretary McGuire. In addition to the problem of fixed-price contracting the statement recommends that advertised contracts, most subcontracts, and contract terminations be excluded from the applicability of the proposed regulation. Treatment of specific cost disallowances is covered in the December 16, 1957, MAPI statement entitled "Defense Procurement and Contract Costs" which is incorporated as a part of our current presentation.

Comments and further suggestions from interested member companies will be appreciated. May we acknowledge again assistance from the MAPI Accounting Council and the CTA Financial Council in connection with the Institute's work in this area.

MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N. W. WASHINGTON 6, D. C. REpublic 7-6512

November 14, 1958

Honorable Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

My dear Mr. McGuire:

In accordance with your suggestion of October 15, 1958, made during the joint industry-government conference, we are submitting herewith a further amplification of the views of the Machinery and Allied Products Institute in regard to the proposed adoption of a comprehensive set of contract cost principles. This statement is presented in behalf of the capital goods and allied equipment industries. Although, as you know, many of the companies in these industries are important government prime and subcontractors, the bulk of their production falls in the commercial area.

May we express once more our appreciation for the personal interest which you and Secretary McNeil have taken in this subject, as evidenced by the October 15 conference and by your willingness to receive supplementary written statements of industry views. Ideally, we might have hoped for additional time in which to file our supplemental statement, but we are most anxious to comply with the filing deadline of fifteen days from the date on which the transcript of the October 15 meeting was received by this organization.

In our opinion, the proposal for application of a set of comprehensive cost principles to all types of negotiated contracts becomes wholly meaningful only as we relate it to developments in the entire field of national defense. For this reason we should like to review briefly the history of its suggestion and--before proceeding to any detailed examination of the proposal itself--to set it against the backdrop of our total national defense program, considering it in this broader perspective.

The antecedents of the present proposal.--For some years the Department of Defense, acting partly upon its own motion and partly by reason of suggestions from Congressional committees and the General Accounting Office, has attempted to develop a set of cost principles which could be applied to negotiated, fixed-price contracts as well as cost-reimbursement contracts. This process, covering a period of some four or five years, is an outgrowth, of course, of developments dating back to the World War II use of T. D. 5000, the War and Navy Departments' "Green Book," the post-World War II Joint Termination Regulation and, finally, Section XV of ASPR which controls the reimbursement of contractors' expenses under cost-reimbursement type contracts.

This record of developments, culminating in the present proposal, contains one interesting experience that is especially relevant to the document here under consideration. A Munitions Board memorandum of November 15, 1949, which limited the mandatory application of ASPR cost principles to cost-type contracts, nevertheless permitted their use "as a working guide" in fixed-price negotiations. In practice the working guide assumed the status of a rigid standard and, for this reason, permissive authority for the use of cost principles in connection with fixed-price contract negotiations was revoked by Department of Defense Instruction 4105.11, November 23, 1954.

So much for a brief history of the current proposal's antecedents. Let us now consider the history of that proposal against the broad background of the over-all national defense program.

Urgent need for reappraisal.--This recital of the present proposal's history is important, we think, because of some startling recent developments in military technology that have altered radically and permanently the total defense posture of the United States. The changed circumstances flowing from these developments are financial and managerial as well as technological and strategic. They are of such a fundamental nature as to require a most careful re-examination of all procurement policy and procedure. We believe that you should give primary consideration to the question of whether or not the proposal for a comprehensive set of cost principles drawn in the form of Section XV of ASPR--which has never been a completely sound proposal in our judgment--may not be altogether inappropriate at this time.

The Soviet Sputnik.--As we have noted, the case for application of ASPR cost principles to all types of negotiated contracts has developed during the post-World War II period which culminated in the launching of an earth satellite by the Soviet Union. This latter event, marking the dawn of the Space Age, has given rise to grave Congressional concern with the state of our national defense, highlighted by the hearings before the Preparedness Investigating (Johnson) Subcommittee of the Senate Armed Services Committee.

In addition to its numerous recommendations for enlargement and improvement of our national defense in terms of military programs and weaponry--with which this statement is not directly concerned--the Johnson Subcommittee recommended in connection with stepping up the tempo of our defense effort a simplification of our military procurement procedures. With this latter recommendation our statement most emphatically is concerned.

The testimony of certain witnesses pointed up the shortcomings of our present procurement system, and such testimony is emphasized in the remarks of Senator Saltonstall in proposing certain amendments to the Armed Services Procurement Act (10 USC 2301 et seq.) on October 14, 1958. Senator Saltonstall said:

> "We have great confidence in the vitality and initiative of American industry. The free competitive system which has enabled our nation to achieve unheralded industrial advances should be able, as it has in the past, to achieve military weapons superiority second to none. But, as Professor Livingston of Harvard so aptly pointed out when he testified before the Preparedness Investigating Subcommittee hearings, our present system of defense contracting does not encourage those forces in our industrial establishment to work... Ironically, Livingston pointed out, even in the controlled economy and industrial establishment of the Soviet Union great rewards were provided for success in scientific and technological areas, and penalties for failure. The Russians know full well the virtue of the incentive system. If the future security of the United States depends upon its ability to develop in the shortest possible time modern weapons of destruction so as to deter our enemies from aggression, then we must make full use of the inherent characteristics of the American industrial system which give it vigor and strength."

It should be emphasized that the remarks of Senator Saltonstall and Dr. Livingston are typical of suggestions, both in and out of government, for increasing contractor incentives.

Contradictory trends in government procurement.--The spirit of the observations quoted above appears to have been reflected in a series of developments within government itself. First, it seems evident that the Military Services themselves are undertaking a fresh appraisal of the awesome technological problems thrust upon them by the Space Age. There is evidence, moreover, of a desire on the part of the Services to share increasingly with private industry the technological and financial burdens thus created.

General Quesada, newly appointed Administrator of The Federal Aviation Agency, bespoke this attitude in a recent speech in which he suggested that industry and government must "start work immediately on working out some new concepts embracing the ways in which we reward industry's efforts for scientific and technological development of advanced weapons." The report of the ad hoc Committee on Research and Development of the U. S. Air Force Scientific Advisory Board--the Stever Report--emphasizes the same point in these words: "Contracting procedures should be changed to give contractors greater incentive to do research development work more effectively." In the legislative area the extension of the Renegotiation Act for a period of only six months--with the proviso that the process be subjected in the meantime to a searching Congressional study--would seem to offer further evidence of a new look by Congress at the whole question of providing incentives and removing disincentives to more efficient production of war materiel.

Within the framework of the Armed Services Procurement Regulation itself we find within recent months substantial improvement in regulations relating to pricing policies for negotiated contracts and in the acquisition of contractors' proprietary technical know-how. This whole complex of statements and action had encouraged us to believe that a new spirit was abroad in the whole area of government procurement. Unhappily, the dogged pursuit of this proposal for an across-the-board application of cost principles seems to us wholly inconsistent with the current emphasis on the new spirit described above and would, in our judgment, represent a serious backward step.

Let us turn now from the background of this proposal to a more detailed examination of specific questions which it involves.

