Draft #1 - June 15, 1960

DEVELOPMENT OF THE NEW COST PRINCIPLES

Discussion Questions for Panel

1. Origin - Why do we have a new set of cost principles...were the old principles unfair to Government...to Industry...who or what supplied the impetus for change?

2. Issues - Since it took several years to produce the final draft, with substantial rewrite during the process, what were the obstacles to agreement...the key issues...from a Government viewpoint...from an industry viewpoint?

3. Enlarged Applicability - Perhaps the most significant single change is the introduction of applicability to fixed price negotiation and termination settlement, as well as to cost reimbursement type contracts.
   (a) What is the premise upon which this enlarged applicability is based?
   (b) How does this take into account the varying element of risk...or should it do so?

4. Contract Principles vs. Tax Principles - Numerous costs such as interest, contributions, general advertising, etc. are classed as unallowable in military contracts although recognized as legitimate and necessary business expenses for tax purposes. What is the premise for difference in treatment? Should there really be a difference?

5. Timing - One of the big problems in making the new principles effective has been the question of timing. Commerce Clearing House recently republished the old principles, because the publishers felt that many companies would undoubtedly have to follow both sets of principles for perhaps years to come. Since contractors now must accept the new principles on new prime contracts, why must they get permission to change over on old contracts if they so desire? Shouldn't the principles be adoptive on a company-by-company basis, rather than contract-by-contract, or service-by-service?

6. Subcontractor Position - What is or should be the premise for cost treatment of subcontractors...should it necessarily follow the prime?

7. Fixed Price Applicability - How should the word "Guidelines" be interpreted...do the lines divide proper costs from improper...in negotiation, may the contractor and the contracting officer take "all costs" into consideration or only those classed as "allowable"? How should this be interpreted in furnishing a certified statement of costs as provided in ASPR 3-807.7?

8. Disputes - Because the new principles are more explicit than the old, they may perhaps be considered more rigid. Disputes, however, will still arise. Increased "rigidity" may have a more severe effect on subcontractors than on primes. What is or should be the recourse of a subcontractor who must live within the new rules but who is not recognized to have any privity of contract with the Government?

9. Advance Understandings - The new principles place substantial emphasis on the desirability of advance understanding for the treatment of those costs such as "deferred compensation" and "selling costs" which may present difficulties in the determination of reasonableness and allocability. Is there an obligation on the military services to enter upon good faith negotiations for such advance agreements? Are there pitfalls? How does the subcontractor approach the problem? Is he, or should he be, bound by the agreement made between a prime and the military?

10. Standardization - Wherever there is a mix of contracts and subcontracts (a condition most prevalent under weapons systems contracting), or a mix of contracts among the several services, there is the problem of uniformity. In a single plant, a contractor needs uniform accounting methods and treatment. What is being or should be done to reconcile the problems arising between old principles and new, between contracts with and without advance understandings, between prime and subcontract treatment?

CF

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (S&L

SUBJECT: Merck, Sharp and Dohme Decision on Rapid Amortization

The Minutes of the Materiel Secretaries' Weekly Conference of 4 June 1959 requested a progress report on the actions taken as a result of the subject case.

The draft of the contract cost principles dated 12 May included provisions designed to take care of the decision. DODD 4105.34, as amended, authorized the contractor to elect whether to apply "true" or normal depreciation in the pricing of the items sold. This policy is continued in the cost principle draft with two additional concepts (underscored portion is most pertinent):

1. While the contractor is given an election to use "true" or "normal" depreciation, it is stated that <u>his election must be consistently applied</u>. In the Sharp and Dohme case, the petitioner collected $100,000 on the basis of his <u>election</u> to be paid at "true" depreciation rates, but shifted his election to "normal" in the ASBCA case to collect his losses of economic value.

2. A second clarifying provision was included as follows:

> "(d)(i) . . . the emergency period (5 years) shall be computed in accordance with the determination of the Emergency Facilities Depreciation Board <u>and allocated ratably over the full five-year emergency period; provided no other allowance is made which would duplicate the factors, such as extraordinary obsolescence, constituting 'true depreciation'</u> . . ."

Since the Emergency Facilities Depreciation Board considers the factor of extraordinary obsolescence, in its finding of "true depreciation", and since the revised principle bars "duplicate" allowance of costs for this factor, we believe that the addition

of these provisions will remedy the Sharp and Dehme decision for the future.

G. C. BANNERMAN
Director for Procurement Policy

Prepared by: TAPilson
Rewritten by: TAPilson/mt/19Jun59
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See attached green for coord.

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

MCPPP 2 July 1959

SUBJECT: Latest Draft of Proposed Revision ASPR Section XV

TO: Hq USAF (AFOOT-PMC - Mr. Vecchietti)
Washington 25, D.C.

1. In looking over the 26 June 1959 draft of ASPR Section XV, we have come across two items which may require clarification. We realize this may not be possible but if you agree and if the changes can be made, we recommend them.

2. The first is in paragraph 15-205.6(f)(2) which says, "Deferred compensation is allowable to the extent that (i) except for past service pension costs it is for services rendered during the contract period; ...". This citation excepts past service pension costs from the general requirement that deferred compensation costs are allowable only to the extent they are for services rendered during the contract period. However, "pension" is a specific term of reference and is not inclusive of retirement plans in general. In other words "retirement" rather than pension is the generic term and we suggest the insertion of words "and retirement" between "pension" and "costs" in that paragraph.

3. It is possible to interpret the cost principles so as to make substantial segments of management incentive award payments unallowable. For example, a contractor might make incentive awards early in calendar year 1959 with respect to services performed by recipients during calendar year 1958. Most often an award is paid in installments over several years. Therefore, the latest draft could be interpreted to cause incentive compensation payments made on an installment basis to be unallowable when not for services during the contract period. We do not believe this is the intent.

FOR THE COMMANDER:

L. E. TODD
Acting Chief, Pricing
and Financial Division
Directorate of Procurement & Production

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 15 May 1969 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 15-205.22(c) of the prohibition relating to "write downs" or "write ups" of material values which had appeared in earlier drafts and which now appears, in part, in current ASPR 15-202.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON

Subj: The Contract Cost Principles and Procedures, comment on

Ref: (a) Enclosure from ASPR-15-207(XII) of 15 May 1959 re Contract Cost Principles and Procedures revised draft of 15 May 1959

1. Reference (a) has been reviewed by my staff and with the exception of the following comments I approve its issuance:

a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c)." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(iv) Sales and leaseback agreements." This is considered necessary in view of the specific limitation on such rentals in ASPR 15-205.34 (c).

b. Page 34, line 4, change (i) to read "the item is regularly manufactured and sold by the contractor through commercial channels for commercial end use." (underscoring supplied). Change (ii) to (iii) and add a new (ii) as follows: "The charges for the item(s) are normal in amount." These revisions are considered essential to avoid a situation where the "commercial" customer obtains repair of a piece of equipment at a price or subcontract to the Government and the prices of the items have not been established in the non-governmental market. Also, if the trial values of most items is substantial, it seems only equitable that they should be charged to the Government contracts on a cost basis (rather than at a price which includes a profit element) in order to avoid the payment of profits on profits.

c. Page 37, top line: the word "allowable" should be changed to "unallowable."

d. Page 47 - Either add (i) after "instances" in the fourth line or delete (ii) in the fifth line.

2. As you know, industry has been primarily concerned with the application of the cost principles to other than DOD contracts. The result thereof [illegible] to many of us is a strong verification of this position. Although we do not agree that issuance of the principles should be delayed to accommodate further discussion of this subject, I recommend that in the practical implementation of the principles, the services be cautioned to avoid the "demands" pricing which industry fears. Should evidence of such pricing exist after a reasonable period of implementation of the principles, I strongly recommend further consideration on this matter at that time.

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE

SUBJECT: Contract Cost Principles

The Department of the Army concurs in the draft of Section XV, Contract Cost Principles and Procedures, dated 12 May 1959, [illegible] dated 15 May 1959, subject as above.

Courtney Johnson
Assistant Secretary of the Army
(Logistics)

making it an allowable overhead item. Budgeteers want the principles as restrictive as possible. Auditors want them so detailed as to give them a pat answer to every question. Of course I hasten to add that what I have just said is in the nature of a caricature, and certainly not true of all representatives of each group mentioned.

All of the proponents of these different views have much to be said in their favor. During the some ten years that I have been struggling with this problem, I don't recall a single argument that did not have some merit under a specific set of circumstances. Likewise, I don't recall many proposals which couldn't justly be criticized under another set of circumstances.

This brings me to a point which I want to cover before we start trying to answer some of your questions. The point is this: these principles are, for the most part, intended to be stated in terms of objectives rather than specifics or allowable and unallowable costs. They are not intended to give the pat answer in black and white to every question you can dream up, but rather are intended to be sufficiently flexible to permit an equitable resolution of any problem that arises, depending on the circumstances. So, if we can't answer some of your questions precisely, I hope it will be because of lack of knowledge of sufficient facts surrounding the problem, rather than plain ignorance.

Since I have a captive audience, I would like to impose upon your good nature to do a little preaching on one of my favorite bits of philosophy. There is considerable criticism, not only of Sec. XV, but of Government regulations in general, that they are too detailed, too rigid and too restrictive.

agree with industry in not liking all of these restrictions which sometimes straightjacket us and deter us, in some cases, from doing what appears to be reasonable in a particular circumstance. But let us look at why we have all these controls and restrictions. Most of them, in the area we're discussing, were instituted to outlaw abuses by those who attempted--either through bad judgment or greed--or even with a touch of larceny in their hearts, to get more out of the Government than that to which they were equitably entitled. Human nature, operating in the gold-fish-bowl atmosphere which is such a necessary and integral part of our Government, dictates that some action must be taken by the executive department when these abuses are aired in the public press, by the legislature, or by others. This action usually takes the form of a regulation whereby, even though the abuse sought to be prevented may be more or less isolated, the restriction applies across the board. Thus industry, individually and through its associations, can do much to prevent the expansion of such regulations by recognizing their quasi-public responsibility when dealing with the Government, and avoiding abuses which must necessarily lead eventually to regulation. All too often, unfortunately, when it becomes known in industry that one contractor has found a "loophole," other contractors tend to climb on the bandwagon instead of trying to use their influence toward self-policing. Thus is born another regulation!

Now I will get out of the pulpit and on to the next general point. It concerns the degree of applicability of the cost principles to negotiated fixed-price contracts. Resolution of problems in this connection was the cause of--I would say--90% of the difficulty and delay in getting them out.

I hope you will take my word that compromises made in order to reach agreement on this aspect, account for what I'm sure many of you consider some pretty weird wording and arrangement.

Few people objected to having cost principles for determining costs under cost-reimbursement type contracts. However, many objected to their application in the fixed price area and for various reasons. They said for example:

1. They will lead to "formula" pricing; i.e. costs plus a percentage profit will become price.
2. Negotiation and competition will disappear.
3. Pricing will be done by armies of auditors checking costs in the most minute detail.
4. The nature of risk in negotiated contracts is such that cost treatment <u>should</u> be different here than in cost type contracts.

However, right prevailed in the end because the opponents were not able to successfully refute such ideas as:

1. Costs are costs regardless of the type of contract. No type of contract should be more advantageous than another merely because of differences in cost treatment.
2. Only by this means could we hope to achieve at least a degree of uniformity of treatment by the thousands of individuals negotiating, administering, and auditing contracts.
3. That no one could deny that pricing of some forms of contracts (e.g. final formula pricing of an incentive contract) was based almost exclusively on costs.
4. But finally and most importantly, we found the words to describe the application to fixed-price contracts which allayed the fears

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (M&L)

SUBJECT: Contract Cost Principles

This will confirm the concurrence of this office with the revised draft, dated May 12, 1959, of the Contract Cost Principles for inclusion in the Armed Services Procurement Regulations.

It is my understanding that your office has already been notified by telephone of our concurrence.

Herbert F. York

DRAFT
27 April 1959

SECTION XV

CONTRACT COST PRINCIPLES AND PROCEDURES

15-000 Scope of Section. This Section contains general cost principles and procedures for the determination and allowance of costs in connection with the negotiation and administration of cost-reimbursement type contracts and contains guidelines for use, where appropriate, in the evaluation of costs in connection with certain negotiated fixed-price type contracts and contracts terminated for the convenience of the Government.

Part 1 - Applicability

15-101 Scope of Part. This Part describes the applicability of succeeding Parts of this Section to the various types of contracts in connection with which cost principles and procedures are used.

15-102 Cost-Reimbursement Supply and Research Contracts with Concerns Other Than Educational Institutions. This category includes all cost-reimbursement type contracts (ASPR 3-404) for supplies or for experimental, developmental, or research work (other than with educational institutions, as to which ASPR 15-103 applies), except that it does not include facilities contracts (see ASPR 15-105) or construction contracts (see ASPR 15-104). The cost principles and procedures set forth in Part 2 of this Section shall be used in connection with cost-reimbursement supply and research contracts with other than educational institutions -

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimburseable costs under cost-reimbursement type contracts, including cost-reimbursement

type subcontracts thereunder, and the cost-reimbursement portion of time-and-materials contracts (ASPR 3-405.1);

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR Section VIII, Part 4), and for settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 2 is to be used as a guide where costs are to be considered in negotiating fixed-price type contracts, as indicated in Part 6 of this Section.

15-103 Cost-Reimbursement Research Contracts with Educational Institutions. This category includes all cost-reimbursement type contracts (ASPR 3-404) for experimental, developmental, or research work with educational institutions. The cost principles and procedures set forth in Part 3 of this Section shall be used in connection with cost-reimbursement research contracts with educational institutions--

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR Section VIII, Part 4), and for settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 3 is to be used in determining the allowable costs of research and development performed by educational institutions under grants. Further, Part 3 is to be used as a guide where costs are to be considered in negotiating fixed-price type contracts with educational institutions, as indicated in Part 6 of this Section. /Editor's note: If this paragraph 15-103 is printed, ASPR 15-300 should be deleted./

15-104 Cost-Reimbursement Construction Contracts. This category includes all cost-reimbursement type contracts (ASPR 3-404) for the construction, alteration, or repair of buildings, bridges, roads, or other kinds of real property. It also includes such contracts for architect-engineer services related to such construction. It does not include contracts for vessels, aircraft, or other kinds of personal property. The cost principles and procedures set forth in Part 4 of this Section shall be used in connection with cost-reimbursement construction contracts--

(i) as the contractual basis, by incorporation by reference in the contract, for determination of reimbursable costs under cost-reimbursement type contracts, including cost-reimbursement type subcontracts thereunder;

(ii) as the basis for the negotiation of overhead rates (ASPR Section III, Part 7); and

(iii) as the basis for the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to "voucher out" its costs (ASPR VIII, Part 4), and for settlement of such contracts by determination (ASPR 8-209.7).

In addition, Part 4 is to be used as a guide where costs are to be considered in negotiating fixed-price type construction contracts, as indicated in Part 6 of this Section.

15-105 Cost Reimbursement Facilities Contracts. (Reserved.)

15-106 Reserved.