Considerations of Public Policy

In the recent industry-Department of Defense conference on this subject, repeated reference was made by government spokesmen to considerations of public policy, particularly as they dictated the disallowance of certain items of expense regarded by industry as normal costs of doing business. Although raised for the most part in connection with the discussion of specific items of cost, we suggest that certain overriding considerations of public policy apply with even greater force to the question of the applicability of contract cost principles with which this supplemental statement is primarily concerned.

A reading of the Armed Services Procurement Act (10 USC 2301 et. seq.) in conjunction with its principal administrative implementation, the Armed Services Procurement Regulation, makes the advertised bid method of public contracting a preferred method as an unmistakable matter of both legislative and administrative policy. Although the statute deals with the point only by indirection, ASPR, we think, harmonizes completely and specifically with legislative intent in according the next order of priority in procurement preference to the firm, fixed-price contract. (Since the descending order of subsequent preference is well summarized in a quotation from Lt. Col. George Thompson, USAF, appearing at a later point in this statement, we shall not now dwell further on the matter.)

In addition to these express legislative and administrative preferences of procurement policy, ASPR itself contains one further significant statement of general procurement policy that deserves repetition in this connection: "It is the policy of the Department of Defense to procure supplies and services from responsible sources at fair and reasonable prices, calculated to result in the lowest ultimate over-all cost to the government."

We regard these propositions as central and fundamental policies of Defense procurement to which all other considerations of public policy--from whatever source drawn or imagined--must be subordinated. Moreover, we cannot believe that policy demands a broadened application of proposed cost principles if, as a result, "ultimate over-all cost to the government" is increased. And this is precisely the result we predict in that eventuality.

At the risk of repetition we cannot fail to add that the widespread and continuing suggestions for the enhancement of private incentive in defense

work--to some of which we have referred briefly above--are not only entirely consistent with these basic policies of military procurement but would lead almost certainly, in our judgment, to improved contract performance, an increased interest in defense production and a very considerable reduction in ultimate over-all cost to the government.

The real issue to be decided.--The realities of the situation as well as the evident concern of your staff with questions of public policy demand that the resolution of the question now before you be based upon the broadest possible considerations of public policy. This being so, the issue to be decided may be stated very simply: Would the present proposal for application of contract cost principles in their present form to all types of negotiated contracts serve the public interest?

We do not believe that it would.

The Present Proposal

In turning to the applicability of the proposal before you, we should point out once more that we do not regard ASPR cost principles--in either their present or proposed form--as desirable or proper standards even for cost-reimbursement type contracts.

The principal change in procurement practice to be effected by adoption of the current proposal would consist in applying a revision of the present ASPR cost principles to fixed-price as well as cost-reimbursement type contracts. Having in mind the effect of the proposal's adoption upon the broad public policy question posed above, we should like to consider it in terms of its essential nature, its effect on negotiated, fixed-price contracts, its use and effect in "cost-related areas," its effect upon normal business incentives, its effect on subcontracts, its effect on contract termination, and its effect upon the normal incidents of contract negotiation.

The nature of the proposal.--As a part of the colloquy on the subject of applicability at the recent Pentagon conference, the observation was made that industry spokesmen were confusing the applicability of proposed cost principles with their content. We submit that one can no more consider the results of applying this proposal without considering all four corners of the document than one could judge the worth of a horse without examining the beast. What, exactly, is the nature of this proposal?

Although the document here involved purports to be a statement of cost principles, it consists in fact of a relatively brief statement of principles followed by an extended and detailed specification of costs which are allowable or unallowable in certain contract situations. Experience persuades us that in a practical contracting situation the statement of principles, such as it is, will be disregarded and the contract administrator will rely upon the specified list of allowable or unallowable costs. Moreover --and despite protestations to the contrary with which we shall deal later-- the extent of allowability or unallowability of any item of contract expense identified in these "principles" would almost certainly be the same under either a cost-reimbursement or a fixed-price type contract.

We have reiterated these elementary propositions only because we regard them as fundamental to any consideration of the applicability of the proposed cost principles.

The proposal's effect on fixed-price contracts.--Having in mind the basic and unavoidable character of this proposal, we reiterate an argument which we have advanced repeatedly in the past that promulgation of a "comprehensive" set of cost principles applicable to both negotiated, fixed-price and cost-reimbursement type contracts will serve to convert fixed-price contracts--in one degree or another--into cost-reimbursement agreements. We regard this result as inevitable, both as a matter of logic and as a matter of experience.

In their present form the proposed cost principles represent an artful piece of draftsmanship and an evident effort to respond to prior industry criticisms relating to the inevitable effects of an across-the-board application of cost principles. Specifically, the proposal declares that cost principles are to be used (1) "for the determination of" reimbursable costs or cost-reimbursement type contracts, and (2) either (a) "as a basis for" the development and submission of cost data and price analyses--in support of negotiated pricing, repricing, etc., or (b) "as the basis for evaluation of cost data" in retrospective pricing and settlement or "as a guide in the evaluation of cost data" in forward pricing.

The excerpts from the regulation quoted above are, of course, those phrases which go to the very heart of applicability of the proposed set of comprehensive cost principles. The distinction which the draftsman of this regulation has attempted to make between applicability of cost principles in cost-reimbursement and fixed-price contract situations is an exceedingly nice one. We believe, nevertheless, that this distinction, however nicely drawn, will become a distinction without a difference in practice.

A chronology of the process by which the present phraseology of applicability came into being may be instructive. When this proposal was first publicly mooted in Mr. Lloyd Mulit's letter of May 28, 1956, the Institute called attention to what we regarded as a built-in weakness in the proposal--"...we urge that any generalization of contract cost principles be so framed and administered that it may not serve as a deterrent to greater emphasis on firm, fixed-price contracting." Doubtless, other industry associations had the same concern.

The September 10, 1957, draft of this proposal attempted--with somewhat less than complete success--to avoid this change by careful distinction as between the proposal's application to fixed-price contracts and cost-type contracts. Our comments of December 16, 1957, once again pointed to the impossibility of a distinction in practice.

Apparently unsatisfied with this attempt, as was industry, Pentagon draftsmen have tried once more with the greatest care and the utmost sincerity to overcome this problem in the language quoted above. We commend the effort. We cannot fail, however, to entertain grave doubts as to the manner in which this theory of differing applicability will be treated in actual procurement practice.

The almost inevitable obliteration of any distinction in actual practice is illustrated by a landmark decision of the Armed Services Board of Contract Appeals, the Swartzbaugh case. As you will recall, the question involved a dispute over the interpretation of a contract price revision article. The contracting officer sought to apply present cost principles. In its opinion the Board said "in contradistinction to a cost-reimbursement contract, Form IV of the Price Revision Article depends on negotiation and its sequel, compromise. Under contracts calling for the reimbursement of costs it is appropriate to audit in detail each expenditure and to test its allowability by the standards of the statement of cost principles (ASPR, Section XV). Such a detailed audit is neither required nor desirable in price revision...The statement of cost principles (ASPR, Section XV) upon which many of the disallowances were specifically based by contracting officers is not controlling in negotiations for revision of price."

The case in question involved a redeterminable, fixed-price contract but the principle announced by the Board of Contract Appeals applies equally to the negotiation of price under any type of fixed-price contract. We believe the philosophy of the Swartzbaugh case is entirely correct, but we think this philosophy would be largely destroyed by adoption of the proposal here under discussion, and The Pentagon's own past experience with the Munitions Board memorandum referred to above further convinces us of this result.

The proposal's use in "cost-related areas".--The case for an across-the-board application of contract cost principles appears to rest finally upon the proposition that such a standard is required for examination of "cost-related areas" under both fixed-price and cost-price contracts. A corollary proposition holds that a cost under a fixed-price contract is no different from a corresponding cost under a cost-type contract and that both should, therefore, be judged by reference to the same standard, i.e., a common or comprehensive set of cost principles.

We think no one would argue seriously that there is any essential difference between an item of expense under a fixed-price contract and a similar expense under a cost-type agreement, nor that the manufacturer incurring either cost must recover it in the selling price of his product. And to argue from this truism that both costs should, or must, be judged by reference to the same standard seems eminently proper as a matter of pure theory.

We are not, however, dealing with a theoretical exercise but a practical procurement situation. Let us consider the effects of the theory.

Assuming a 10-per-cent fixed fee under a cost-type contract, this minor part of the whole price is the absolute limit of the contractor's risk and thus the limit of possible incentive. Conversely, a fixed-price contract, with no predetermined fee or profit, has a much wider area of risk for profit or loss and, logically, a much greater degree of incentive to the contractor. Moreover, it is precisely because the range of incentive in the latter case is so much greater than in the first that fixed-price contracting is preferred as a matter of policy.

This contrast goes to the very heart of our case against a comprehensive set of cost principles just as the propositions recited above

constitute--as we understand it--the core of your staff's case for their adoption. With the issue thus squarely joined let us consider for a moment what this proposal would do to contractor incentive.

It seems to us inevitable that reference to the proposed cost principles in pricing or repricing fixed-price agreements will very greatly reduce the area of risk and the incentive possibilities of such contracts. Insofar as "cost-related areas" thereunder are subjected to the proposed cost principles such contracts will have been effectively converted into cost-type contracts--and price will be established by rote.

Finally, we should like once again to point out that fixed-price negotiations will degenerate into formula pricing at the very time that serious and responsible students of the procurement process are calling for immediate and drastic improvement in defense contract incentives.

The proposal's effect on normal business incentives.--As we have already suggested, both applicable law and regulations express a clear preference in defense contracting for firm, fixed-price agreements let either by formal advertisement or direct negotiation. An excellent capsule statement of this preference has been made by a leading contract pricing authority, as follows:

> "Our objective then is to negotiate a contract type and price that includes reasonable risk and provides the contractor with the greatest incentive for efficient and economical performance. In all cases it is basic to our pricing philosophy that a contractual arrangement lacks incentive until we reach a firm agreement on price. The firm, fixed-price contract obviously supplies this incentive to the fullest degree, and it is the type preferred in the Department of Defense. We also prefer fixed-price types of cost-reimbursement types and firmed fixed pricing over retroactive pricing." (Underscoring supplied.)/1

We concur completely with this statement of policy. Moreover, its emphasis upon retention of maximum incentive to efficient performance is entirely consistent with the observations of General Quesada to which we referred very briefly above. In the course of his remarks on this subject, General Quesada further called attention to the fact that the process of cost reimbursement tends to penalize the efficient producer and to reward the inefficient producer. The point is by no means a new one--although few have made it as well as General Quesada--and we raise it again here simply to reinforce the statement of our conviction that the cost-reimbursement process has a built-in disincentive character which now, in our judgment, would be transferred to all fixed-price contracts by adoption of the present proposal.

1/ Lt. Col. George W. Thompson, "The Pricing Significance of Contract Types Used in Negotiated Military Procurement," XVIII Federal Bar Journal, No. 2, April-June, 1958, p. 136. Lt. Col. Thompson was recently awarded the Legion of Merit for his outstanding contributions to Air Force Procurement.

The Institute firmly believes that the presently proposed set of comprehensive cost principles should have no application to any type of fixed-price contract. As contrasted with the cost-reimbursement situation, the contractor under a fixed-price contract must assume the risks associated with the price fixed prior to the incurrence of costs through contract performance. If the contract price has been fixed at too low a level the contractor may suffer a loss which is not recoverable from the government. Under cost-reimbursement contracting, on the other hand, the contractor faces no such problem. He will be reimbursed for contract costs incurred and, in most cases, will be paid a fixed-fee profit determined by formulas prescribed by ASPR. Under such a contractual arrangement the contractor has little or no incentive for the most efficient and expeditious contract performance. However, in the fixed-price area, when a contractor has no such profit guarantee, contract performance must of necessity be both efficient and expeditious or any originally hoped-for profit will be completely consumed by costs. Thus, under fixed-price contracting, the contractor's incentives and his concurrent risks are maximized.

The proposal's effect on subcontracts.--The manner and degree in which the proposed cost principles would apply to subcontracting are not entirely clear from the draft proposal. Nevertheless, its reference to "the use of cost principles and standards...in contracting and subcontracting" (Par. 15-101) clearly implies a fairly extensive application.

In the vast majority of cases no privity of contract exists between a defense subcontractor or vendor and the government--a point, incidentally, upon which the government has frequently relied to its advantage in proceedings before the Armed Services Board of Contract Appeals. This being true, a cost-reimbursement prime contractor, bound personally by Section XV and with his costs examined by reference thereto, may be placed in the situation of having to justify the costs of a subcontractor over which neither he nor the government exercises any control. He might as a result be required to absorb a subcontractor's disallowances as well as his own. It seems to us also that an already overpowering and very costly apparatus of contract administration will be further enlarged and normal commercial relationships between contractors will be seriously disturbed.

We urge, therefore, if the proposed contract cost principles in their present form are made a part of ASPR that they be amended specifically to exempt from their application all subcontracts which lack privity with the government.

The proposal's effect on terminations.--In its present form the proposed set of contract cost principles would apply to the allowance and disallowance of costs in termination settlements. It would replace the considerably more liberal set of special termination cost principles presently found in Section VIII of the Armed Services Procurement Regulation.

It seems to us that this further evidence of insistence on rigid application of the proposed cost principles in all "cost affected" areas emphasizes once again the spurious logic of applying them to all types of contract price negotiations in the first instance. As we have already suggested

in our discussion of the essential difference between fixed-price and cost-price contracting situations, we think the logic of a general and unrestricted application of the proposed cost principles is wholly illusory.

Rather obviously, a contractor is in no way to blame for a decision to terminate its contract for the convenience of the government. The equities of the situation seem to us to demand a more liberal treatment of accrued costs than would be permitted under this proposal, and the fact that cost principles now appearing in Section VIII of ASPR are, in fact, considerably more liberal, would seem to indicate that this point has been recognized in the past. Moreover, no justification has been offered for a failure to continue to recognize this.

The proposal's effect on the process of contract negotiations.--We have already voiced our concern over the virtual certainty that adoption of the proposed set of comprehensive cost principles would convert many, if not most, fixed-price contracts into simple cost-reimbursement agreements. We think this view is supported when one applies to the present proposal the acid test of a practical contracting situation.