15-107 Advance Understandings on Particular Cost Items. The extent of allowability of the selected items of cost covered in Parts 2 through 5 has been stated to apply broadly to many accounting systems in varying contract situations. Thus, as to any given contract, the reasonableness and allocability of certain items of cost may be difficult to determine, particularly in connection with companies or separate divisions thereof which may not be subject to effective competitive restraints. In order to avoid possible subsequent disallowance or dispute based on unreasonableness or non-allocability, it is important that prospective contractors, particularly those whose work is predominantly or substantially with the Government, seek agreement with the Government in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability are difficult to determine. Such agreement may also be initiated by contracting officers individually, or jointly for all defense work of the contractor, as appropriate. Any such agreement should be incorporated in cost-reimbursement

type contracts, or made a part of the contract file in the case of negotiated fixed-price type contracts, and should govern the cost treatment covered thereby throughout the performance of the contract. But the absence of such an advance agreement on any element of cost will not, in itself, serve to make that element either allowable or unallowable. Examples of costs on which advance agreements may be particularly important:

(i) compensation for personal services;

(ii) use charge for fully depreciated assets;

(iii) deferred maintenance costs;

(iv) pre-contract costs;

(v) research and development costs;

(vi) royalties;

(vii) selling and distribution costs; and

(viii) travel costs, as related to special or mass personnel movement.

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

15-201 Basic Considerations

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

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

15-201.3 Definition of Reasonableness. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with companies or separate divisions thereof which may not be subject to effective competitive restraints. What is reasonable depends upon a variety of considerations and circumstances

involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, consideration shall be given to:

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

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

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

(iv) significant deviations from the established practices of the contractor which may unjustifiably increase the contract costs.

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

(i) is incurred specifically for the contract;

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

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

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

15-202 Direct Costs. (a) A direct cost is any cost which can be identified specifically with a particular cost objective. Direct costs are not limited to items which are incorporated in the end product as material or labor. Costs identified specifically with the contract are direct costs of the contract and are to be charged directly thereto. Costs identified specifically with other work of the contractor are direct costs of that work and are not to be charged to the contract directly or indirectly. When items ordinarily chargeable as indirect costs are charged to Government work as direct costs, the cost of like items applicable to other work of the contractor must be eliminated from indirect costs allocated to Government work.

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

15-203 Indirect Costs. (a) An indirect cost is one which, because of its incurrence or joint objective, is not readily subject to treatment

as a direct cost. Minor direct cost items may be considered to be indirect costs for reasons of practicality. After direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs are those remaining to be allocated to the several classes of work.

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

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

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

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

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

(e) A base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. Normally, the base period will be the contractor's fiscal year, however, use of a shorter period may be appropriate in case of (i) contracts whose performance involves only a minor portion of the fiscal year; or (ii) where it is general practice in the industry to use a shorter period. In any event the base period or periods shall be so selected as to avoid inequities in the allocation of costs. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

15-204 Application of Principles and Standards. (a) Costs (including those discussed in ASPR 15-205) shall be allowed to the extent that they are reasonable (see ASPR 15-201.3), allocable (see ASPR 15-201.4), and determined to be allowable in view of the other factors set forth in ASPR 15-201.2.

(b) Selected items of cost are considered in ASPR 15-205. However, ASPR 15-205 does not cover every element of cost and every situation that might arise in a particular case. Failure to treat any item of cost in ASPR 15-205 is not intended to imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this Part and, where appropriate, the treatment of similar or related selected items.

15-205 Selected Costs.

(1) Advertising Costs.

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

(i) advertising in trade and technical journals, provided such advertising does not offer specific products or services for sale but is placed in

journals which are valuable for the dissemination of technical information within the contractor's industry;

(ii) help-wanted advertising, as set forth in (33) below, when considered in conjunction with all other recruitment costs;

(iii) costs of participation in exhibits--

(A) upon invitation of the Government, or

(B) which exhibits are valuable for the dissemination of technical information within the contractor's industry, provided, such costs are not allowable under this subparagraph (B) if the participation is for the purpose of offering specific products or services for sale;

(iv) advertising for the exclusive purpose of obtaining scarce materials, plant, or equipment, or disposing of scrap or surplus materials in connection with the contract.

( ) (b) Except as provided above, all other advertising costs are unallowable.

(2) Bad Debts. Commercial 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. However, in any instance where such a loss results from a

Government contract or subcontract, appropriate and equitable recognition may be accorded thereto.

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

(4) Bonding Costs.

(a) Bonding costs arise when the Government requires assurance against financial loss to itself or others by reason of the act or default of the contractor. They arise also in instances where the contractor requires similar assurance. Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

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

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

(5) Civil Defense Costs.

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

(b) Costs of capital assets under (a) above are allowable through depreciation in accordance with (9) below.

(c) Contributions to local civil defense funds and projects are unallowable.

(6) Compensation for Personal Services.

(a) General. (1) Compensation for personal services includes all remuneration paid currently or accrued, in whatever form and whether paid immediately or deferred, for services rendered by employees to the contractor during the period of contract performance. It includes, but is not limited to, salaries, wages, directors' and executive committee members' fees, bonuses (including stock bonuses), incentive awards, employee stock options, employee insurance, fringe benefits, and contributions to pension, annuity, and management employee incentive compensation plans. Except as otherwise specifically provided in this paragraph (6), 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.

(2) Compensation is reasonable to the extent that the total amount paid or accrued is commensurate with compensation paid under the contractor's established policy and conforms generally to compensation paid by other contractors of the same size, in the same industry, or in the same geographic area, for similar services. In the administration of this principle, it is recognized that not every compensation case need be subjected in detail to the above tests. Such tests need be applied only to those cases in which a general review reveals amounts or types of compensation which appear unreasonable or otherwise out of line. However, certain conditions give rise to the need for special consideration and possible limitation as to allowability for contract cost purposes where amounts appear excessive. Among such conditions are the following:

(i) Compensation paid to owners of closely held corporations, partners, sole proprietors, or members of the immediate families thereof, or to persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. Determination should be made that such compensation is reasonable for the actual personal services rendered rather than a distribution of profits.

(ii) Any change in a contractor's compensation policy resulting in a substantial increase in the contractor's level of compensation, particularly when it was concurrent with an increase in the

ratio of Government contracts to other business, or any change in the treatment of allowability of specific types of compensation due to changes in Government policy.

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

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

(4) In addition to the general requirements set forth in (1) through (3) above, certain forms of compensation are subject to further requirements as specified in (b) through (j) below.

(b) 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 (25) below.

(c) 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 over-all compensation is determined to be reasonable and such costs are paid or accrued pursuant to an agreement entered into in good faith between the contractor and the employees before the services were rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payment. (But see

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

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

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

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

Such costs otherwise allowable are subject to adjustment according to the principles set forth in (f)(3) below. (But see ASPR 15-107.)

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

(f) Deferred Compensation. (1) As used herein, deferred compensation includes all remuneration, in whatever form, for which the

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

(2) Deferred compensation is allowable to the extent that (i) except for past service pension costs it is for services rendered during the contract period; (ii) it is, together with all other compensation paid to the employee, reasonable in amount; (iii) it is paid pursuant to an agreement entered into in good faith between the contractor and employees before the services are rendered, or pursuant to an established plan followed by the contractor so consistently as to imply, in effect, an agreement to make such payments; and (iv) for a plan which is subject to approval by the Internal Revenue Service, it falls within the criteria and standards of the Internal Revenue Code and the regulations of the Internal Revenue Service. (But see ASPR 15-107.)

(3) In determining the cost of deferred compensation allowable under the contract, appropriate adjustments shall be made for credits or gains arising out of both normal and abnormal employee turnover, or any other contingencies that can result in a forfeiture by employees of such deferred compensation. Adjustments shall be made only for forfeitures which directly or indirectly inure to the benefit of the contractor; forfeitures which inure to the benefit of

other employees covered by a deferred compensation plan with no reduction in the contractor's costs will not normally give rise to adjustment in contract costs. Adjustments for normal employee turnover shall be based on the contractor's experience and on foreseeable prospects, and shall be reflected in the amount of cost currently allowable. Such adjustments will be unnecessary to the extent that the contractor can demonstrate that its contributions take into account normal forfeitures. Adjustments for possible future abnormal forfeitures shall be effected according to the following rules:

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

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

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

TAB A

(g) Fringe Benefits. See (15).

(h) Overtime, Extra-Pay Shift and Multi-Shift Premiums. See (25).

(i) Training and Education Expenses. See (42).

(j) Insurance and Indemnification. See (16).

(7) Contingencies.

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

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

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

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

(ii) those which may arise from presently known or unknown conditions, the effect of which cannot be measured so precisely as to provide equitable results to the contractor and to the Government; e.g., results of pending litigation, and other general business risks. Contingencies of this category are to be excluded from cost estimates under the several items of cost, but should be disclosed separately, including the basis upon which the contingency is computed in order to facilitate the negotiation of appropriate contractual coverage (see, for example, (16), (20), and (39) below).

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

(9) Depreciation.

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

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

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

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

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

(A) the straight line method;

(B) the declining balance method, using a rate not

exceeding twice the rate which would have been used had the annual allowance been computed under the method described in (A) above;

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

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

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

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

(i) with respect to the emergency period (5 years), shall be

computed in accordance with the determination of the Emergency Facilities Depreciation Board, provided no allowance is made which would duplicate the factors constituting "true depreciation" and

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

(e) Depreciation on idle or excess facilities shall not be allowed except on such facilities as are reasonably necessary for standby purposes.

(f) No depreciation, rental, or use charge shall be allowed on the contractor's assets which have been fully depreciated when a substantial portion of such depreciation was on a basis that represented, in effect, a recovery thereof as a charge against Government contracts or subcontracts. Otherwise, a reasonable use charge may be agreed upon. (But see ASPR 15-107.) In determining this charge, consideration should be given to cost, total estimated useful life at time of negotiation, and effect of any increased maintenance charges or decreased efficiency due to age.

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

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

(11) Entertainment Costs. Costs of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see (10) and (42)).

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

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

(14) Food Service and Dormitory Costs and Credits. Food and dormitory services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, living accomodations 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. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for

15-205

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

(15) 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.

(16) Insurance and Indemnification.

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

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

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

(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 similar insurance shall be limited to exclude coverage of profit;

(iii) costs of insurance or of any contributions to any reserve covering the risk of loss or of damage to Government property are allowable only to the extent that the contractor is responsible for such loss or damage.

(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 (6) above).

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

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

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

(b) Indemnification includes securing the contractor against liabilities to third persons and other losses, not compensated by insurance or otherwise. The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract, except as provided in (a)(3) above.

(17) Interest and Other Financial Costs. Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of prospectuses, costs of preparation and issuance of stock rights, and costs related thereto, are unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in (41) below. (But see (24).)

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

(19) 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.

(20) Maintenance and Repair Costs.

(a) Costs necessary for the upkeep of property (including Government property unless otherwise provided for), which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are to be treated as follows (but see (9)):

(i) normal maintenance and repair costs are allowable;

(ii) extraordinary maintenance and repair costs are allowable, provided such are allocated to the periods to which applicable for purposes of determining contract costs. (But see ASPR 15-107.)

(b) Expenditures for plant and equipment 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.

(21) 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.

(22) Material Costs.

(a) Material costs include the costs of such items as raw materials, parts, subassemblies, components, and manufacturing supplies, whether purchased outside or manufactured by the contractor, and may include such collateral items as inbound transportation and intransit insurance. In computing material costs consideration will be given to reasonable overruns, spoilage, or defective work (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 (b) through (e) below.

(b) Costs of material shall be suitably adjusted for applicable portions of income and other credits, including available trade discounts, refunds, rebates, allowances, and cash discounts, and credits for scrap and salvage and material returned to vendors. Such income and other credits shall either be credited directly to the cost of the material involved or be allocated (as

credits) to indirect costs. However, where the contractor can demonstrate that failure to take cash discounts was due to reasonable circumstances, such lost discounts need not be so credited.

(c) Reasonable adjustments arising from differences between periodic physical inventories and book inventories may be included in arriving at costs, provided such adjustments relate to the period of performance of the contract.

(d) When the materials are purchased specifically for 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.

(e) 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.

(23) Organization Costs. Expenditures, such as incorporation fees, attorneys' fees, accountants' fees, brokers' fees, fees to promoters and organizers, in connection with (i) organization or reorganization of a business, or (ii) raising capital, are unallowable (see (17) above).

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

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

(26) Patent Costs. Costs of preparing disclosures, reports, and other documents required by the contract and of searching the art to the extent necessary to make such invention disclosures, are allowable. In accordance with the clauses of the contract relating to patents, costs of preparing documents and any other patent costs, in connection with the filing of a patent application where title is conveyed to the Government, are allowable. (See also (35) and (36) below.)

(27) Pension Plans. See (6) above.

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

military security requirements, are allowable.

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

(30) Precontract Costs. Precontract costs are those incurred prior to the effective date of the contract directly pursuant to the negotiation and in anticipation of the award of the contract where such incurrence is necessary to comply with the proposed contract delivery schedule. Such costs are allowable to the extent that they would have been allowable if incurred after the date of the contract. (But see ASPR 15-107.)

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

(a) Costs of professional services rendered by the members of a particular profession who are not employees of the contractor are allowable, subject to (b) and (c) below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see (23) above).

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

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

Tab A

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

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

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

Retainer fees to be allowable must be reasonably supported by evidence of bona fide services available or rendered.

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

(32) Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets. Profits or losses of any nature arising from the same 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 (9) (b) above as to basis for depreciation).

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

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

(a) Rental costs of land, building, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as rental costs of comparable facilities and market conditions in the area, the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental agreement. Application of these factors, in situations where rentals are extensively used, may involve along with other considerations, comparison of rental costs with normal ownership costs plus a reasonable return on investment.

(b) Charges in the nature of rent between plants, divisions, or organizations under common control are allowable to the extent such charges

do not exceed the normal costs of ownership, such as depreciation, taxes, insurance, and maintenance; provided that no part of such costs shall duplicate any other allowed costs.

(c) Unless otherwise specifically provided in the contract, rental costs specified in sale and leaseback agreements, incurred by contractors through selling plant facilities to investment organizations, such as insurance companies, or to private investors, and concurrently leasing back the same facilities, are allowable only to the extent that such rentals do not exceed normal ownership costs, plus a reasonable return on investment, which would have accrued had the contractor retained legal title to the facilities.

(35) Research and Development Costs.

(a) Basic research, for the purpose of this Part 2, is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than any practical application thereof. Applied research, for the purpose of this Part 2, consists of that type of effort which (i) normally follows basic research, but may not be severable from the related basic research, (ii) represents efforts to determine and expand the potentialities of new scientific discoveries or improvements in technology, materials, processes, methods, devices, and techniques, and (iii) represents efforts to "advance the state of the art." Applied research does not include any such efforts when their principal aim is the design, development, or test of specific articles or services to be offered for sale, which are within the definition of the term development as hereinafter provided.

(b) Development is the systematic use of scientific knowledge which is directed toward the production of, or improvements in, useful products to meet specific performance requirements, but exclusive of manufacturing and production engineering.

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

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

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

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

(g) Research and development costs (including amounts capitalized), regardless of their nature, which were incurred in accounting periods prior to the award of a particular contract, are unallowable except where allowable as precontract costs (see (30) above).

(h) 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 expeditures (especially for development) should be scrutinized with great care in connection with contractors whose work is predominantly or substantially with the government. Advance agreements as described in ASPR 15-107 are particularly important in this situation. In recognition that cost sharing of the contractor's independent research and development program may provide motivation for more efficient accomplishment of such program, it is desirable in some cases that the government bear less than an allocable share of the total cost of the program. Under these circumstances, the following are among the approaches which may be used as the basis for agreement: (i) review of the contractor's proposed independent research and development program and agreement to accept the allocable costs of specific projects; (ii) agreement on a maximum dollar limitation of costs, an allocable portion of which will be accepted by the Government; (iii) an agreement to accept the allocable share of a percentage of the contractor's planned research and development program.