The contracting officer is directed by Section III, Part 8, of ASPR to prepare some form of price analysis in every negotiated procurement. In the absence of competitively established prices available to the contracting officer, his fulfillment of this regulatory requirement customarily takes the form of a demand on the contractor or prospective contractor for a cost analysis of the proposed contract price. (This is borne out by the experience of capital goods manufacturers who report an increasing volume of demands for cost data with respect to negotiated fixed-price procurement together with a concomitant increase in pre-contract audits of contractors' books and records.)

It is understandable that, in many situations, the government will request pre-contract cost analyses. This is done on the basis that the contractor's costs are a factor to be considered together with many other factors (ASPR 3-101) in determining a reasonable negotiated price.

Two important questions, however, are raised immediately--questions which are made more critical by the proposal now before us. First, are costs as submitted by a fixed-price contractor in a pre-contract price analysis to be judged by the ordinary standards of business or by an arbitrary manual of cost allowance and disallowance? Second, assuming a pre-contract audit, what form will that audit take and to what use would it be put?

The first of these questions answers itself when one examines the present proposal. The second, relating to the form of a military audit report, has been described by one of the members of the Navy panel of the Armed Services Board of Contract Appeals as follows:

> "In other than cost-reimbursement contracts, the government audit report is merely advisory and generally the form of the report clearly segregates, in separate columns, those costs which are accepted, those which are questioned, and those which are disallowed--so as to permit proper examination at the contracting officer and

Board levels in accordance with the cost principles applicable to the particular type of contract involved." (Underscoring supplied.)/2

This statement makes clear that advisory audit reports on contractor-furnished data presently include an itemization of "unallowable" estimated costs. To what extent such "unallowability" is presently based on ASPR Section XV is not at all clear; if Section XV is now made directly applicable to fixed-price contracts there can be no question as to the source of such "unallowability." Indeed, such advisory audit reports would probably serve, under a broadly applicable set of cost principles, as the basis for unilateral disallowance of expense items now proscribed by the proposed draft of comprehensive cost principles.

Faced with an "advisory" audit report based directly on a revised Section XV of ASPR--as here proposed--and which "advises" him that many of the contractor's costs are "unallowable," can we expect our hypothetical contracting officer to engage in the "exercise of sound judgment" which another section of ASPR (Part 8, Section III) demands of him? As a practical matter, we think his judgment will have been stultified by this development.

Thus, it seems to us that the fictional character of the distinction now sought to be drawn between the application of cost principles to fixed-price contracts and to cost-type contracts (see page 6, supra) is amply illustrated.

The proposal's effect on the "All Costs" concept.--Just as we believe the adoption of this proposal would so circumscribe a contracting officer's area of discretion as substantially to deprive him of the exercise of any real judgment in contract negotiations, so do we think it would inevitably tend to make unallowable under fixed-price contracts certain unquestioned costs of doing business which are presently disallowed under cost-type contracts.

Consider once again the "advisory" audit report to our hypothetical contracting officer who is directed by the regulation "to employ Section XV of ASPR as the basis for the evaluation of cost information...Whenever such information becomes a factor in pricing, repricing, etc.,..." This means, of course, that some thirty-odd specific elements of normal business cost are to be regarded as unacceptable and are to be disregarded in arriving at a contract price.

The Institute has long objected to the arbitrary and categorical disallowance under cost-type contracts of such items as advertising, selling expenses, etc. We have thought such rejection economically unsound and, in the long run, unwise from the standpoint of both government and industry. To adopt the proposal for a comprehensive set of cost principles will compound the direct subsidy to the government--and the corresponding disadvantage to other customers of a government contractor--which such disallowance necessarily requires.

2/ John Green, "Costing and Pricing in Contract Appeals Procedures," XVIII Federal Bar Journal, No. 2, April-June, 1958, p. 189.

We repeat our suggestions of the past--which are set out in the attachment to this letter--that, with minor exceptions dictated by law and public policy, those portions of all legitimate and reasonable costs of doing business properly allocable to government work should be reimbursed as proper contract costs. We cannot but view with dismay a situation in which this principle is to be all but obliterated in government contract work.

Specific Recommendations as to Applicability of the Present Proposal Summarized

1. That the draft of comprehensive contract cost principles not be published in its proposed form.

2. That if the Department of Defense desires to pursue the goal of a broadly applicable set of cost principles, that it confine the publication of regulations in the area to principles alone, as suggested on pages 11 and 12 of our letter of December 16, 1957, copy attached.

3. That if a set of cost principles in the approximate form of this proposal is to be published, that certain specific exemptions be made to its applicability, as summarized below:

   (a) That contract cost principles be made specifically inapplicable to (1) advertised contracts, (2) all firm, fixed-price contracts, (3) all subcontracts except those clearly involving privity with the government, and (4) contract terminations. (As a corollary we recommend that cost principles now appearing in Section VIII of ASPR be retained for application to contract termination.)

   (b) That as to all other types of fixed-price contracts, general principles only (enumerated in Paragraphs 15-100 through 15-203 of the proposed draft) as distinguished from that portion of the draft which is a catalog of allowances and disallowances (15-204 "Application of Principles and Standards") be made applicable to such contracts.

Application of Principles and Standards

The Institute has commented repeatedly in the past on the proposed comprehensive cost principles' treatment of specific items of cost. We think it unnecessary to reiterate at length the arguments already advanced in prior statements and, with that in mind, we are attaching an extra copy of our statement of December 16, 1957.

We do want to acknowledge significant improvements which have been made by your staff in the September 10, 1957, revision of the proposed cost principles, particularly in such areas as executive compensation, research and development, and the allowance of overtime costs. Important as those

improvements are, we continue to believe that if the Department of Defense deems it essential to publish a set of cost principles in substantially the form here proposed, then its treatment of specific items of cost should be further liberalized in accordance with prior recommendations in the attached statement.

We should like once again to thank you, your staff, and your associates for your courtesy, your patience, your understanding, and your obvious personal concern with the resolution of this most important question. May I assure you again of the Institute's desire to cooperate in any way possible.

Respectfully yours,

Charles Stewart
President

CWS:mo
Enclosure

B. Differences in specific items of cost

1. Advertising expense - (allow only advertising in trade journals and "Help Wanted" advertising).

Industry: Institutional and product advertising should be allowed as a cost.

DOD: Institutional and product advertising are not necessary to obtaining or performing Government contracts. Only advertising in technical journals and "Help Wanted" advertising are allowable.

2. Compensation for personal services - ("profit sharing" allowed, stock options not allowed).

Industry: Bonuses, profit sharing plans and stock options to employees should be allowed.

DOD: Bonuses and profit sharing plans are allowed if reasonable, but not stock options.

3. Contributions and donations (disallowed) -

Industry: Allow reasonable contributions and donations as costs.

DOD: They are not a cost of performing a Government contract and are not allowed.

4. Interest - (not allowed)

Industry: The cost of borrowing money to perform a contract should be an allowable cost.

DOD: Interest costs should not be allowed since 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 case 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.

B. Difference in specific items of cost - continued

5. Plant reconversion costs - (not allowed)

Industry: Cost of reconverting a plant from military to civilian production should be allowable.

DOD: Such costs should be charged to future operations.

6. Research and development costs - (allowed, but restricted)

Industry: Desires that product or applied research be charged to all work.

DOD: Allow product or applied research only if the Government is interested in the product being developed.

7. Training and education - (allowed, but restricted)

Industry: The contractor's regular training and educational programs should be reimbursable, plus educational grants.

DOD: The cost principles allow training and educational expenses, but state in detail the limitations. Educational grants are disallowed.

COMPREHENSIVE CONTRACT COST PRINCIPLES

Cost Requiring Special Tests or Reviews

Item	Made Unallowable by Present ASPR Section XV	Special Consideration Required by ASPR Section XV
Bidding costs	-	-
Compensation for personal services	-	Yes
Future contingencies	Yes	-
Emergency depreciation or amortization	-	-
Use charge on fully depreciated assets	-	Yes
Insurance	-	Yes
Costs of materials transferred between plants or affiliates	-	Yes
Overtime, extra-pay shift and multi-shift premiums	-	Yes
Pre-contract costs	-	Yes
Professional service costs	-	-
Recruiting costs	-	-
Rental costs	-	-
Research and development costs	Yes	-
Royalties	-	Yes
Selling costs	Yes	-
Severance pay	-	-
Unadjudicated taxes	-	-
Meeting or conference expense	-	-
Travel costs	-	-

1 December 1958

COMPREHENSIVE CONTRACT COST PRINCIPLES

Partially Unallowable Costs

Item	Made Unallowable by Present ASPR Section XV
Advertising costs	Yes
Civil Defense costs	-
Depreciation on idle or excess facilities	-
Use charge in fully depreciated assets	Yes
Fines and penalties	-
Insurance on lives of officers, partners or proprietors	Yes
Patent costs	-
Reconversion costs	-
Costs of special benefits or emoluments offered to new employees	-
Applied research and development costs	-
Accruals for mass or abnormal severance pay	-
Commissions and bonuses	Yes
Unrecovered true depreciation	Yes
Insurance	-
Deferred maintenance	-
Lease-back costs	-

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COMPREHENSIVE CONTRACT COST PRINCIPLES

Unallowable Costs

Item	Made Unallowable by Present ASPR Section XV
Bad debts	Yes
Stock options	-
Historical contingencies	Yes
Contributions and donations	Yes
Entertainment	Yes
Excess facility costs	-
Interest	Yes
Bond discounts	Yes
Costs of financing and refinancing	Yes
Legal and professional fees paid in preparation of prospectus	Yes
Costs of preparation and issuance of stock rights	Yes
Losses on other contracts	Yes
Organization costs	Yes
Reorganization costs	Yes
Costs of raising capital	Yes
Legal, accounting and consulting services (of certain types)	Yes
Federal income taxes	Yes
Taxes in connection with financing, refinancing or refunding	Yes
Special assessments	
Losses from sales or exchanges of capital assets	Yes
Contingent fees for securing government orders	Yes

1 December 1958

COMPREHENSIVE CONTRACT COST PRINCIPLES

Generally Allowable Costs

Item	Made Allowable by Present ASPR Section XV
Bidding costs	-
Bonding Costs	Yes
Compensation for personal services	Yes
Normal depreciation	Yes
Employee morale, health and welfare costs	-
Food services and dormitory costs	-
Fringe benefits	-
Labor relations costs	-
Insurance	-
Maintenance and repair costs	Yes
Manufacturing and production engineering costs	Yes
Material costs	Yes
Overtime and shift premiums	Yes
Patent costs	Yes
Plant protection	Yes
Precontract costs	-
Professional service costs	-
Recruiting costs	Yes
Rental costs	-
Research and development costs	-
Royalties	Yes
Service and warranty costs	-
Severance pay	-
Special tooling	-
Taxes	Yes
Trade, business, technical and professional activity costs	-
Training and educational costs	-
Transportation costs	-
Travel costs	-

1 December 1958

COMPREHENSIVE CONTRACT COST PRINCIPLES

Criteria for Allowability

Criteria for determining allowability of individual items of cost include:

a. Reasonableness
b. Allocability
c. Generally Accepted Accounting Principles
d. Significant Deviation From Contractor's Established Practices
e. Limitations Specifically Stated in The Contract Cost Principles

Reasonableness

PRUDENCE is the acid test of reasonableness. The NATURE and AMOUNT of the cost to be allowable must be that which would result from the judgment of an ordinarily prudent person in the conduct of COMPETITIVE business.

Additional tests of reasonableness for consideration are:

a. Generally recognized as ordinary and necessary performance.
b. Arm's length bargaining
c. Legal restraints
d. Specific contract terms

Allocability

RELATIONSHIP to the contract is the acid test of allocability. A cost is allocable, hence allowable, if it is ASSIGNABLE or CHARGEABLE to the work. In other words, allocability means that the cost is "necessary for or incidental to" the performance of the contract.

AMOUNTS chargeable, or allocable, must be in fair proportion to the benefit received by the contract from the NATURE of the cost incurred (i.e. a proportionate share of the president's salary).

Generally Accepted Accounting Principles

Classification as DIRECT or INDIRECT costs or as credits to a contract may follow any generally accepted accounting principle or practice that is appropriate to particular circumstances.

1 December 1958

DRAFT
9 Dec 58/JMM

COST PRINCIPLE FOR RESEARCH AND DEVELOPMENT

1. Basic research, for the purpose of this regulation, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this regulation, consists of that type of effort which (1) normally follows basic research, but may not be severable from the related basic research, (2) represents efforts to determine and expand the potentialities of new scientific discoveries, and techniques, and (3) represents efforts to "advance the state of the art." Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.

2. Development is the systematic use of scientific knowledge which is directed toward the production of, or improvements in, useful products to meet specific performance requirements, but exclusive of manufacturing and production engineering.

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

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

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

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

7. Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable.

8. The reasonableness of expenditures for independent research and development should be determined in light of all pertinent considerations such as previous contractor research and development activity, cost of past programs and changes in science and technology. Such expenditures should be pursuant to a broad planned program, which is reasonable in scope and well managed. Such expenditures should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the government. Advance agreements as described in ASPR 15-204.1(b),

are particularly important in this situation. In recognition that cost sharing of the contractor's independent research and development program may provide motivation for more efficient accomplishment of such program, it is desirable in some cases that the government bear less than an allocable share of the total cost of the program. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (i) review of the contractor's proposed research program and agreement to accept the allocable costs of specific research projects; (ii) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; and (iii) agreement to accept the allocable share of a percentage of the contractor's planned research program.

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

PPLY AND LOGISTICS

December 31, 1958

CR

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)
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 you are aware, our staffs have been re-evaluating our previous draft of the contract cost principles in the light of the strong protests lodged by industry at the 15 October 1958 meeting and in subsequent correspondence. The attached memorandum contains the results of this staff analysis and contains much food for thought as to our final resolution of this matter. While I am not necessarily in agreement with all of the recommendations contained in this report, I think that it provides a basis for our further discussions. I would like to meet with you upon my return to Washington in early February for the purpose of formulating a recommendation to the Secretary of Defense.