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

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

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

of the patent;

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

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

(iv) the patent is expired.

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

(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.

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

(d) See ASPR 15-107.

(37) Selling Costs.

(a) Selling costs arise in the marketing of the contractor's products and include costs of sales promotion, negotiation, liaison between Government representatives and contractor's personnel, and other related activities.

(b) Selling costs are allowable to the extent they are reasonable and are allocable to Government business (but see ASPR 15-107). Allocability of selling costs will be determined in the light of reasonable benefit to the Government arising from such activities as technical, consulting, demonstration, and other services which are for purposes such as application or adaptation of the contractor's products to Government use.

(c) Notwithstanding (b) above, salesmen's or agents' conpensation, 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.

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

(39) Severance Pay.

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

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

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

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

(40) 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.

(41) Taxes.

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

(i) Federal income and excess profits taxes;

(ii) taxes in connection with financing, refinancing or refunding operations (see (17));

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

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

(b) Taxes otherwise allowable under (a) above, but upon which a claim of illegality or erroneous assessment exists, are allowale; provided that the contractor prior to payment of such taxes:

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

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

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

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

contractor had been reimbursed by the Government for the taxes, interest, or penalties.

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

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

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

(c) 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.

(43) Training and Educational Costs.

(a) Costs of preparation and maintenance of a program of instruction at noncollege level, designed to increase the vocational effectiveness of bona fide employees, including training materials, textbooks, salaries or wages of trainees (excluding overtime compensation which might arise therefrom), and

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

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

are allowable.

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

(i) training materials;

(ii) textbooks;

(iii) fees charged by the educational institution;

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

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

are allowable.

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

technology, the period may be extended.

(d) Maintenance expense, and normal depreciation or fair rental, on facilities owned or leased by the contractor for training purposes are allowable to the extent set forth in (20), (9), and (34) above, respectively.

(e) Grants to educational or training institutions, including the donation of facilities or other properties, scholarships or fellowships, are considered contributions and are unallowable (see (8) above).

(44) Transportation Costs. Transportation costs include freight, express, cartage, and postage charges relating either to goods purchased, in process, or delivered. These costs are allowable. When such costs can readily be identified with the items involved, they may be directly costed as transportation costs or added to the cost of such items (see (22) above). Where identification with the materials received cannot readily be made, inbound transportation costs may be charged to the appropriate indirect cost accounts if the contractor follows a consistent, equitable procedure in this respect. Outbound freight, if reimbursable under the terms of the contract, shall be treated as a direct cost.

(45) Travel Costs.

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

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

(c) Travel costs incurred in the normal course of over-all administration of the business are allowable and shall be treated as indirect costs.

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

(e) Necessary, reasonable costs of family movements and personnel movements of a special or mass nature are allowable, subject to allocation on the basis of work or time period benefited when appropriate. (But see ASPR 15-107.)

Part 6 - Guidelines for Application in the Negotiation and Administration of Fixed-Price Type Supply and Research Contracts with Organizations Other Than Educational Institutions and in the Negotiation of Termination Settlements for the Convenience of the Government

15-600 Scope of Part. This Part provides guidance for the use of Part 2 of this Section (i) in the evaluation of costs in pricing of negotiated fixed-price type supply and research contracts and subcontracts with organizations other than educational institutions, in those instances where such evaluation is required to establish prices for such contracts and (ii) in the negotiation of termination settlements.

15-601 Definition of Fixed-Price Type Contracts. "Fixed-price type" contracts include, for purposes of this Part, the following:

(i) firm fixed-price contracts (ASPR 3-403.1)

(ii) fixed-price contracts with escalation (ASPR 3-403.2)

(iii) fixed-price contracts providing for the redetermination of price (ASPR 3-403.3)

(iv) fixed-price incentive contracts (ASPR 3-403.4)

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

(vi) labor-hour contracts (ASPR 3-405.2)

15-602 Basic Considerations. (a) Under fixed-price type contracts, the negotiated price is the basis for payment to a contractor whereas allowable costs are the basis for reimbursement under cost-reimbursement type contracts. Accordingly, the policies and procedures of ASPR Section III, Part 8, are

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

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

(i) Retrospective Pricing and Settlements. In negotiating firm fixed prices or settlements for work which has been completed at the time of negotiation (e.g., final negotiations under fixed-price incentive contracts, redetermination of price after completion of the work, or negotiation of a settlement agreement under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. However, even in these situations, the finally agreed price or settlement may represent something other than the sum total of acceptable costs plus profit, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

(ii) Forward Pricing. The extent to which costs influence forward pricing varies greatly from case to case. In negotiations covering future work, actual costs cannot be known and the importance of cost estimates depends on the circumstances. The contracting officer must consider all the factors affecting the reasonableness of the total proposed price, such as the technical, production or financial risk assumed, the complexity of work, the extent of competitive pricing, and the contractor's record for efficiency, economy and ingenuity, as well as available cost estimates. He must be free to bargain for a total price which equitably distributes the risks between the contractor and the Government and provides incentives for efficiency and cost reduction. In negotiating such a price, it is not possible to identify the treatment of specific cost elements since the bargaining is on a total price basis. Thus, while cost data is often a valuable aid, it will not control negotiation of prices for work to be performed, or a target price under an incentive contract.

15-603 Cost Principles and Their Use. (a) When, pursuant to ASPR 15-601, costs are to be considered in the negotiation of fixed-price type contracts, Section XV, Part 2, shall be used as a guide in the evaluation of cost data required to establish a fair and reasonable price in conjunction with other

pertinent considerations as set forth more fully in ASPR Section III, Part 6.

(b) In retrospective pricing, 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 contracting officer in his conduct of negotiations.

(c) In applying Part 2 of this Section XV to fixed-price contracts, contracting officers will: (i) not be expected to negotiate agreement on every individual element of cost; and (ii) be expected to use their judgment as to the degree of detail in which they consider the individual elements of cost in arriving at their evaluation of total cost, where such evaluation is appropriate. However, the negotiation record should fully substantiate and justify the reasoning leading to any negotiated price.

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

Time	Subject	Government Spokesman	Industry Spokesman
(Lunch 1300-1400)			
1400-1500	Research and Development	Mr. W. Munves Office of Counsel Air Force	Mr. E. Leatham ~~National Security Industrial Assn., Inc.~~ NAM
1500-1530	Contributions and Donations	Mr. A. C. Lazure Ordnance Corps, Army	Mr. Herbert T. McAnally AIA American Institute of Certified Public Accountants
1530-1600	Interest	Mr. F. E. Hall Army Audit Agency	Mr. T. Herz U. S. Chamber of Commerce
1600-1620	Training and Education	Mr. A. Kay Office of the Ass't. Sec. of Defense (M,P&R)	Mr. T. Herz U. S. Chamber of Commerce
1620-1630	Plant Reconversion Costs	Mr. J. Ruttenberg Navy Comptroller, Contract Audit Division	Mr. Frank Kipp Automobile Manufacturers Association
1630-1640	Overtime	Lt. Col. W. W. Thybony Office of the Ass't. Sec. of Army (Materiel)	Mr. Frank Kipp Automobile Manufacturers Association
1640-1700	Closing Remarks		

A - D A

Meeting with Industry Representatives
Contract Cost Principles

Moderators: Cdr. J. M. Malloy
Mr. E. Leatham

October 15, 1958

Time	Subject	Government Spokesman	Industry Spokesman
0900-0930	Introduction	Mr. E. Perkins McGuire Assistant Secretary of Defense (Supply and Logistics) Cdr. J. M. Malloy Office of the Ass't. Sec. of Defense (S&L)	Mr. E. Leatham
0930-1015	Applicability	Mr. T. A. Pilson Office of the Ass't. Sec. of Defense (S&L)	Mr. J. Marschalk Strategic Industries Association
1015-1050	"All Costs" concept	Mr. H. Wallace Air Force, Auditor General Mr. R. D. Benson Office of the Ass't. Sec. of Air Force (Financial Manage- ment)	Mr. Martin A. Kavanaugh Aircraft Industries Assn. of America, Inc.
(Intermission 1050-1100)			
1100-1130	Reasonableness and Allocability	Mr. K. K. Kilgore Office of the Ass't. Sec. of Defense (Comp)	Mr. E. G. Bellows Nat'l. Security Industrial Association, Inc.
1130-1200	Advance Understandings	Mr. M. E. Jones Office of Naval Material	Mr. Geo. Hogg, Jr. Electronic Industries Association
1200-1230	Advertising	Mr. A. J. Racusin Office of the Ass't. Sec. of Air Force (Materiel)	Mr. M. Moulton National Association of Manufacturers
1230-1300	Compensation	Mr. G. A. Middleton Navy Comptroller, Contract Audit Division	Mr. Herbert T. McAnley American Institute of Certified Public Accountants

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

SUPPLY AND LOGISTICS

10 November 1958

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

SUBJECT: Allowability of Profit-Sharing Plans Under Current Air Force Contracts

The Air Force has again raised the problem, by telephone inquiry from Max Golden, of the action which should be taken with respect to the allowability of profit-sharing plans under current contracts. I understand that the great majority of Air Force contractors are refusing to negotiate final prices under incentive and price redeterminable contracts in view of the probability of an imminent change in Air Force policy with respect to the allowability of profit-sharing plans. The Air Force is desirous of breaking this stalemate and is asking for our acquiescence to a change in Air Force policy which would recognize these expenses as allowable.

As you recall, there is no specific guidance in the ASPR now with respect to profit-sharing as it applies to fixed price contracts. Although profit-sharing is not mentioned specifically, the present Section XV of ASPR with respect to CPFF contracts deals with the over-all reasonableness of compensation. The Army and Navy have always treated profit-sharing as a portion of over-all compensation. There is no existing regulation from our office which would prevent the Air Force from changing its own policy so as to recognize profit-sharing as an allowable cost. However, I believe that you had previously indicated that the Air Force should not change their current policy until a final decision in this matter was reached by Mr. McElroy.

It seems to me that the maintenance of the status quo in this important area may well invoke a substantial hardship on both the Air Force and its contractors. I know of no sentiment at the present time that would indicate that the present preliminary decision taken by Mr. McElroy will be changed. In view of this situation, I recommend that we advise the Air Force that there would be no objection from this office to a change in the Air Force policy which would treat profit-sharing plans as a portion of over-all compensation, subject of course to the over-all test of reasonableness similar to that set forth in our latest draft of the comprehensive set of cost principles.

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

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

SUPPLY AND LOGISTICS

CR

NOV 10 1958

AsstSecDef(S&L) has seen

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

SUBJECT: Status Report on Contract Cost Principles

I have had two meetings with Departmental representatives as a follow-up of our 15 October meeting on the cost principles. We are in general agreement that the principles as presently drawn are basically sound. However, based on the industry presentations, we think there is a need for further consideration and probable change, in some degree, of the present treatment of applicability, advance understandings, advertising, contributions, research and development, and plant reconversion. We are in the process of developing new language in the above areas.

Our meeting on the research and development principle was particularly encouraging. We are now drafting a new principle which will eliminate entirely the various definitions of the several kinds of research. We would simply provide that any type of research and development which is directly related to a contract product line would be recovered fully by a contractor to the extent that we purchase such products. All research and development not related to a product line would be charged as an overhead item to any type of contract. It follows from the above, that any research or development expense incurred by a contractor, which is directly related to a product which we are not buying, would be borne by the contractor. With respect to R&D not related to a contract product line, we will indicate methods of control over costs, such as review of individual shopping lists, a percentage share arrangement, a maximum dollar limitation, or a combination of these methods. We feel strongly that no standard percentage can be prescribed. The Departments also agree that we should provide a coordinated method of arriving at our "share" of a contractor's research program. We think that the forum now used for negotiated overhead rates may well be used for this joint determination.

As you requested, I have discussed the compensation principle with Under Secretary MacIntyre. He suggests that we recognize that, in the

administrative review of compensation, we can only hope to focus on the out-of-line or unreasonable situation. Since this is true, he suggests that we try to inject some flavor of this approach into our cost principle to relieve our people of a difficult task. This approach would also help to close a possible opening for hostile critics in specific situations involving profit-sharing plans. Secretary MacIntyre indicated that he was offering this approach as a suggestion only, and he will not press for its adoption if we can not easily accommodate it. I now feel that the suggestion has merit, and I am concerned only that we do not reverse the basic approach to the entire set of cost principles. We will endeavor to draft language to accommodate Secretary MacIntyre's suggestion.

I am attaching a copy of the transcript of the 15 October meeting together with a copy of the latest Industry comments which we received this afternoon. I have been informed that the Machinery and Allied Products Institute will submit separate comments later this week.

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

Inclosures

10 November 1958

NOV 10 1958

MEMORANDUM FOR MR. McNEIL

I am attaching a status report of our progress on Section XV together with a copy of the latest industry comments which just came in. Ernest Leathem is going to see me on Thursday with respect to the industry comments.

Inclosures

GR

NOV 10 1958

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

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

Inclosures

DRAFT
15 Dec 58/JMM

Proposed Amendments to Draft Dated 21 August 1958

APPLICABILITY

15-000 Scope of Section. This Section contains general cost principles and standards for use in connection with (i) the determination of costs under cost-reimbursement type contracts, (ii) the utilization of cost data by contracting officers in the negotiation of fair and reasonable prices under the various types of fixed price contracts, and (iii) the preparation and presentation of costs and cost estimates by prospective contractors, contractors, and subcontractors.

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) costs of terminated cost-reimbursement contracts;

(C) terminations when the amounts thereof are determined unilaterally by the contracting officer in accordance with ASPR 8-209.7(a).

(D) the determination of final overhead rates.

(ii) By contracting officers in the evaluation of cost data in CONNECTION WITH fixed-price incentive and redeterminable type contracts and negotiated termination settlement agreements, 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 (i.e., final negotiations under fixed-price incentive contract, redetermination of price after completion of the work, or negotiation of a settlement agreement under a contract terminated for the convenience of the Government), the treatment of costs is a major factor in arriving at the amount of the price or settlement. Accordingly, ASPR Section XV, Part 2, shall serve as the basis for evaluation of cost data (but see paragraphs (C) and (D) below). However, the finally agreed price or settlement represents something other than the total sum of acceptable costs AND PROFIT, since the final price accepted by each party does not necessarily reflect agreement on the evaluation of each element of cost, but rather a final resolution of all issues in the negotiation process.

(B) In Forward Pricing. To the extent that costs are a factor in forward pricing (i.e., 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), ASPR Section XV, Part 2, shall be utilized to provide general guidance in the consideration of cost data incident to the negotiation of fair and reasonable prices rather than as a prescribed basis for determining such prices. In this respect, the policies and procedures set forth in ASPR Section III, Part 8, are governing and shall be followed. The extent to which costs influence ~~toward~~ 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.

(C) In view of the considerations set forth above, the contracting officer will not be required to specifically evaluate and explain the treatment accorded each individual item of cost in substantiating the justification of a price.

(D) Part 2 is not prescribed by this regulation for incorporation in fixed-price incentive and redeterminable type contracts. While recognizing the significance of costs in the establishment of prices under these types of contracts, the use of cost principles in such situations must be flexible because the problem is one of negotiating a fixed price rather than the determination of allowable or unallowable costs. Since fixed-price incentive and redeterminable type contracts are basically of the fixed-price type, nothing in this Part 2 shall be construed as preventing the submission by contractors of requests for consideration of any item which is considered by the contractor to contribute to performance of the contract. Such requests shall be in addition to and shall be specifically excluded from the development and submission of cost data and price analysis contemplated by ASPR 15-101.1(iv) below. Such information may be taken into consideration by the Contracting Officer in determining the overall price to the extent appropriate to the circumstances of the particular procurement.