Perkins McGuire

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

1 Incl
Memo to ASD (S&L)
29 Dec 58

ASA(LOG) 400.1912 12-31-58 fw 7-11-57

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

SUPPLY AND LOGISTICS

CR

29 December 1958

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

SUBJECT: Contract Cost Principles

1. At your direction, I have held numerous meetings with representatives of the Military Departments and the Assistant Secretary of Defense (Comptroller) to consider the contract cost principles in the light of the strong protests which have been received from industry. Our objective has been to take a fresh look at the entire philosophy underlying our past efforts to develop a so-called comprehensive set of cost principles. Additionally, we have reviewed the individual items of costs and our recommendations in this regard are set forth herein.

2. Separate meetings were held on the research and development principle with additional representatives of the Military Departments and this office who are concerned directly with the Department of Defense research program. We have agreed on a substantial revision of our previous draft of this principle and this new draft has been sent to the various Assistant Secretaries for an expression of their views.

3. There is attached, as Tab A, a revision of certain portions of the cost principles. These changes are summarized as follows:

A. Title. Changed to "Contract Cost Principles and Procedures". This change is made to counter the industry claim that we have included procedural and instructional type material in addition to "principles". We feel that the detail which is included is the minimum necessary for proper administration.

B. Advance Understandings. This principle has been changed to clearly indicate that "The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable". Additionally, we have segregated the items for which advance understandings are "normally essential" from those where agreements are "normally appropriate".

C. Direct Costing. We recommend certain technical changes in this principle to take care of a concept which was inadvertently omitted and to avoid duplication of charges under certain circumstances.

D. Advertising. This principle has been liberalized somewhat to include the cost of exhibits sponsored by the Government as well as advertising for scarce materials or disposing of scrap or surplus materials.

E. Contributions and Donations. We have made a substantive change in this principle to allow the costs of reasonable contributions to established nonprofit charitable organizations. It is our feeling that industry fully substantiated this type of cost as an unavoidable expense. We do not believe that we have opened "Pandora's box" and, further, we feel that no insurmountable problems of administration will be encountered.

The Air Force representative does not concur in the above recommendation feeling that, as proposed, this principle would open the door to further demands by industry, as well as lead to abuses and complex administrative problems.

F. Interest. While we recommend that interest costs remain unallowable, we propose an addition to ASPR 3-808.4 to indicate that the extent of a contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee or profit.

G. Plant Reconversion Costs. This principle has been liberalized to allow additional costs by mutual agreement where equity so dictates in special circumstances.

H. Rental Costs. This principle has been liberalized to include "market conditions in the area" as a test of reasonableness of rental costs.

4. I am attaching as Tab B, a suggested revision of the compensation principle. The objective of this revision is to recognize that in the determination of the reasonableness of total compensation, contracting officers, as a practical matter, can only cope with the unreasonable or out of line situation. Since this is true, it is felt that we should inject some flavor of this approach into our cost principle to assist contracting officers in an extremely difficult area of contract administration. The substance of this revision is currently contained in paragraph 54-905 (a) of the Air Force Procurement Instructions.

5. We have spent most of our time in reviewing our previous position with respect to the Applicability section of the principles since it is the most controversial area both within the Department of Defense and with industry. In our review of industry comments, we have taken particular note of the strong protests lodged against the application of detailed cost principles to contracts of the fixed-price type. While we never intended to utilize the cost principles as a detailed blueprint for the establishment of prices in the fixed-price area, we feel that industry is justified in their objections to our previous drafts in this regard. In addition to the industry protests, the Military Departments have expressed a strong desire that our regulations specifically recognize the pricing principles incorporated in ASPR Section III, Part 8, as the basic guidelines for the determination of fair and reasonable prices for fixed-price type contracts. This approach is in contradistinction to our previous draft which, however artfully worded, gives the unmistakeable flavor of pricing by formula. Procurement personnel of all of the Departments are apprehensive lest contracting officers use the cost principles as a crutch to avoid criticism, to the detriment of our generally accepted pricing philosophy. They have maintained, as did industry, that this will be the inevitable result of our previous approach regardless of our intent to the contrary.

Our overall analysis of the specific items of cost as now recommended is that they are fair and equitable for strict application to cost type contracts. In reviewing any of the specific items of cost, we are necessarily primarily concerned with respect to their allowability in the riskless cost type contract. We feel that we should be more conservative, more detailed, and more specific in this type of contract than in those of the fixed-price type.

The need for cost analysis with respect to fixed-price type contracts varies in a broad spectrum. In the final pricing of incentive contracts, major reliance must be placed on costs. In redeterminable type contracts, we are generally looking ahead and, while cost analysis is an important factor in establishing fair and reasonable prices, it must be used judiciously and not slavishly. In firm fixed-price contracts, the use of cost analysis and the detail of its use varies on a broad scale. As we endeavor to fit a given set of cost principles, tailored as they must necessarily be to the cost-type contract, to these many and varied pricing situations, we run the great danger of so inhibiting our contracting personnel that the inherent advantages of fixed-price contracts and our pricing techniques will be lost.

We have previously been guided and influenced by the truism that "a cost is a cost regardless of the type of contract". We do not take issue with this generality; however, to give effect to this principle tends to result in a detailed evaluation of costs in most instances. This motivation for specificity in the evaluation of a price will inevitably lead to formula pricing. There are many situations in which we need be concerned only with the general level of estimated costs and secondarily with the types of costs included in the estimate.

We have stated repeatedly in ASPR that the negotiation of a fair and reasonable price requires the exercise of good business judgment. The exercise of this judgment requires flexibility in the negotiation process to concentrate on the major elements of a price. Negotiation implies and demands a give and take approach so as to arrive at a mutually acceptable fair and reasonable price. In this atmosphere of give and take (not adamant dictation by one party to the negotiation) it is essential that the Government negotiator be provided with the flexibility to recognize the validity of a contractor's requests with respect to any element of cost in return for a more advantageous concession by the contractor with respect to another element of the price.

The observations set forth above are not new. They are the basic and inherent problems which have prevented an easy resolution to this question over the past few years. If the principles are issued with their applicability as set forth in the 21 August 1958 draft, we can look forward to continued and violent disagreement with industry. We can foresee future misunderstanding on the part of contracting officers as they endeavor to reconcile the applicability of the cost principles with the pricing techniques of ASPR Section III, Part 8. We can expect pressure toward formula pricing emanating from reviewing authorities such as the General Accounting Office.

In many respects, we find ourselves in the horns of a dilemma. Some members of the working group strongly advocated a complete separation of all fixed-price type contracts from any tie-in with the cost principles. They would create a separate part in Section XV to cover fixed-price type contracts in which the principles would not be used as a "guide" since previous experience in using the present Section XV, Part 2, as a guide in pricing fixed-price contracts had resulted in formula pricing. The majority, however, while concurring in the concept of a separate part for fixed-price contracts, believes that since cost analysis is an important factor in pricing many fixed-price contracts, we need to state that the cost principles will be used "to provide general guidance" in the pricing of such contracts. While recognizing that even this latter tie-in to the principles runs the danger of some formula pricing, it is recommended here as a middle ground which offers the best accommodation of the many conflicting points of view which are involved.

While we have redrafted the Applicability Section many times, we are not able to present a fully coordinated new draft at the present time. Tab C, attached, appears to offer the most practical solution. It is furnished herewith to serve as the basis for future discussions of the basic policy questions underlying the resolution of this difficult problem.

The representative of the Assistant Secretary of Defense (Comptroller) does not concur with the views expressed herein. It is his view that to the extent costs are a factor in pricing, they should be evaluated on a uniform basis regardless of the type of contract involved. He believes that the present proposal is inconsistent with the policy previously established after thorough consideration at the highest levels within the Department, and that the Applicability section contained in the 21 August 1958 draft, with certain minor revisions, should be retained.

J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division

3 Incls
1. Tab A
2. Tab B
3. Tab C

TITLE OF SECTION

In order to avoid the charge that ASPR Sec. XV is not "Cost Principles" as the present title would indicate, we recommend that the title be changed to "Contract Cost Principles and Procedures."

ADVANCE UNDERSTANDINGS

Modify 15-204.1(b) of the 21 August draft to read as follows:

"...Such agreement may be initiated by contracting officers individually or jointly for all defense work of the contractor, as may be appropriate. Any such agreement should be incorporated in cost-reimbursement type contracts or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost determinations covered thereby throughout the performance of the related contract. The absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. However, the nature of certain costs is such that advance agreements are normally essential. These are:

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

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

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

DIRECT COSTING

In order to take care of a concept which had been inadvertently omitted and to avoid duplication of charges under certain circumstances, we recommend addition of the following sentence at the end of 15-202(a):

15-202(a) Add:

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

ADVERTISING

15-204.2 Listing of Costs.

(a) Advertising Costs.

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

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

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

(iii) costs of participation in exhibits sponsored by the Government for the purpose of developing military applications of products.

(iv) advertising relating to accomplishment of the contract mission for the purpose of obtaining scarce materials or equipment, or disposing of scrap or surplus materials.

(2) Except as provided in (iii) and (iv) above, all advertising which offers products for sale is unallowable.

CONTRIBUTIONS AND DONATIONS

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

The propriety of the amount of particular contributions and the aggregate thereof for each fiscal period must ordinarily be judged in the light of the pattern of past contributions, particularly those made prior to the placing of Government contracts. The amount of each allowable contribution must be deductible for purposes of Federal income tax, but this condition does not, in itself, justify allowability as a contract cost.

INTEREST ON BORROWINGS

Proposal: Maintain unallowability of interest as a COST, but revised profit policy appearing in ASPR 3-808.4 by adding a new subparagraph (d) and relettering the remaining subparagraphs. The inserted paragraph will read:

"d. Extent of the Contractor's Investment.

The extent of a contractor's total investment in the performance of the contract will be taken into consideration in the fixing of the amount of the fee or profit."

PLANT RECONVERSION COSTS

(cc) Plant Reconversion Costs. Plant reconversion costs are those incurred in the restoration or rehabilitation of the contractor's facilities to approximately the same condition existing immediately prior to the commencement of the military contract work, fair wear and tear excepted. Reconversion costs are normally unallowable except for the cost of removing Government property and the restoration or rehabilitation costs caused by such removal. However, in special circumstances where equity so dictates, additional costs may be allowed to the extent mutually agreed upon. Whenever such costs are given consideration, care should be exercised to avoid duplication through allowance as contingencies, as additional profit or fee, or in other contracts.

RENTAL COSTS

(hh) Rental Costs. (Including Sale and Leaseback of Facilities).

Revise paragraph (1) of the principle to read as follows:

(1) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as market conditions in the area, the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement. Application of these factors involves along with other considerations comparison of rental costs with costs which would be allocable if the facilities were owned by the contractor.

DRAFT
15 Dec 58/JMM

COMPENSATION

A. To take care of the gigantic problem incident to an examination of ALL compensation plans, change paragraph (b) as follows:

> "b. Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. In the administration of this principle, it is recognized that not every compensation case need be subjected in detail to the above tests. Such tests need be applied only to those cases in which a general review reveals amounts or types of compensation which appear unreasonable or otherwise out of line. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following: etc."

B. Take care of the past service pension credit problem by deleting the phrase "for services currently rendered" from 15-204.2(F)(6)a, and insert at the beginning of paragraph b(1):

> "Except for past service pension costs, it is for services rendered during the contract period."

Part 7 - Fixed-Price Type Contracts

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

(i) firm fixed-price contracts (ASPR 3-403.1)

(ii) fixed-price contracts with escalation (ASPR 3-403.2)

(iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)

(iv) fixed-price incentive contracts (ASPR 3-403.4)

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

15-701 Basic Considerations. (a) Under fixed-price type contracts, prices, not separate elements of cost plus profit, are to be negotiated. A negotiated price is the basis for payment to a contractor under fixed-price type contracts; allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are governing and shall be followed in the negotiation of fixed-price type contracts.

(b) As recognized in ASPR Section III, Part 8, there are within the fixed-price type category of contracts certain situations, e.g., incentive and redeterminable contracts, in which costs are a significant factor in the negotiation of prices. In such situations, costs must be submitted by contractors, evaluated by the Government, and used as

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

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

(b) In using Part 2 of this Section XV for general guidance, contracting officers are not necessarily required to evaluate specifically each individual item of cost (as is required for cost-reimbursement type contracts) in establishing a price; nor shall they be required, in substantiating or justifying a negotiated price, to explain the treatment accorded each such item of cost. Notwithstanding the above, contracting officers are required to fully substantiate and justify any negotiated price. (See ASPR 3-811).

EIGHTY-SIXTH CONGRESS
HOUSE OF REPRESENTATIVES
COMMITTEE ON ARMED SERVICES
SUBCOMMITTEE FOR
SPECIAL INVESTIGATIONS

Monday
February 9, 1959

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

Dear Mr. Secretary:

The subject of Section XV, Armed Services Procurement Regulations, concerning cost allowances on Department of Defense contracts is, again, on the agenda for this Subcommittee.

The staff has been informed of your interest and actions on the subject, from time to time.

As you must realize, the lack of Regulations over a period extending from 1953, to say nothing of the lack of uniformity among the Service Departments in their treatment of contractors during this period, has been a proper and continuing concern of this Subcommittee.

Now we are upon a new fiscal year and, so far, no answer or definitive policy has been laid down.

A reputable news agency has advised the Subcommittee that its information is that the Department of Air Force has directed the allowance of executive bonuses and pensions as a cost allowance under existing price redeterminable and incentive-type contracts.

I am unable to answer this inquiry; and I, therefore, solicit your advice as to:

1. The status of the proposed cost allowances and revision of Section XV, Armed Services Procurement Regulations, and

extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while cost data is often a valuable aid, it will not control negotiation of prices for work to be performed in the future, e.g., negotiation of a firm fixed-price contract, an intermediate price revision covering, in whole or important part, work which is yet to be performed, or a target price under an incentive contract.

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

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

(c) In applying Part 2 of this Section XV to fixed-price contracts, contracting officers will: (i) not be required to negotiate agreement on each

individual element of cost; and (ii) be expected to use their judgment as to the degree of detail in which they consider the individual elements of cost in arriving at their evaluation of total cost, where such evaluation is appropriate. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.