(iii) By contracting officers in the negotiation of firm fixed-price type contracts.

A. In negotiating firm fixed-price type contracts, (including those containing escalation provisions) and the non-cost-reimbursement portion of time and materials contracts, the use of cost analysis as a pricing aid is ordinarily not necessary. Accordingly, utilization of the cost principles set forth in this Part 2 is not appropriate. In some situations, the various techniques of pricing enumerated in ASPR Section III, Part 8, will not be adequate. In these instances, cost estimates can be of assistance in the negotiation of a fair and reasonable price; however, primary concern is with the level of estimated cost and secondarily with the types of costs included in the estimates. These cost estimates will usually require evaluation primarily on a cost ~~element~~ category basis, e.g., the reasonableness of the total labor estimate giving consideration to total estimated manhours or the reasonableness of the overhead figures on a rate basis. In this connection, the general principles set forth in ASPR 15-201, 15-202 and 15-203 should be utilized to the maximum degree practicable.

(iv) By contractors, prospective contractors, and subcontractors, as a basis for the development and submission of cost data and price analyses to contracting officers for the purpose

of negotiating estimated costs under cost-reimbursement type contracts or prices under fixed-price type contracts, with the exception of those proposals expected to lead to the negotiation of firm fixed-prices where the prices are to be established prior to or at the outset of the work. The above exception includes fixed-price contracts containing escalation provisions and the non-cost-reimbursement portion of time and materials contracts.

(v) By the Audit Agencies in their advisory capacity of providing accounting ADVICE in the situations enumerated in (iv) above.

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ASSISTANT SECRETARY OF DEFENSE

Washington 25, D. C.

SUPPLY AND LOGISTICS

CP

Dear

We have completed our staff analysis of the views of industry as expressed in connection with the draft of the comprehensive set of cost principles dated 10 September 1957.

We believe that the next step should be to consider with industry certain issues which have been raised by industry comment and which are basic to the realization of a mutually acceptable document. The issues have been separated into twelve questions, four of which are basic to the use of a comprehensive set of cost principles and the remainder of which relate to those individual items of expense which were most widely commented on.

There is attached a listing of the major issues which were taken from the prior comment of industry. This, together with a consideration of certain sections of the September 10, 1957 draft which have been rewritten, will be used as the agenda for the meeting. We believe that it is necessary to adhere to this agenda in view of the extent of the questions raised. We believe that the conclusions reached with respect to these questions will serve as a basis for the solution of whatever other questions of lesser significance may remain.

We are inviting industry to meet with us on Wednesday, 15 October at 9 a.m. in room 3E 869, The Pentagon for a discussion of the principles in order to permit their early publication. It is believed that a small representative group can be most effective in maintaining the meeting at a productive level. In terms of participation, each Association should limit itself to a single spokesman and it is suggested that attendance be confined to the minimum necessary to assist the spokesman. As indicated in my letter last February, it is my plan to attend this meeting, along with the Assistant Secretary of Defense (Comptroller) and the Materiel Secretaries of the Military Departments, in order that we may have a clear understanding of Industry's position and of the proposed revisions as they now stand.

For your ready reference there is attached a copy of the draft dated 10 September 1957. In addition, there are attached revised drafts of the following paragraphs which will constitute part of the agenda:

Paragraph or Part	Purpose of Change
Part 1, "Applicability"	To clarify intent that Part 2 has application to "negotiated" pricing and to clarify the nature of the evaluation of cost data in such pricing.
15-204.1(b)	To express the intent that contractors should negotiate in advance the reasonableness and allocability of the enumerated items of expense under certain conditions; that failure to do so involves grave risks for the contractor with respect thereto; and that the option to negotiate may be exercised by the contracting officer as well as the contractor or prospective contractor.
15-204.2(f) Compensation	To simplify the coverage; to modify it to provide for the allowability of management incentives to the extent that the total compensation is reasonable; and to sharpen the guidance with respect to reasonableness of compensation.
15-204.2(y) Overtime	To provide compatibility with the principles contained in ASPR 12-102.
15-204.2(ii) Research and Development Costs	To provide that independent applied research and development may be allocated to appropriate sponsored applied research and development contracts in instances in which a contractor's normal course of business does not involve production work.

A similar letter is being sent to the other industry Associations which have been active in assisting the Department of Defense in the solution of this complex problem.

Sincerely yours,

Inclosures

21 August 1958

A G E N D A

Meeting with Industry Representatives
Contract Cost Principles

October 15, 1958

A. Differences in general concepts between industry comments and September 10 draft:

1. Applicability -

   Concern evidenced that the application to fixed-price type contracts may lead to formula pricing. Discussion of revised Part 1.

2. "All Costs" concept -

   Contention that Government should accept a share of all normal business costs.

3. Reasonableness and allocability -

   Feeling expressed that the terms "reasonableness" and allocability" need no further amplification in the principles. Contractor's normal practice and accounting system should govern acceptance of specific costs.

4. Advance understandings -

   Objections were raised to the provision encouraging advance negotiations to reach agreement on the basis for allowing certain costs. Discussion of clarifying revision of Paragraph 15-204.1(b).

B. Specific items of cost:

1. Advertising
2. Compensation for personal services -

   Discussion of revision of Paragraph 15-204.2(f).

3. Contributions and donations
4. Interest
5. Overtime -

   Discussion of revised Paragraph 15-204.2(y).

6. Plant reconversion costs
7. Research and development -

   Discussion of revised Paragraph 15-204.2(ii).

8. Training and education

Draft
21 August 1958

Proposed Amendments to Draft Dated 10 September 1957

SECTION XV

CONTRACT COST PRINCIPLES

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

Part 1 - Applicability

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

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

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

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

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

(C) costs of terminated cost-reimbursement contracts.

(ii) As a basis for:

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

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

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

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

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

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

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

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

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

Negotiation Requirement

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

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

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

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

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

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

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

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

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

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

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

Draft
21 August 1958

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

Proposed Amendment to Draft Dated 10 Sept 1957

sec. 15-204.2(A)(6)

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.

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

SUPPLY AND LOGISTICS

CR

2 December 1958

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

SUBJECT: Status Report on Contract Cost Principles

I have continued to meet regularly with Departmental representatives on both the main body of cost principles and the research and development principle. With respect to the latter, I can now report substantial agreement. I am attaching a draft of this principle which is currently being circulated for final comment. I expect that our recommendation to you will be substantially as indicated in the attached draft. You will note that we have adopted the latest industry proposal, which was submitted in Mr. Leathem's letter of November 7, 1958, almost word for word. We have, however, added our safeguard in paragraph 8 of the attached draft. Our committee is firmly and unanimously of the view that this approach is the only practical one.

We have finished our review of the industry comments with respect to particular items of cost. We will recommend a change in the title of the section (to Contract Cost Principles and Procedures). Additionally, we have agreed on a revision of the treatment of advanced understandings, rentals and plant reconversions costs. We will present a revised proposal on advertising costs, compensation and contributions and donations, although our recommendations in these latter three cases will not be unanimous.

We are currently working on a revision of the applicability section. As indicated by the industry comments, this section holds the key to the entire package. There is developing within the Departments, particularly in the Navy and Air Force, a basic fear that we may be trying to go too far in making our cost principles applicable in the fixed-price area. I am told that these sentiments have at least some backing at the Secretarial level. The Army position is not clear at the moment, although there is agreement with the Navy and Air Force thinking at the Army staff level. We will meet again on Thursday of this week to endeavor to draft a revision of the applicability section which will have the effect of lessening the impact of the cost principles in the fixed-price area, but which, on the other hand, will not leave a void in this area as currently exists. I do not intend to let this disagreement on applicability drag on; however, I think that we owe it to industry to seriously reconsider our previous position in this most basic portion of the cost principles.

Subj: Status Report on Contract Cost Principles 2 December 1958

It is my hope that we can provide you and the other Materiel Secretaries with a specific proposal for your further consideration by the end of next week.

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

1 Incl
Draft dtd 1 Dec 58

DEPARTMENT OF THE AIR FORCE
HEADQUARTERS UNITED STATES AIR FORCE
WASHINGTON 25, D. C.

AFMPP-PR 4 December 1958

MEMORANDUM FOR COMMANDER J. M. MALLOY, OASD (S&L)

SUBJECT: Comprehensive Cost Principles

1. This is in compliance with your request at our meeting on 2 December 1958, that I furnish you a written resume on my thinking on the "Applicability" aspects of the subject principles. I'm sure you can appreciate the fact that, due to the limited time available for preparation, these thoughts are far from being in finished form. They will, however, serve as a basis for further discussion in our efforts to reach a common ground to present to the Secretaries. This paper, of course, does not purport to present a formal "Air Force position".

2. It is my firm conviction that the proposed Cost Principles in their present form - or even with a reasonable degree of liberalization and clarification of certain, specific, individual principles - cannot be issued except by a unilateral decision by the Department of Defense to do so over the protests of industry.

3. There appears to be but two alternatives open whereby a set of principles can be issued, which will have a semblance of acceptance on the part of industry. These are:

a. Acceptance of industry's "all costs" concept and relying on the tests of reasonableness and allowability.

b. Revision of the "Applicability" section to recognize clearly the line of demarcation between cost-reimbursement type and fixed-price type contracts.

4. While industry would undoubtedly prefer the former (2a. above), this alternative is not considered to be appropriate in Government contracting, for the reasons outlined by the Government throughout the long history of this effort, culminating in the discussion of this point at the 15 October 1958 conference between industry and Department of Defense representatives.

5. On the other hand, alternative 2b. above, appears to me to be fundamentally sound, and if adopted, should enable us to promulgate the principles at an early date with substantial acceptance by industry -

at the same time preserving the Government's ability to price effectively its fixed-price type of contracts, including the consideration of cost data in areas where this is essential, eg., incentive and redeterminable contracts.

6. In support of revision of the "Applicability" section as stated above, the following points are offered:

a. It is in keeping with the basic premises of ASPR Section III, Part 8, "Price Negotiation Techniques," from which the following pertinent excerpts are listed:

> 3-807(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..... 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."
>
> 3-807(b) "While the public interest requires that excessive profits be avoided, the contracting officer should not become so pre-occupied 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."
>
> 3-807(c) "A fair and reasonable profit cannot be made by simply applying a certain predetermined percentage to the cost estimate or selling price of a product."
>
> 3-808.2(c) "Rough yardsticks may be developed.... 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(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." (The balance is 3-808.3 is too lengthy to incorporate herein. It is however, highly significant in considering the problem at hand, setting forth as it does comprehensive treatment on the use of cost analysis.)

3-808.6 "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....the contractor's price lists.....should be examined....and negotiations conducted on the basis of the "best user,""most favored customer" or similar practice customarily followed by the contractor."

b. In implementing ASPR Section III Part 8, the AFPI contains the following pertinent provisions:

3-808.1 "Under fixed-price type contracts, including redeterminable types, prices are to be negotiated, not separate elements of cost plus profit. In many cases, a breakdown of price into cost and profit elements will be useful in the process of analysis, evaluation, and negotiation of proposed prices. 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 contracts."

3-809(a)(2) "Auditors do not recommend 'disallowance' of costs under fixed-price type contracts as they do under cost-reimbursement type contracts because costs are not reimbursed, prices are paid. Therefore, auditors 'question' costs in advisory reports. The contracting officer, in negotiating price, will take such questioned costs into consideration, exercising judgment in this area and giving due regard to the fact that prices, not costs, are finally negotiated."

c. The use of cost principles in the fixed price area need not be abandoned or lost, it need only be put more sharply into proper perspective, consistent with the above cited ASPR and AFPI provisions.

Industry recognizes this fact. Mr. Leathem stated, at the 15 October 1958 meeting: "I don't think any of us in industry will argue on cost-reimbursement type contracts nor on incentive type contracts or price redetermination type contracts, in which from the outset we have accepted costs as a pricing technique, but we object very strenuously to being subjected to cost determinations when we did not accept this type of determination in establishing the price from the outset of the contract.

d. There can (and should) be included in the principles a direct caveat against "formula pricing". In those cases (in fixed-price type contracts) where cost estimates are a factor, primary concern is with the level of estimated costs and secondary concern with the types of costs included in estimates. This is especially true in areas of prospective pricing, where costs estimates are not the sole determinant for pricing. The Government should provide the best incentive to efficiency be negotiating prices which will encourage contractors to control costs.

7. None of the foregoing is intended to convey the thought that our people should not - where cost analysis is required in negotiating a fixed-price type contract - utilize the cost principles as an aid in their evaluation of the contractor's proposal. I feel that we are on basically sound grounds in the concept underlying the proposed comprehensive set, but that we have been too cautious in our terminology (to avoid giving the impression of complete abandonment of our right to question certain costs), particularly in our zealousness to retain the "comprehensive" concept.

8. To get more specific as to the contents and composition of the "Applicability" section, the following observations are submitted for consideration by our working group:

a. It should state clearly that the principles are mandatorily applicable to, and should be incorporated by reference in, cost-reimbursement type contracts (this includes terminations of such contracts).

b. It should state specifically that formally advertised contracts are not subject to the principles (terminations will be subject to the applicable principles set forth in ASPR Section VIII).

c. It should state that, as to the fixed-price type of contracts, the provisions of ASPR Section III, Part 8 are governing

and should be adhered to, with a specific caveat against "formula pricing" of such contracts. In this respect, it appears advisable to include in Section XV some of the language of Section III Part 8, as cited in paragraph 6 above, which will allay industry"s fears of "Formula pricing".

d. It must, despite the foregoing, make clear that in pricing incentive and redeterminable type contracts, there will perforce be greater weight placed on cost considerations than is necessary in the other fixed-price types of contracts.

e. It may be more practicable to break out all of the foregoing except a. as a separate short Part in Section XV, with a cross-reference thereto in the Part 2 "Applicability" section. This will clearly form a line of demarcation, and at the same time will enable us to establish true "principles" for the fixed-price variety of contracts.

9. As you have undoubtedly observed, the ideas expressed herein do not represent too radical a departure from the current concept. Yet, I feel they go a long way towards accommodating what I consider to be a fundamentally sound industry position on applicability. At the same time, we will not have placed ourselves in an indefensible position with respect to the General Accounting Office.

10. I am furnishing copies of this paper to the other representatives on our working group in the expectation that it may be possible, at our meeting this afternoon, to draft some specific recommendations for language along these lines to go in Section XV. You will recall that I have generally adhered to the feelings expressed by the departmental representatives at our last meeting.

G. J. Vecchietti

G. J. VECCHIETTI

cc: Lt. Col. Thybony (Army)
Mr. M. E. Jones (Navy)
Mr. Kenneth Kilgore (OSD)

CR

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

SUBJECT: Department of Defense Policy with Respect to the Treatment of Compensation Expense in Connection with DOD Contracts.

You have asked for a statement of Department of Defense policy with respect to compensation for personal services in connection with the pricing of Department of Defense contracts. It is considered that the compensation of individuals for personal services includes all remuneration in whatever form for services rendered during the period of contract performance. It includes incentive compensation for management employees as described and limited in the 21 August 1958 draft of the Contract Cost Principles.

The cost of such compensation should be favorably considered in contract pricing to the extent that total compensation of individual employees is reasonable for the service rendered. While the amount of compensation in individual instances is a difficult matter to evaluate, the tests of reasonableness set forth in the 21 August 1958 draft of the Contract Cost Principles are considered adequate for this purpose. It is my understanding that the Air Force has established administrative controls which are designed to preclude the inclusion of unreasonable compensation costs in contract pricing.

Barkus McGuire

Assistant Secretary of Defense
(Supply and Logistics)

Prepared by:
CR - Cdr JJMalloy/rbs/12 Dec 72026
3D774

Coordinated with:
J. J. [illegible]

CC:
ASD(Comp)

Cdr Malloy 091

CR

12 December 1958

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

SUBJECT: Letter on Compensation Expense to the Assistant Secretary of the Air Force (Materiel)

I have redrafted the attached letter along the lines of our discussion and I have cleared it with Max Golden. The last sentence of the first paragraph was added at the specific request of Mr. Golden. I think it best that this sentence be added so that there can be no misunderstandings with respect to the intent of our letter.

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

Cdr Malloy

DRAFT/TAPilson/jec/12Dec58

Applicability of Cost Principles

At the 15 October meeting, in endeavoring to support the comprehensive use of cost principles as defined in the DOD draft dated 21 August 1958, I stated, in effect, that the consideration of costs appears in the procurement process (and that these are the "cost-related" areas) as follows:

1. In termination and in reimbursement of costs under cost-type contracts;

2. In the establishment of reasonable redetermined pricing under price-redetermination and incentive-type contracts;

3. In the establishment of reasonable prices and targets in the negotiation of fixed-price contracts when other pricing aids are insufficient to establish reasonableness of price;

4. By auditors in the provision of cost data to support a factual basis for a proper reimbursement and for the establishment of reasonable prices;

5. By the Board of Contract Appeals, the Courts, and elsewhere in the final resolution of questions of cost.

I have checked the transcript of the meeting, as supplemented by the general letter of industry and the supplemental letter of MAPI and have found that while there were protests against applying this set to all situations, there was not a single argument that these are not the "cost-related" areas in the procurement process. It is my belief that it cannot be successfully established that they are not. What, then, did industry say?

A. Mr. Marschalk, in reporting a situation which he contended to be "formula pricing" pointed out that the formula was incomplete and therefore the formula profit was inadequate, and he said:

"It is this fairy-story use of the words 'profit' and 'cost' which lies at the bottom of all industry's objections to applying this regulation IN ITS PROPOSED FORM to ANY KIND OF CONTRACT. It is the fiction that a cost is not a cost when it is a disallowed cost."

"There are many other places where proposed applicability will create serious difficulties for industry and government BECAUSE OF THE NATURE OF THE RULES AS NOW PROPOSED."

Although speaking to the problem of the "applicability" of the principles, Mr. Marschalk spoke in favor of the "ALL COSTS" concept, when he said:

"Recognizing that the recovery of all legitimate costs is the only fair prospect in this circumstance, we are compelled to the conclusion that it is the only fair prospect in any form of a contract."

B. Mr. Stewart, NAPI, paid particular attention to the applicability. He said:

"We have felt, as your previous speaker has felt, for some time that THESE principles are bad for all contracts." They are certainly bad in the cost-reimbursement type area and they are even worse if they go beyond the cost-reimbursement area.

"The MERE EXISTENCE of a set of cost principles...cannot fail to circumscribe the negotiating officer's area of discretion and judgment and would seem to relieve him of his duty to negotiate a reasonable price.

"...we need to look at these cost principles both as to their applicability AND THEIR CONTENT, and you can't divorce one from the other..."

C. At the end of the meeting, Mr. Leathem, in summarizing the activities of the day, asserted that the Government is "actually taking away from... the present levels of cost recovery," and he stated:

"...the most important statements we made to you today are the statements that ALL COSTS MUST BE THE BASIS FOR CONSIDERATION, no matter how you slice the cake, and until and unless you agree with this principle, WE CAN NEVER HAVE AGREEMENT BETWEEN GOVERNMENT AND INDUSTRY IN THIS WHOLE FIELD OF COST REIMBURSEMENT.

D. In the Industry supplemental comments of 7 November, the problem of ALL COSTS and Applicability was again discussed. It was stated:

"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.

"...it is not fair to require to certify that SOMETHING LESS THAN LEGITIMATE COSTS, ACTUALLY INCURRED, ARE 'total costs.'

"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.

"...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..."

"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."

E. Mr. Stewart, MAPI, gave perhaps one half of his attention to the problem of applicability. Among the things which he said were the following:

"...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."

He complains that:

"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."

He observes:

"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. [In the paragraphs which follow, Mr. Stewart isolates 'risk' as the point of difference between the several types of contract.]"

It is to be noted that virtually every objection is related to the content of the principles. Mr. Marschalk stated objection IN ITS PRESENT FORM TO ANY KIND OF CONTRACT (even cost-reimbursement). Mr. Stewart said that the application of "THESE principles are bad for all contracts." In the general Industry comment, the statement was made that "A COST IS A COST WHEREVER INCURRED, but that if the Government would recognize the all-costs theory, "THEN THEIR APPLICABILITY COULD BE EXPANDED." Mr. Stewart in MAPI's supplemental comment reasserted the conclusion that the principles in EITHER THEIR PRESENT OR PROPOSED FORM were inadequate for all purposes—including cost-reimbursement. Mr. Stewart seems to recognize that a cost is a cost under all of the "cost-related" circumstances when he asserted that the argument could not be seriously made that there is any difference in cost treatment under the several types of contract.

Thus, Industry is, in fact, arguing against <u>THIS SET</u>, not any set. It seems to me that if the DOD desires to move toward Industry acceptance of this draft, the attention ought to be directed toward an analysis of the propriety of the extent and type of treatment in the several elements of cost rather than in the Applicability aspects.

At the outset, Messrs. Kilgore and Pilson anticipated the applicability problem and after much coordination between ASD(COMP) and ASD(S&L) and the military departments, the following conclusion was reached:

"Cost treatment should be equalized as much as possible between the several types of contracts so that one type of contract will be neither less nor more attractive to a contractor or to the Government by reason only of the cost treatment. Thus, the selection of the contract type can be based upon the merits of the negotiation, i.e., the conditions surrounding the required product or service and the extent of any contingencies covering risks, rather than the external influences arising out of cost treatment."

I believe that industry recognized the validity of this conclusion.

At the same time, the risk problem was recognized. We stated:

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

I believe that our contingency cost principle, together with the consideration of this factor in profits (covered by ASPR 3-808.4 (b)) contains proper policy consideration of this element—not differences in cost treatment.

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".

ASSISTANT SECRETARY OF DEFENSE
Washington 25, D.C.

Supply and Logistics

CR

31 December 1958

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.

(signed)

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

1 Incl
Memo to ASD (S&L)
29 Dec 58

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)

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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 unmistakable 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 on 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.

(signed)

J. M. MALLOY
Cdr, SC, USN
Staff Director, ASPR Division

3 Incls
1. Tab A
2. Tab B
3. Tab C

12/9/58

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;

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

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

(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 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.

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(i):

"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.)

DEPARTMENT OF THE NAVY
OFFICE OF THE COMPTROLLER OF THE NAVY
CONTRACT AUDIT DIVISION
WASHINGTON, D. C.

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

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

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

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

LATEST ALLEN SMYTHE ARTICLE - CONTRACT COST PRINCIPLES
NY HERALD TRIBUNE 9/29/59

Assertion: Cost Principles "may" be soon published.

Evaluation: True.

Assertion: New rules will affect $14 billion per year in new procurement.

Evaluation: True.

Assertion: $26 billion in outstanding contracts would be amended to include the new "liberalized" rules.

Evaluation: Our party line is that the new rules are not a more liberal set than existing principles and practices. Provision is made for applying the principles to existing procurement for a "consideration." We don't know wherein, however, the "consideration" will be found.

Assertion: Publication is expected about 15 October.

Evaluation: Substantially accurate.

Assertion: Effective date 1 January 1960.

Evaluation: Actual outside effective date 1 July 1960.

Assertion: There were historical difficulties with Congress and industry but latest draft has been "screened from trade and congressional groups."

Evaluation: The latest drafts have been carefully guarded.

Assertion: Industry still opposed since not sufficiently generous.

Evaluation: Our best judgment is that industry will not seriously oppose the document.

Assertion: Requires changes in contractors' accounting systems.

Evaluation: Our party line is that this is not true to any significant extent.

Assertion: AIA prefers the status quo to the new "completely revised" set.

Evaluation: This is the historical AIA position.

Assertion: Some trade group officials estimate increases at "only several million dollars" which they believe insufficient.

Evaluation: See above re party line vs generosity of the new set.

Assertion: Small businessmen believe the new set will "only confuse and not help."

Evaluation: If true, this is news to us.

Assertion: Main increases are (1) general research, (2) executive benefits, overtime, and administrative expenses.

Evaluation: General research may be increased; executive benefits shall not be different than PRESENT practices; overtime and "administrative practices" should be about the same as current practices.

New Contract Cost Rules Likely To Get Approval

By Allen M. Smythe

After six years of effort, top procurement officials of the Pentagon may be on the point of revising their contract cost allowance rules, by far the most important defense fiscal regulations. The new proposed rules will affect an annual expenditures of $14,000,000,000 in new negotiated contracts for military hardware. More than $26,000,000,000 in outstanding active contracts would be amended to include these new liberalized rules and thus standardize the defense accounting system.

The final July 26 draft of these cost principles are awaiting approval by Assistant Secretary of Defense E. Perkins McGuire, who has just returned from vacation. They will then go to Secretary of Defense Neil H. McElroy for an expected routine indorsement and then be printed in the Federal Register. This procedure could be completed by Oct. 15, 1959. Effective date would be Jan. 1, 1960.

Several times before in the last few years new cost rules have come near to official approval but have been held up at the last minute by vigorous business or Congressional opposition. However, the final July 26 draft has been carefully screened from trade and Congressional groups. Only twenty keyed copies were made and these are carefully guarded.

Although increases are allowed to defense contractors in a number of cost items, the defense industry is generally opposed to the new rule. Main complaint is that the increases are not great enough to offset the cost and inconvenience of changing the accounting systems to fit the new rules.

Robert W. McMillan, top legal official of the aviation industry trade group, the Aerospace Industries Association, said, "Apparently the final draft is a compromise of various viewpoints in the Pentagon. The present rules are workable and in general industry would prefer them with some changes in the most controversial items rather than a completely revised set."

Other trade group officials thought the increases granted would amount to "only several hundred million dollars" and that this was not sufficient. Officials representing small business thought the new rules would only confuse and not help their members. Main increases granted are in the items of general research, executive benefits, overtime, and administrative expenses.

N.Y. Herald Tribune - 9/29/59

SW 7711

Questions presented at Monterey, California.

1. Mr. Charmak says that production engineering is separate from R&D. Defined as costs "related to a product being produced." Does this mean that production engineering must be so immediately related that it becomes a direct cost of a particular contract or order? Can production engineering be just related in a general sense and a proper overhead expense? If so, what is the distinction between production engineering (presumably allowable) and development (requiring advance understanding).

2. If all "basic" research has been approved as an overhead cost for prior years without getting prior approval, isn't the contractor gambling on possible disallowance of part of future "basic" research by trying to get an advance understanding and approval. Isn't it wiser to wait until a disallowance occurs? Has the Navy changed its attitude on "basic" research with new regulations and now requires advance understandings?

3. Whis is safest method of establishing allowability of questionnaire items? (1) Advance understanding with contracting officer on each contract or (2) Advance understanding with resident auditor on accting system and allowability of items desired in overhead accts.

4. If the Navy will accept development costs as an overhead item without burden where the contractor has followed this practice for years, why have the Navy auditors begun this year to disallow burden on disallowed development costs, thus forcing contractors to appeal (and incur the expense of so doing)?

5. Assuming a company has entered into an "advanced understanding" re independent research, must each contract nevertheless contain a clause re allowability before obtaining reimbursement? (Or is ASPR itself adequate without having individual clauses in contracts?)

6. Would you please expand on the idea of "burdening the R&D cost center"? Are you suggesting that both the direct and indirect costs incurred in the R&D cost center may be allocated to cost type contracts?

7. Has Mr. Charmak's interpretation that basic research means increasing the particular investigator's knowledge rather than increasing knowledge in general (and the similar interpretation with respect to advances in the state of the art) been communicated to the technical people reviewing contractors' R&D programs and to the other Govt. representatives negotiating R&D cost allowances? This question is asked because recent negotiations have indicated that the opposite interpretations are being used.

8. A recent Air Force policy letter issued by Gen. Davis directs that contractor costs in excess of the amount reimbursable under study contracts are to be disallowed. Do you consider such directive to be consistent with the intent of the revised cost principles?

9. Mr. Chermak says preferred treatment is to burden R&D labor. Yet talks about R&D as overhead. Isn't it a well established accounting principle that you do not apply burden to burden?

10. Should a prime contractor on a CPFF prime contract agree to special provisions governing overhead in its CPFF subcontracts in view of the fact that the prime contractor generally has no voice in the negotiation of subcontractor overhead rates?

11. Are the following likely to be considered as research expense (subject to sharing) by Govt. auditors? (1) Technical effort necessary to submission of unsolicited proposals. (2) Non-contract technical studies conducted at Govt. request or suggestion.

12. Does negotiation with the Christenat Committee and reaching of an agreement with them constitute an advance understanding on research & development which will insure recovery of a proportionate amount of the agreed upon costs against <u>all</u> contracts or do we also need an advance understanding & contract clause with each contracting officer?

13. How do you feel about disallowing all R&D cost. Of course the contractor would have to have additional profit to subsidize this.

14. Would you comment on allowability of R&D costs based on a reasonable fixed percentage of sales. Would you say that applied research or product development of products whose basic research was done under a CPFF contract is allowable if the products are improved by this applied research and are being sold for Government contracts to other prime contractors.

15. Has the Navy actually completed negotiation of advanced research & development rates with any contractor? (pursuant to ASPR 15) (1) If so what form are the agreements taking? (i.e., dollar maximum, overall % or % by program), (2) if so, what % of support is generally given by the Govt. (i.e., 30%, 40%, 80% of contractors total independent R&D costs, etc.)?

16. Please discuss the possibility of achieving a uniform set of cost principles ASPR US AEC.

17. What is the "generally accepted accounting procedure & practice" for allocation of G&A for a multi-plant corporation?

18. Is it fair to require one contractor to burden his research costs while on the other hand you permit his competitor to continue not burdening it.

19. As a former AF contracting officer I know a feeling exists in the Govt regarding advance understanding for R&D. These people (at the working level) feel they are sinning if they allow R&D. How can we expect to get ahead if this philosppphy exists. Further, MCPC in the AF as well as the ARDC review Committee balks at any advanced understanding re Jack Pauls lecture.

20. Is an "advance understanding" agreement limited to question of reasonableness and allocability or may it also cover questions of allowability?

21. Assume that a contractor is performing under contracts with both the USAF and the AEC and that it accumulates bidding costs into an overhead account, applied to direct labor. Since the AEC will not allow such costs, may the contractor accumulate bidding costs to the USAF separately from those incurred in bidding to the AEC, recovering such USAF bidding costs as an overhead item applied to USAF direct labor only. (This question addressed to Mr. Wesselink.)

22. What are "burden centers," "burden rates" and their relationship to overhead?

23. Has the Navy any procedure for getting, in a timely manner, advance understandings affecting contracts of more than one Bureau. If so, what is it?