Part 7 - Fixed-Price Type Contracts

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

(i) firm fixed-price contracts (ASPR 3-403.1)

(ii) fixed-price contracts with escalation (ASPR 3-403.2)

(iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)

(iv) fixed-price incentive contracts (ASPR 3-403.4)

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

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

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

(i) Restrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, or negotiation of a settlement agreement under a contract terminated for convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. However, even in these situations, the finally agreed price or settlement may represent something other than the sum total of acceptable costs, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

(ii) Forward Pricing. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the

CONTRACT COST PRINCIPLES

ARMY POSITIONS

The new proposals made by the Special Working Group and submitted to the Materiel Secretaries, by memorandum from the Assistant Secretary of Defense (Supply and Logistics) dated 31 December 1958, have been coordinated within the Army and the recommended Army positions are set forth in Tabs C 1 through C 10 as follows:

C 1 - Title

C 2 - Advance Understandings

C 3 - Direct Costing

C 4 - Advertising

C 5 - Contributions

C 6 - Interest

C 7 - Plant Reconversion

C 8 - Rentals

C 9 - Compensation

C 10 - Applicability

2. The fact or falsehood of the query put to me, as Chairman of this Subcommittee, by our inquirer.

Sincerely yours,

(Signed)
F. Edw Hebert
Chairman

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE

Supply and Logistics September 7, 1960

Dear Admiral Boyle:

Your letter of 8 July asks for our response to nine specific questions relating to the application of ASPR 15-205.35, covering allowability of a contractor's independent research and development costs, in light of the provisions of ASPR 15-107 which provides for an advance understanding on particular cost items (including research and development), and DOD Instruction 4105.52 which provides for uniform negotiation of such costs and establishes an Armed Services Research Specialists Committee to provide scientific and technical advice in connection with the negotiation.

At the outset a brief analysis of the documents cited may facilitate an understanding of the problem.

ASPR 15-205.35 allows a contractor's independent research and development expenses on the basis specifically described. It indicates that advance understandings are particularly important with contractors whose work is predominantly or substantially with the Government. General guidelines as to the reasonableness of this cost item are included and several alternative techniques are provided for use in those situations where it is determined that the cost is unreasonable and, hence, the Government should not bear its full allocable share of the total research program.

DOD Instruction 4105.52 makes provision for the negotiation of contractors' independent research and development costs by a single military department when (i) the research and development costs are substantial, (ii) a substantial portion of the contractor's business is with the Department of Defense, and (iii) the contractor's defense work involves contracts with more than one military department. The Instruction also establishes the Armed Services Research Specialists Committee and assigns to the Committee the mission of providing, when requested, advice to the sponsoring department on the scientific and technical factors which influence the extent to which the independent program should be supported.

Now we will respond to your specific questions.

1. Question 1 presumes that the Armed Services Research Specialists Committee will negotiate advance understandings. As stated above, the negotiations of research costs will be undertaken by the military departments rather than by the Research Specialists Committee. While the recommendations of the ASRSC will necessarily be advisory in nature, they will, nevertheless, be given great weight by the military departments.

The second portion of the question has to do with whether the negotiation procedures are available (a) to any contractor who desires to recover research and development expenses, or (b) who also does business with more than one department. It will not be necessary for all contractors who desire recovery of independent research and development expense to be considered under the procedures established by DOD Instruction 4105.52. Thus, where a small amount of cost is involved, either because of the size of the research and development program or due to the minor amount of defense contracts, or where a contractor is dealing only with one Department, it will usually not be feasible to utilize the centralized negotiation procedure. However, a contractor who is dealing with more than one military department and who particularly desires to negotiate a centralized advance understanding, notwithstanding the amount of cost involved, will be accommodated to the extent that the current workload will permit. A contractor who is dealing with only one department, but with several different activities within the one department, may request a centralized negotiation within the department, the results of which will be used throughout the department.

2. This question asks whether the dollar volume of contracting determines whether a contractor will negotiate centrally and inquires if there are additional factors which suggest the need for such negotiation. The dollar volume of contracting, as such, is not significant; however, the amount of independent research and development expense allocable to defense work is an important criterion. Additional factors are whether a substantial portion of the contractor's business is with the Department of Defense and whether the contractor's defense work involves contracts with more than one military department.

3. This question asks if contractors who will participate in the centralized negotiation of research and development expense will be limited to those who negotiate final overhead rates on a centralized basis. The centralized negotiation of research and development expense will not be restricted to those who centrally negotiate final overhead rates. Advance understandings reached by the research and development negotiators will of course be utilized during the negotiation of final overhead rates.

4. This question asks the role that Government scientific and technical personnel will play in negotiating advance understandings in the research and development area. The Armed Services Research Specialists Committee will review, when requested by the negotiator representing the sponsoring department, the independent research and development programs of defense contractors and will determine whether there has been an adequate segregation between the independent research and the independent development programs. Additionally, the committee will report and make recommendations directly to the sponsoring department on the scientific and technical factors affecting the basis or extent to which a contractor's independent research and development program should be supported. In carrying out its responsibilities, the committee will utilize, where appropriate, the services of other research specialists.

5. This question asks whether the military departments will "control" a contractor's independent research and development program. Our approach is concerned only with the problem of cost allowability and not "control." When the cost of a contractor's independent research and development program is found to be "reasonable", there is no question of "control" involved. Of course, when a determination is made that a contractor's proposed program is not reasonable and, hence, the full allocable portion will not be allowed, there is a measure of control being exercised. This type of control, however, is oriented toward the reimbursement of costs under Defense contracts. Any contractor is obviously free to pursue any type or level of research at his own expense. The provision making independent development costs allowable only on the basis of a showing of relationship of such costs to the product lines for which the Government has contracts might be considered a type of control. However, broad control of the contractor's independent research and development program is not intended.

6. This question asks if a distinction will be made between contractors whose business is primarily commercial as against those whose business is primarily Government. The mix of Government and commercial business is an important consideration in connection with the evaluation of many elements of cost and will be particularly so in connection with research and development costs. We have found it necessary to scrutinize costs with more care in connection with contractors whose work is predominantly or substantially with the Government. However, the same tests of reasonableness will be applied in each instance and the mix of government and commercial business will not, per se, control the final result.

7 and 8. These questions concern themselves with the use of cost sharing formulae and request clarification as to whether cost sharing is appropriate unless there has been a preliminary finding that the over-all cost is unreasonable. It is our view that a preliminary decision of unreasonableness should generally precede the use of cost sharing methods. In the event a contractor's business is substantially commercial, it is expected that the pro rata amount of research and development expense allocated to commercial business will act as a deterrent to the incurring of unreasonable or unnecessary costs. In such instances a cost sharing arrangement will not normally be necessary or desirable. However, in those instances where a contractor's business is primarily with the Government and the contractor's research and development program is so substantial as to appear to be unreasonable in amount, it may be desirable to enter into a cost sharing arrangement in order to provide a motivation for more efficient accomplishment of the program.

9. This question asks whether further guidelines will be issued to contracting officers setting forth tests of reasonableness or other criteria for the recognition of research and development costs. While we do not now

anticipate that further direction will be necessary from this level, experience in operation may dictate otherwise. In addition, the military departments will issue such implementing instructions of a procedural nature as are necessary to operate the system which has been established.

Sincerely yours,

/s/

G. C. BANNERMAN
Director for Procurement Policy

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