24. Please explore a little more the distinction between research and development-- a specific case: A company has developed a proprietary product (built one hand made prototype). It then plans to make a pilot run of a few more units *under the supervision of the engineer (and in his lab) who developed the product. After completion of the run, production drawings will be released since they can't be completed before. What category do the original costs fall into and what category do those connected with the pilot run fall into? What about allowance of these costs in overhead? The units to be made in the pilot run will be used for evaluation and not sold.

25. (a) You made a careful distinction between basic research, applied research and development engineering. Question: How do these distinctions affect the means by which these costs may be recovered. (b) You recommended that contractors reach an advance understanding as to the percent of total research & development dollars may be recovered. I read the ASPR to mean that such cost sharing may be "desirable" but not essential. Any comment?

26. In the absence of an advanced understanding are R&D expenses unallowable if not specifically authorized in cost type contracts? I read nothing in new ASPR that says that either advance understandings or specific contractual authority are mandatory for R&D expenses to be allowable.

27. Re applied research under old ASPR 15. It is my understanding that the Controller of the Navy has issued to his field auditors an interpretation that states in part "applied research related to product lines for which the contractor has CPFF rates on the premise that this applied research is general research and as such is specifically unallowable by ASPR. Question:1)Is that interpretation not inconsistent with the current definition of applied research? 2) Why is this interpretation not readily available to contractors?

(a)
28./ Under Navy contracts, should advance agreements per Sec. XV be made with the Auditor or the contracting officer. (2) On a FFP or FPR contract, some contracting officers will not recognize the cost sharing of research, can this unrecognized share be reallocated to call the CPFF contracts.

Pentagon to Stand Fast On Contractor Ad Policy

By L. EDGAR PRINA
Star Staff Writer

The Pentagon will stand fast on its policy of allowing defense contractors to charge the Government for company advertisements in trade and technical journals.

This was disclosed by Defense Department officials when asked yesterday whether any changes in the Armed Services Procurement Regulation were contemplated in the wake of President Eisenhower's blast at the "munitions lobby."

The President has been described as primarily disturbed over ads taken by the weapons makers in newspapers and other media which are obviously intended to influence military decisions.

The recent Boeing Co., ad extolling its Bomarc missile was said to have particularly annoyed him, coming as it did while the Pentagon was drafting a new air defense plan and Congress was considering funds for Bomarc and the Army's rival Hercules weapon.

Taxpayer Pays

Although the Pentagon does not allow general circulation advertising, such as the Boeing ad, as a direct contract cost, some members of Congress are convinced that the taxpayer, in the end, foots the bill—or most of it—just as he does in the trade and technical journal ads. They say that the entire advertising and public relations programs of the big defense industries need examination.

What the Pentagon does permit is stated in a key provision of its Procurement Regulation, Section 15-204 (). Headed "Examples of Items of Allowable Costs" it reads:

"Advertising in trade and technical journals, provided such advertising does not offer specific products for sale but is placed for the purpose of offering financial support to journals which are valuable for the dissemination of technical information within the contractor's industry."

The regulation does not define "trade and technical journals" but one official said the Pentagon approves as "allowable costs" only those advertisements placed in nonprofit publications.

Helped Wanted Ads

The Pentagon also allows "help wanted" ads as defense contract costs no matter what medium is used — newspapers, magazines, radio or television.

While the Pentagon hierarchy is disturbed by ads which attempt to influence its decisions, the official said he did not believe the Defense Department could or should try to control the amount of company advertising or its content, except to insure against breaches of security.

"If a company wants to spend all its profits on advertising, that's their business—they still have to answer to their stockholders," he said.

But some Congressmen take a different view. Representative Ford, Republican of Michigan, for example, told The Star:

"These (defense) ads are a waste of the taxpayers' money because the money comes out of the contract, the cost of which is paid by the Federal Treasury, and you know where the Treasury gets its money—from you and me and every other taxpayer."

Mr. Ford, who is a member of the House Defense Appropriations Subcommittee, said many weapons ads "create the wrong impression because the manufacturers tend to magnify their accomplishments." Then he added:

"Most Disgusting"

"But the most disgusting thing to me is the tremendous number of ads these companies place in various trade and semi-official service publications."

The Congressman asserted that the advertising policies of the defense contractors were, in effect, helping to finance inter-service fights over weapons and roles and missions.

There is no doubt that the Air Force Association, Association of the United States Army and Navy League monthly publications obtain much of their revenue from weapons manufacturers' ads. These publications, of course, are sounding boards for individual service viewpoints.

Other sources say that concern at the White House comes from the feeling that the public ultimately pays for the large-scale advertising and public relations campaigns of the giant defense industries and that in some cases these campaigns are directed at overriding decisions of officials in the Executive Branch and Congress who are paid by the public to make these decisions.

Big Contractors

Most of the controversial ads are placed by aircraft companies, which are the prime contractors for the big missile programs. When it is considered that the aircraft industry, the largest in the country both in terms of labor force and dollar volume of business, is more than 90 per cent dependent on Government contracts, the problem is seen to be a serious one.

On the matter of lobbying on Capitol Hill by aircraft and missile manufacturers, there appears to be little direct pressure exerted, although the laws regulating this activity are full of loopholes.

The aircraft companies have dropped their own individual lobbyists. They are represented now by the Aero-Space Industries Association, to whom they pay substantial fees. But the association, while it has three individuals and two law firms registered as lobbyists, says only one—Harold Mosier—is really engaged in this activity. The others are registered "just to be safe."

The records filed with Congress would indicate that even Mr. Mosier does little lobbying. He reported expenditures of only $1,159.05 in 1958 and a salary of $16,224.

Congressmen concerned with tightening lobbying regulations —Senator Kennedy, Democrat of Massachusetts, for one—are known to feel that many organizations have turned their real efforts at influencing legislation on officials of the Executive Branch. The reason given: Much legislation actually is proposed to Congress by the Executive Branch and there are no regulations governing "lobbying" in that area.

This matter may very well be explored by a House Armed Services Subcommittee headed by Representative Hebert, Democrat of Louisiana, when it holds hearings on the controversial problem of the employment of retired Army, Air Force and Navy officers in defense industries.

CR

19 February 1959

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

SUBJECT: Contract Cost Principles

I am providing you herewith with certain background material for use in connection with the Material Secretaries' meeting on the Contract Cost Principles. Additionally, I am providing you with a spread sheet, showing the resolutions which we propose of the various issues discussed with Industry at the 15 October 1958 meeting.

In connection with the Material Secretaries' meeting, it is my expectation that the majority of the recommendations made by the Special Task Group, which I headed, will be favorably indorsed. In the area of specific elements of cost, the recommendation which we have made with respect to contributions and donations will provoke discussion and possible dissent. I am advised that the Air Force will oppose making this element an allowable cost. While staff elements within the Army and Navy favor its allowability, I am unable at this time to predict the final departmental positions.

As outlined in my report to you, the question of applicability of the cost principles is the major point at issue within the Department of Defense at the present time. As you will recall, this subject was raised as a major issue by Industry. I have held numerous discussions on the question of applicability subsequent to submission of my report to you. These discussions were primarily had with Mr. Bannerman and Mr. Kilgore. The discussions were designed to seek a basis for agreement between our office and that of the Comptroller, so that we might approach the meeting with the Material Secretaries on a common basis. As a result of these discussions, I have redrafted the applicability section of the cost principles in a manner which I believe will be agreeable to the Comptroller's office and our own. I have sought to make certain concessions to Industry without destroying the basic concept of the previous drafts of the applicability section. I have provided copies of this redraft to the Military Departments on an informal basis. The material which has been so provided is set forth on your spread sheet. I am endeavoring to provide the framework upon which mutually acceptable agreement can be reached at the meeting

cc: Cdr. Malloy

next Tuesday. While I cannot predict the outcome of this effort, I am optimistic. If this move is unsuccessful, I feel that the Secretaries will find it difficult to reach a common ground, at least, in this first meeting.

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

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

February 24, 1959

MEMORANDUM FOR: Mr. Perkins McGuire
Assistant Secretary of Defense

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

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

(signed)
Raymond J. Saulnier

COPY

Tab C

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

FEB 2 1 1959

COMPTROLLER

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

SUBJECT: Contract Cost Principles

I have read the proposals of the working group which you transmitted by memorandum of 31 December 1958 and concur in all of the working group's proposals except for the proposed handling of applicability to fixed price contracts and the stated reasoning supporting it.

The version proposed in the 21 August 1958 draft, with perhaps the inclusion of specific reference to ASPR Section III, Part 8, appears to be a much more meaningful and logical approach. The proposed revision would fail to furnish the uniform guidance which I had understood we set as our objective. It is deficient in that it does not differentiate between the significance of cost principles in retroactive (redetermination and incentive) pricing as against prospective pricing situations. It could well necessitate the separate, piecemeal issuance of additional guidelines covering specific areas or conditions as problems arise in the future. In addition, while it is understood that the Comptroller General might now be willing to concur in the 21 August draft, in view of his earlier criticism of that proposal, it is doubted that he would be amenable to further beclouding the applicability statement. Attached are comments in greater detail on this recommendation.

Thus, it is believed that we should proceed, as soon as possible, to issue the principles substantially on the basis proposed on 21 August, after reflecting the other changes recommended by the working group.

W. J. McNeil

Inclosure
Comments on applicability

P.S. I wonder how soon some very sincere people in this business world recognize that — whether we like it or not — [illegible] is based on cost regardless of the label on the contract [illegible]

12 February 1959

CONTRACT COST PRINCIPLES
APPLICABILITY TO FIXED PRICE CONTRACTS

Mr. McGuire's memorandum of 31 December 1958 transmitted for consideration the proposal of a working group to substantially change the material on applicability of cost principles to fixed price contracts and to place it in a separate part of ASPR Section XV.

Basically, the proposal provides that cost principles shall be used to provide "general guidance" in the evaluation of cost data in any fixed price contract where costs are a consideration (as opposed to the basis for evaluation). There follow some of the reasons why this proposal is considered to be less appropriate than the prior approach of 21 August 1958.

1. Confusion in purpose and effect -- In paragraph 5 of the staff memo giving reasons for the proposed revised approach, a major point revolves around the fear of formula pricing in fixed price contracts where costs are a major factor in pricing. There appears to be some confusion as to the part which cost principles play in pricing such contracts. Cost principles apply only to the determination of costs. What effect costs have on pricing is entirely a separate matter based upon the circumstances as well described in the 21 August draft and elsewhere in ASPR.

Actually, pricing is a "formula" (not a dirty word) matter to the extent costs must be relied upon as the major factor -- which is very often the case. Prices equal costs plus profit allowed. But there is no requirement to negotiate and agree upon costs and profits separately, except for incentive-type contracts. Yet the contracting officer, in such cases, must unilaterally evaluate costs as a basis for arriving at his determination of price (which price must be agreed upon with the contractor), and for justifying it to his superiors. In the case of incentive type contracts, the agreed pricing formula requires negotiation of costs separately before price can be determined. Costs must be approached by the contracting officer item by item in such cases -- in the one case through negotiation, in the other by unilateral evaluation.

Therefore, detailed evaluation of cost items is appropriate. They should be defended on the same basis as cost-reimbursement-type contracts, especially where fixed prices are retroactively determined. Profit allowances, however, (not costs) should be flexible in each case considering the appropriate factors, especially the contractor's risks and efficiency.

2. Problem in arrangement of ASPR -- While the mere extraction of the fixed price applicability material from Part 1 and placement in another Part (7) appears to be a minor mechanical or technical matter, it could well lead to confusion. The working group apparently did not consider this problem. Based upon strong objections to a prior attempt to renumber the Parts, especially Part 2 because it is referred to in thousands of existing cost type contracts, the assumption is that Part 2 would continue to be a statement of detailed cost treatment for supply contracts with commercial institutions. Parts 3 and 4 would cover educational institutions and construction contracts respectively. This would leave Part 1 logically for "applicability" -- not only for cost-type contracts, but all costs. The proposed alternative additional Part, probably 5, would be another on applicability to fixed price contracts. This would appear to be an illogical and inconsistent arrangement.

3. Who will be governed by the principles? -- Almost from the inception of this project, there was basic agreement on the important concept that all three of the parties involved in procurement cost matters -- the contracting officer, the contractor, and the auditor -- would be guided by the principles. This has been eminently clear in all prior proposals but is not covered in the current proposal. This exclusion could well lead to confusion and an increase in the cost of administration. The concept should be reinstated.

4. Effect of risk on application of cost principles -- In justifying the proposed new applicability Part, there appears to be some confusion with respect to risk in two respects. The first relates to the reference to "the riskless cost type contract." This seems to say that there is no risk in cost type contracts, and to imply that there is a high degree of risk in all types of fixed price contracts. There are, of course, some risks in the cost type contract -- the problems of termination, ceilings, unallowable costs, etc. On the other hand, the degree of risks in fixed price contracts varies greatly. For example, generally in fixed price incentive contracts, the risks would be little greater than in the cost type. In fact, some contractors have admitted that they favor incentive contracts because of the substantial elimination of risk without the stringent limitation on profits. Likewise, retroactive price redetermination approaches the cost-reimbursement basis insofar as risk is concerned.

The second aspect of the confusion relates to the nature of payment for risk. Risk is taken into account in two ways. First, by our own pricing and profit policy, risk is one of the factors considered

in establishing the level of profit. Second, the principles contain a provision allowing for contingencies in estimating costs. Thus, it would not appear that we should try to take care of the risk factor by including as a cost in fixed price contracts elements such as advertising, entertainment or contributions, which we would disallow in cost type contracts. This philosophy would tend to becloud management evaluation of fees versus profits by classes of contracts, and runs counter to our previously adopted position that no type of contract should be more attractive than any other solely on the basis of treatment of costs.

5. Retrospective vs prospective use -- The proposed version lumps all fixed price contracts in the same category insofar as application of the cost principles are concerned -- a general guidance basis. The prior version provided for better guidance in this respect in that it differentiated between their use in retrospective and prospective situations. In situations where we are looking at historical costs, as in the case of price redetermination and particularly incentive formula settlements based exclusively on incurred costs, it is believed that the principles must be the basis for determination. There may be a less compelling reason for asserting they are the basis for prospective repricing (perhaps only a guide), yet to the contracting officer they should be the basis.

CR

23 March 1959

MEMORANDUM FOR MR. JOHN JOHNSON, GENERAL COUNSEL, NATIONAL AERONAUTICS AND SPACE AGENCY

SUBJECT: Contract Cost Principles

I am inclosing a single copy of the latest draft of the Contract Cost Principles. As you are aware, we have been considering a revision of Section XV, Part 2, of ASPR for sometime. We are endeavoring to publish a revision of the Cost Principles at an early date.

I am furnishing you this draft in accordance with our desire to develop the ASPR with due regard to the views of NASA. Only a limited number of copies of this particular draft have been made and its distribution within the Department of Defense is being strictly controlled. Needless to say, I would be most receptive to any substantive suggestions which NASA may care to provide.

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

CR

27 April 1959

MEMORANDUM FOR LT. COL. WILLIAM H. TINKHAM
MR. H. E. JONES
MR. GEORGE VECCHIETTI
MR. KENNETH KILGORE

SUBJECT: Contract Cost Principles, Review of 27 April 1959 Draft

At the 16 April 1959 meeting of the Material Secretaries, it was decided that the further review of the Contract Cost Principles would be accomplished by the same group which worked with me on the revision occasioned by the 15 October 1958 meeting with Industry. Accordingly, I am scheduling two meetings to consider the 27 April 1959 draft at 10 A.M. in Room 3C-883 on 5 May and 7 May 1959. For this purpose, I am inclosing 6 copies of the 27 April 1959 draft. A limited number of additional copies are available.

In this latest draft, we have incorporated certain changes for the following reasons:

1. Changes suggested by Industry representatives during meetings held on 1-3 April 59.

2. Certain editorial rearrangement of the material in previous drafts.

3. Certain changes in ASPR so that the cost principles applicable to Terminations are set forth.

4. A rearrangement of the Cost Principles applicable to Construction Contracts.

While all of the editorial changes are not pointed out here, they will be specifically pointed out during our meetings. The following specific changes are highlighted for your particular attention:

1. The redraft of Part I - Applicability.

2. The additional coverage with respect to Exhibits under "Advertising Costs" - - - page 12.

3. A change in the Bad Debts Principle - - - page 12.

4. A change under "Rental Costs" - - - page 34.

5. A change under "Training and Education Costs" in subparagraph (b) - - - page 44.

6. 2 Changes in Paragraph 15-603 on page 50. These changes are in subparagraph (b) and subparagraph (d).

There is attached as TAB B a series of suggestions designed to conform ASPR Section VIII to ASPR Section XV.

We have tried here to provide a working draft of the changes in Section VIII which seem appropriate. This Tab B may require additional changes of a perfecting nature.

There is attached as TAB C a revision of Part 4 - Construction Contracts, of present ASPR. It is our feeling that we cannot at this time do the complete job of bringing the cost principles for Construction Contracts up-to-date. In lieu thereof, we have merely rearranged the material in present ASPR so as to incorporate all of it in Part 4. We feel that the complete revision of Contract Cost Principles for Construction Contracts should be undertaken in an orderly fashion subsequent to the publication of the revised Part 2. For the same reason, we have reserved a section on cost principles for Facilities Contracts to be developed at a later date.

Our meetings will be most fruitful if we confine ourselves to a consideration of the changes which have been made since the cost principles were last approved by the Material Secretaries. It should be pointed out that no approval has as yet been given to the changes which have been incorporated in the 27 April 1959 draft.

Signed

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

Incl.
Cy 27 Apr 59 draft
(6 cys)

M302A/CWC:ems

4 May 1959

MEMORANDUM

From: M302A
To: MD3A

Subj: Conformance of ASPR Section VIII with Section XV Cost Principles

Encl: (1) Proposed Revision of ASPR Section VIII

1. It is recommended that ASPR Section VIII be revised as indicated by enclosure (1). While Section VIII, Part 2 contains principles applicable to both fixed-price and cost-reimbursement type contracts, this part in ASPR 8-213 also deals with the settlement of certain research and development contracts under fixed-price or cost-reimbursement type no-profit or no-fee with educational or other non-profit institutions. For such cost-reimbursement contracts with non-profit institutions the principles in Section XV, Part 3 should be used in effecting a termination settlement, while the fixed-price types should be settled under Section XV, Part 3 and the principles recommended for insertion in Section VIII, Part 3.

2. The cost principles in ASPR Section XV, Part 2 are considered to be sufficient for the settlement of cost-reimbursement type contracts with other than non-profit institutions. For the settlement of terminated fixed-price contracts, however, the cost principles in Section XV, Part 2, should be supplemented by the additional cost principles recommended for insertion in Section VIII, Part 3.

3. It is also recommended that the language originally submitted under Case 53-74 for ASPR 8-301 and 8-301.1 which was approved by the ASPR Committee be restored when the comprehensive set of principles are published.

C. W. CLARK

APRIL 1959

Contract Cost Principles

The staffs of the military departments and of ASD(S&L) and ASD(Comp) have utilized the time since the industry meeting of 15 October last, and the receipt of the industry comment a month later, to reappraise fully the contract cost principles problem.

On completion of the first review, ASD(S&L) called upon four industry consultants who were in attendance at the 15 October meeting, to review with our staffs the new draft. The group consisted of:

Industry		Government	
Mr. McAnley	- Ernst & Ernst	Cdr. Malloy	- ASD(S&L)
Mr. Haynes	- Boeing	Mr. K. K. Kilgore	- ASD(Comp)
Mr. Bellows	- Maxson Corp	Mr. E. Cook	- Navy(Comp)
Mr. Marschalk	- Strategic Industries Assn.	Mr. L. Cox	- AF(Counsel) member, ASPR Editing Subcmte.

Every paragraph of the draft was again reviewed and an effort was made to find mutually acceptable provisions.

On the basis of this conference another draft has been prepared which is being utilized as the basis for final intra-departmental coordination and certain other inter-agency coordination preparatory to publication.

There is provided on the next two pages a discussion of:

a. Applicability

b. R&D Coverage

Enclosure 1.

Applicability of Contract Cost Principles

In the latest recasting of the Contract Cost Principles, a physical separation has been made between the cost-type use and the fixed price type use. This has been done by specifying the use of Part 2 (which includes the principles themselves) only to:

a. The DETERMINATION of reimburseable costs;
b. the negotiation of overhead rates;
c. the DETERMINATION of costs of terminated cost type contracts when the contractor elects to "voucher out" the cost.

Part 6 provides "guidance" for use in fixed-price type contracts. While this is physically separated from Part 2, it is to be noted that the verbs utilized are not different from those objected to at the industry-government meeting. It specifies that Part 2 shall be used "AS A GUIDE," within the framework of some included formula-preventing policy, "in the evaluation of cost data required to establish a fair and reasonable price. . ."

The previous use of the principles in the settlement of issues has been watered down to say that:

> "In retrospective pricing" when "the acceptability of a specific item of cost becomes an issue" Part 2 "will serve as a guide FOR THE CONTRACTING OFFICER IN HIS CONDUCT OF NEGOTIATIONS."

Research and Development Contract Cost Principles

RESEARCH

Contractor's independent research is allowable as indirect costs, provided they are allocated to all work of the contractor.

In providing a definition of "research," it is stated that it includes "basic research" together with that portion of applied research which represents efforts to advance the state of the art, but which do not relate to a product to be offered for sale. The latter represents a concession to industry.

DEVELOPMENT

Independent development is allowable as "related to the product lines for which the Government has contracts," to the extent such costs are reasonable and are "allocated to all work of the contractor on such product line."

REASONABLENESS OF RESEARCH AND DEVELOPMENT EXPENSES

Reasonableness of this item of expense is subject to "negotiation," and advance agreement is rather strongly suggested "with contractors whose work is predominantly or substantially with the Government."

Part 2

Pages 820 - 821 - Delete present ASPR 8-213 and insert the following:

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

In considering cost data as a guide for negotiation or determination of settlements under fixed-price or cost-reimbursement type no-profit or no-fee contracts for experimental, developmental, or research work with educational or other nonprofit institutions, which contain the termination clause set forth in ASPR 8-704, the items of cost set forth in ASPR Section XV, Part 3 and ASPR 8-302 shall be considered subject to the general policies set forth in ASPR 8-301.1.

Part 3

Additional Principles Applicable to the Settlement of Fixed-Price Type Contracts Terminated for Convenience

Pages 823 - 831 - Delete present ASPR 8-300, 8-301, and 8-302 and insert the following:

8-301 Principles for Establishing the Settlement Amount.

8-301.1 General. (a) A settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portion of the contract, including an allowance for profit thereon which is reasonable under the circumstances. The primary objective is to negotiate a settlement by agreement; however, the total amount payable to the contractor, whether through negotiation or by determination, before deducting disposal or other credits and exclusive of settlement costs, shall not exceed the contract price less payments otherwise made or to be made under the contract. Fair compensation is a matter of judgment and cannot be measured exactly. In a given case, various methods may be equally appropriate for arriving at fair compensation. The application of standards of business judgment, as distinguished from strict accounting principles, is the heart of a settlement. The parties may agree upon a total amount to be paid the contractor without agreeing on or segregating the particular elements of costs or profit comprising this amount. Cost and accounting data may provide guides, but are not rigid measures, for ascertaining fair compensation. In appropriate cases, costs may be stimated, differences compromised, and doubtful questions settled by agreement. Other types of data, criteria, or standards may furnish equally reliable guides to fair compensation. The amount of record keeping, reporting, and accounting, in connection

with the settlement of termination claims, shall be kept to the minimum, compatible with the reasonable protection of the public interest.

(b) In the negotiation or determination of a termination settlement, the principles in the applicable Part of ASPR Section XV, and those principles set forth in 8-302 below reflect certain policy determinations regarding types of costs which shall serve as a guide for the evaluation of cost information by the contracting officer in arriving at fair compensation if such costs are reasonably necessary and properly chargeable or allocable to the terminated portion of the contract.

8-302 Additional Cost Principles

(1) Common Items. The cost of items reasonably usable on the contractor's other work shall not be considered allowable unless the contractor submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the contractor, the contracting officer should consider the contractor's plans and orders for current and scheduled production. Contemporaneous purchases of common items by the contractor shall be regarded as evidence that such items are reasonably usable on the contractor's other work. Any acceptance of common items as allocable to the terminated portion of the contract should be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

(2) Costs Continuing After Termination. If in a particular case, despite all reasonable efforts by the contractor, certain

costs cannot be discontinued immediately after the effective date of termination, such costs may be considered allowable within the limitations set forth in ASPR XV, and this paragraph 8-302, except that any such costs continuing after termination due to the negligent or wilful failure of the contractor shall be considered unallowable.

(3) Initial Costs, including starting load and preparatory costs, generally may be considered allowable.

a. Starting load costs are costs of a nonrecurring nature arising in the early stages of production and not fully absorbed because of the termination. Such costs may include the cost of labor and material, and related overhead attributable to such factors as (i) excessive spoilage resulting from inexperienced labor, (ii) idle time and subnormal production occasioned by testing and changing methods of processing, (iii) employee training, and (iv) unfamiliarity or lack of experience with the product, materials, manufacturing processes and techniques.

b. Preparatory costs are costs incurred in preparing to perform the terminated contract, including costs of initial plant rearrangement and alterations, management and personnel organization, production planning and similar activities, but excluding special machinery and equipment and starting load costs.

c. If initial costs are claimed and have not been segregated on the contractor's books, segregation for settlement purposes shall be made from cost reports and schedules which reflect the high unit cost incurred during the early stages of the contract.

d. When the settlement proposal is on the inventory basis, initial costs should normally be allocated on the basis of total end items called for by the contract immediately prior to termination; however, if the contract includes end items of a diverse nature, some other equitable basis may be used, such as machine or labor hours.

e. When initial costs are included in the settlement proposal as a direct charge, such costs shall not also be included in overhead.

f. Initial costs attributable to only one contract shall not be apportioned to other contracts.

(4) Loss of useful value of special tooling, special machinery and equipment may be considered allowable: provided (i) such special tooling, machinery or equipment is not reasonably capable of use in the other work of the contractor; (ii) the interest of the Government is protected by transfer of title or by other means deemed appropriate by the contracting officer, and (iii) the loss of useful value as to any one terminated contract is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the contract bears to the entire terminated contract and other Government contracts for which the special tooling, special machinery and equipment was acquired.

(5) Rental Costs may be considered allowable under leases clearly shown to have been reasonably necessary for the performance of the terminated contract, less the residual value of such leases, if:

(i) the amount of such rental claimed does not exceed the reasonable use value of the property leased for the period of the contract and such further period as may be reasonable, and

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

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

(6) Settlement expenses including the following may be considered allowable:

(i) accounting, legal, clerical, and similar costs reasonably necessary for (A) the preparation and presentation to contracting officers of settlement claims and supporting data with respect to the terminated portion of the contract, and (B) the termination and settlement of subcontracts; and

(ii) reasonable costs for the storage, transportation, protection and disposition of property acquired or produced for the contract.

(7) Subcontractor Claims, including the allocable portion of claims which are common to the contract and to other work of the contractor may be considered allowable.

8-303 Allowance for Profit.

(Use printed ASPR 8-303)

8-304 Adjustment for Loss.

(Use printed ASPR 8-304)

8-305 Deductions

(Use printed ASPR 8-305)

8-306 Completed End Items.

(Use printed ASPR 8-306)

8-307 Settlement Proposals

(Use printed ASPR 8-307)

Reference changes.

Page 831 8-303(a) - Line 4 - change parenthetical reference 8-302(b)(27) to 8-302(6)

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

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

Page 862 - 872 Clauses 701 and 703, para (f) change references to include applicable principles in Section XV and those in Section VIII, Part 3

OR

15 May 59

MEMORANDUM FOR THE DIRECTOR OF DEFENSE RESEARCH AND ENGINEERING
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.

I am enclosing for your consideration a revised draft, dated 12 May 1959, of the contract cost principles. While this revision does not contain major changes from the draft which we recently discussed, it does represent a refinement of language as a result of the meetings with certain industry representatives on 1-3 April 1959.

I am hopeful that no further revisions need be made in the cost principles and that we can move quickly to accomplish the remaining clearances necessary prior to publication. I am encouraged in this belief by the fact that the attached draft has been recommended for my approval by an interdepartmental working group made up of your designated representatives.

In view of the urgency of this matter, I would appreciate an indication of your approval of the attached draft at your earliest convenience. Should you care to suggest changes of a substantive nature, I suggest that you advise me at the earliest possible time.

Perkins McGuire

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

1 Incl.
Rev. draft dtd
12 May 59

Prepared by: JMMalloy/rbs/14May59
3D774 72026

Coordinated by:
G.C. Bannerman _____

15 May 1959

TO: Mr. Ernest Brackett
NASA

FROM: Cdr. J. M. Malloy

SUBJECT: Contract Cost Principles

As promised in my letter of 12 May 1959, I am attaching a copy of the latest draft of the Contract Cost Principles. This draft has not been released as yet, and hence I would request that you refrain from making any distribution beyond your office. I will keep you posted as to the status of approval of this draft within the Department of Defense.

(signed)

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

ASSISTANT SECRETARY OF DEFENSE
WASHINGTON 25, D. C.

COMPTROLLER

MAY 26 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: Contract Cost Principles and Procedures

By memorandum of May 15, 1959, you requested my approval of the May 12th draft of cost principles. In consideration of the many divergent viewpoints which had to be accommodated therein and the urgent need for principles in the negotiated fixed-price area, I give my approval.

W. J. McNeil

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

CR

SUPPLY AND LOGISTICS

13 May 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)
Through: Director for Procurement Policy

SUBJECT: Contract Cost Principles

Mr. Kilgore and I have met with representatives of the Military Departments to consider the changes which were made in the Contract Cost Principles as a result of the meetings we held with Industry representatives on 1-3 April 1959. I am inclosing as Tab A a new draft of the Cost Principles which we recommend for your approval. This draft has been concurred in by all members of the special working group.

While we made numerous changes in the previous draft as a result of the Industry meeting and our further consideration of the Cost Principles, a great majority of the changes were of a clarifying nature. Several revisions of a technical nature, such as the definitions of direct and indirect costs, were made at the suggestion of the Industry representatives. No change has been made in the research and development principle as a result of our latest reviews. We have made certain editorial rearrangements of the material which we feel has improved the overall content of the regulation. For example, we have included the section on Advance Understandings in Part 1 of the regulation in lieu of having it an integral part of the cost principles themselves which are set forth in Part 2 of the regulation.

Your particular attention is invited to the following changes which we recommend for your approval, but which go beyond the type of clarifying and technical changes mentioned above:

1. Advertising Costs.

The Industry representatives argued strongly and rather persuasively that our proposed coverage of the cost of exhibits was much too narrow. The previous draft contained the following:

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

Our recommended revision is as follows:

"(iii) costs of participation in exhibits—

(A) upon invitation of the Government, or

(B) which exhibits are valuable for the purpose of disseminating technical informa-

tion within the contractor's industry; however, such costs are not allowable under this subparagraph (B) if the exhibit offers specific products or services for sale;"

It is our feeling that the principle as revised does not open the door too far with respect to costs of exhibits. We allow costs of advertising in trade and technical journals which do not offer specific products for sale but are placed in journals which are valuable for the dissemination for technical information within the contractors' industry. It seems logical to us to allow the cost of exhibits under the same circumstances.

2. Training and Educational Costs.

We have revised that portion of this principle which deals with costs of part-time education at an under-graduate or post-graduate college level by deleting the restriction to "technical, engineering, and scientific." Our discussion, even within Defense, indicated that the term "technical" was subject to varying interpretations. In its narrowest sense, it could be considered to exclude certain training which we considered acceptable such as training of contract administration personnel and the training of certain technical personnel in sound business and cost control techniques. The other controls and restrictions which we have as a part of this particular cost principle seem to us sufficient to prevent any abuse.

3. 16-603. Cost Principles and Their Use.

The previous draft of a portion of this paragraph was as follows:

"(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."

We have revised the above as follows:

(b) "In retrospective pricing, whenever an occasion arises in which the acceptability of a specific item of cost becomes an issue, the appropriate part of this Section XV will serve as a guide for the contracting officer in his conduct of negotiations."

The Industry representatives were particularly vocal with respect to our previous draft. While they would have much preferred to see this paragraph eliminated entirely, we were able to work out an acceptable compromise which serves to eliminate the impression which could be read into the previous draft that we would resolve conflicts on specific items of cost by dictation or slavish application of accounting rules.

Many of the suggestions offered by Industry were not acceptable to our working group and have not now been incorporated in the revised draft. Some of these suggestions concern themselves with costs connected with patents, taxes and insurance. The Industry representatives felt quite strongly that we should change our principle on bad debts to restrict the unallowability of such a cost to "commercial" bad debts on the theory that there are numerous instances within the Defense industries wherein bad debt expense is encountered in connection with government contracts, without the fault or negligence of the contractor. While some of us felt that the Industry point here was well taken, the departmental representatives did not consider such a revision appropriate and hence it has not been made in the attached draft.

It is my hope that we can expedite the remaining clearances necessary in connection with these cost principles to the end that they can be sent to the printer during the month of June. In this way, they could be mandatorily effective on 1 January 1960, although they would be available for use upon publication. The following specific actions seem necessary prior to the releasing of this regulation for printing:

1. The attached draft should be specifically approved by the Materiel Secretaries of the Departments and Mr. McNeil as soon as possible. This could be accomplished by memorandum, by discussion at the Materiel Secretaries weekly meeting on 21 May 1959, or in a special meeting called for this purpose.

2. The question as to the necessity of obtaining the specific approval of the Secretary of Defense should be decided.

3. The method by which we deal with the General Accounting Office should be determined and the program of action in this regard should be initiated.

4. We have a commitment to discuss the cost principles prior to publication with Dr. Saulnier and the Committee on Government Activities Affecting Costs and Prices.

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

1 Incl.
Tab A

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON

29 MAY 1959

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

Subj: The Contract Cost Principles and Procedures, comment on

Ref: (a) Memorandum from ASTSECDEF(S&L) of 15 May 1959 re Contract Cost Principles and Procedures revised draft of 12 May 1959

1. Reference (a) has been reviewed by my staff and with the exception of the following comments, I approve its issuance:

a. Page 4, line 19, after "will not," insert "with the exception of the limitations on rentals paid under sale and leaseback agreements. (See ASPR 15-205.34 (c)." Also include on page 5, as one of the examples of costs for which advance agreements may be particularly important, "(ix) Sales and leaseback agreements." This is considered necessary in view of the specific limitation on such rentals in ASPR 15-205.34 (c).

b. Page 31, line 4, change (i) to read "the item is regularly manufactured and sold by the contractor through commercial channels for commercial end use." (Underscoring supplied). Change (ii) to (iii) and add a new (ii) as follows: "the charges for the item(s) are nominal in amount." These revisions are considered essential to avoid a situation where the "commercial" customer of the vendor is a prime or subcontractor to the Government and the prices of the items have not been established in the non-governmental market. Also, if the total volume of such items is substantial, it seems only equitable that they should be charged to the Government contracts on a cost basis (rather than at a price which includes a profit element) in order to avoid the payment of what may be hidden profits.

c. Page 45, top line: the word "allowable" should be changed to "unallowable."

d. Page 47 - Either add (i) after "instances" in the fourth line or delete (ii) in the fifth line.

2. As you know, industry has been primarily concerned with the applicability of the cost principles to other than CPFF contracts. The recent letter from AIA to many of us is a strong reiteration of this position. Although I do not agree that issuance of the principles should be delayed to accommodate a further discussion of this subject, I recommend that in the practical implementation of the principles, the services be cautioned to avoid the "formula" pricing which industry fears. Should evidence of such pricing exist after a reasonable period of implementation of the principles, I strongly recommend further consideration on this matter at that time.

C. P. MILNE
Assistant Secretary of the Navy (Material)

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON

29 May 1959

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

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(signed) C. P. Milne

C. P. MILNE
Assistant Secretar

THE CONTRACT COST PRINCIPLES DILEMMA

Remarks by Commander John M. Malloy, SC, USN, at the Joint UCLA-Strategic Industries Association Symposium, Mirimar Hotel, Los Angeles, California, 20 May 1959.

I suppose there is no more controversial or talked about subject in procurement circles today than the proposed revision of Section XV of the Armed Services Procurement Regulation dealing with contract cost principles.

You are aware, no doubt, that we have had cost principles for cost-type contracts for many years. The latest major revision of these particular principles occurred in 1949. There is no dispute with respect to the need for rather precise cost principles applicable to cost-type contracts, although reasonable men may disagree rather violently on the particular treatment accorded specific elements of cost. About 5 years ago, we undertook to revise and up-date our principles for cost-type contracts and, at the same time, extend the use of cost principles in some way to other types of contracts where costs are a factor in pricing.

We are, I think, approaching the end of this effort. We have received voluminous comments from almost all segments of American industry on the various drafts of this revision. Last October, we conducted a rather unique meeting with industry which involved an all-day discussion by key Government and industry spokesmen on the principal issues which have been raised with respect to the proposed revision of the Regulation.

The verbatim transcript of this meeting provides an interesting and, I think, enlightening discussion. I believe that a few copies of this transcript are still available.

Subsequent to this meeting, we, in the Department of Defense, have been conducting a thorough re-appraisal of this project so as to have a workable and, as nearly as is possible, a mutually acceptable regulation which will be of maximum assistance to all parties at interest.

I would like to outline for you today some of the basic problems involved in this effort. I think it only fair to ask the question - What are we really trying to do by this revision? What are the reasons why the project seems to have taken so long to get off dead center? We are trying basically to develop a common set of guidelines applicable to the determination of costs in all types of contracts in which costs are a factor in pricing. No one will seriously argue that a particular item of cost, say advertising or contributions or entertainment, is different, per se, under differing contractual situations. When these elements of cost are being considered, why should they be treated differently in different types of contracts? What we are really saying is that no one form of contract should be more attractive than another solely because of the cost treatment accorded it.

Further, we feel that we have a responsibility to establish some uniformity of treatment of the various cost elements and, hence, some type of cost principle application would appear to be necessary to accomplish this purpose. I recently discussed the

subject of cost principles with a very knowledgeable Congressman whose reaction was fast and definite on this question of uniformity. He used as his example, the case where one of the Services had established a flat prohibition against allowing incentive compensation based upon profit-sharing plans, when the other two Services were allowing such costs to the extent that the overall compensation received by an individual was determined to be reasonable. Obviously, such differing approaches should be resolved and made uniform.

Additionally, as you can appreciate, in carrying out a 22 billion dollar annual procurement program, we have many thousands of contracting officers, negotiators and auditors who, as a practical matter, need to be informed of at least the generality of the Department of Defense position with respect to certain cost items. Many of you are also familiar with the problems which continually arise in dispute cases being heard by the Armed Services Board of Contract Appeals. You are aware, for example, that the Board on several occasions has, in effect, created its own policies with respect to particular cost items in the fixed-price area, since no policy had been promulgated through administrative channels.

Now you might say that all this seems quite reasonable and logical. What then is the problem? What creates the dilemma? The objections to the use of cost principles on a broad scale are many. For example, there is the fear that there will be such attention paid to costs that our entire philosophy of pricing will be in danger. It is contended that this attention to specific

elements of cost may well drive the contracting officer to rely on cost principles so completely as a basis for pricing in order to avoid criticism, that our generally accepted pricing policies will be negated. It is contended that this situation will lead to formula pricing; that is, totaling up the adding machine tape of costs, to which a standardized profit is added. The effect of such pricing may well destroy the inherent advantages of our family of fixed-price type contracts.

There is another practical problem worthy of note. I think it is true that in developing the specific treatment to be accorded a particular item of cost, we tend to be primarily concerned with its reasonableness and allocability under the relatively riskless cost type contract. I have heard even the so-called liberals in this area say many times that we should be more conservative, more detailed in this kind of contracting atmosphere. The resulting set of principles than, and this can be said, I think, of any particular set which has been developed, is on the conservative side. Many claim that, for this reason alone, it can't, in equity, be considered in any area except the one which primarily reflects its content; namely, the cost-reimbursement type contract.

We have stated repeatedly in our procurement regulation 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 adament dictation by one party to the negotiation) it is essential that the Government negotiator be provided with the flexibility to recognize the validity of any contractor request in return for a more advantageous concession by the contractor.

I have sketched for you some of the pros and cons of this argument. Now let's look at something more basic. I have mentioned pricing philosophy several times and have pointed out that comprehensive cost principles should not destroy this pricing concept. Now then, what is this pricing technique? Why not look at individual costs in each instance and tack on a profit?

Some people feel that a "fair and reasonable price" is one in which the contractor recovers all of his costs and gets a profit appropriate to his effort. This approach, however, ignores a basic business and pricing truism. Within reasonable limits, you can, through your method of contracting, control profits or you can control costs. You can't, within any reasonable degree of preciseness, control both. Through cost-reimbursement type contracts, you can control profit. You can assure that the contractor doesn't get rich, but you cannot, with any substantial

degree of effectiveness, assure that he is using his engineers, labor, and materials with reasonable effectiveness, that he is planning the work for efficient performance, that his designs are capable of low-cost manufacture, that his facilities are most effectively arranged or that any of a number of other factors seriously affecting his costs are being well performed. The Department of Defense does not have the talent, the experience, or the number of people required to undertake the management of American industry. If we do not perform this function, we cannot control costs in the only way they can be controlled under cost-reimbursement contracts. Since costs represent 85 percent of more of the prices we pay, it follows that uncontrolled costs are much more important to the prices we are required to pay than uncontrolled profits. Accordingly, we would prefer to create contractual situations where the contractor's management will bend every effort to keep costs down. Under these circumstances, we are willing to assume risks with respect to the extent of profits. This is the function of fixed-price contracts and of those incentive or redeterminable contracts which are targeted early. In setting firm fixed prices, final prices in redeterminable contracts or targets in incentive contracts, the great effort should be to arrive at a price which is sufficiently low to require the contractor's own management to do its utmost to use his engineers, labor, and materials effectively, to plan his work for efficient performance, to design his product for low-cost manufacture, to arrange his facilities in the best manner and to

to all other things appropriate to reducing his cost. If this is done, we shouldn't worry too much if he makes a higher-than-normal profit. He has earned it, and we have gained by it in most instances.

Fixed-price contracts provide a maximum amount of price control, whereas cost reimbursement type contracts provide for the maximum profit control. I want to emphasize this feature since it is very important. Recognition of this concept is the basis of our pricing philosophy. We might ask the question at this time, can we have both price control and profit control? If not, where should we place the emphasis?

I have spent considerable time on this basic pricing principle because, in my mind, it is at the crux of the dilemma which confronts us in prescribing cost principles to other than cost type contracts. We have the clear responsibility to provide guidelines for the handling of specific costs in any given situation while, on the other hand, we dare not destroy the very incentives for cost reduction which we feel are an inherent part of fixed-price contracts. Within the Department of Defense, I think it is safe to say we are all in agreement on these basic objectives. As you can imagine, however, there is plenty of room for reasonable men to disagree on how to accommodate these objectives.

I wish that I could give you a scoop today on the present status of this project within our office. However, I must content myself by telling you we have been spending a great deal of time re-appraising

our previous position with respect to the applicability of the principles.

We have leaned over backwards to obtain and fully consider the views of industry in our work on the cost principles. In this connection, we recently spent three full days with four industry experts who were asked by Secretary McGuire to assist us in a page by page review of the actual language which we are proposing. The revised cost principles are now in the process of final approval at the Secretarial level. We are undertaking discussions with certain agencies outside of the Department who have an interest in this project. My personal hope and expectation is that we will be able to send our new regulation to the printer in June. We contemplate that the new principles will present some rather substantial administrative problems in their early application and, hence, we are now thinking of a mandatory effective date of 1 January 1960 thereby providing a five months lead time. They would, of course, be available for use upon publication and, in any event, they would only apply to new contracts unless current contracts are amended by mutual consent.

In summary, I have endeavored to describe for you the horns of the cost principle dilemma— the need for guidelines for use

internally and to provide for some uniformity in treatment of costs when costs are a factor in pricing. On the other hand, if this desirable objective could be obtained only at the expense of formula pricing, and at the cost of loss of incentives for price reduction in the fixed-price area, it might well be best to retain the status quo. It is my view that both objectives can be accommodated, and I am convinced that our current efforts will provide this result.

DEPARTMENT OF THE NAVY
OFFICE OF THE GENERAL COUNSEL
WASHINGTON 25, D. C.

OGC/MHS:ag
3 June 1959

MEMORANDUM FOR COMMANDER JOHN M. MALLOY

Subj: Treatment of Taxes in the Revised Draft of ASPR Section XV

1. I understand that the latest draft of ASPR Section XV has been sent to the Materiel Secretaries for review. I have two comments on the treatment of taxes in ASPR 15-205(41). I believe that both of these comments can be accommodated at this time without anyone being accused of "major surgery."

2. ASPR 15-205(41)(a)(iii) speaks only of exemptions available to the contractor directly or available to the contractor based on an exemption afforded the Government. Exemptions are also available to subcontractors for various reasons. In order to include certain of these exemptions, I recommend that ASPR 15-205(41)(a)(iii) be revised to read as follows:

> "(iii) taxes from which exemptions are available to the contractor or cost-reimbursement type subcontractors directly, or available to the contractor or such subcontractors based on an exemption afforded the Government . . . ."

3. The language of ASPR 15-205(41)(b)(i) is not clear as to who makes the determination as to the existence of a claim of illegality or erroneous assessment. It could be the contractor, the Government, or a third party. Taken alone, this ambiguity is not harmful. In fact, insofar as it tends to increase the number of instances in which the Government is notified of a tax problem, it is beneficial. However, the effect of this ambiguity on (41)(b)(ii) may be troublesome. It could be argued that the contractor and the contractor alone is to determine whether a legal problem exists, and only when he so determines that a problem exists must he request in-

structions under (41)(b)(i) and take action directed by the contracting officer under (41)(b)(ii). Any problem in this respect can be avoided by revising ASPR 15-205(41)(b)(ii) to read:

> "(ii) takes all action directed by the contracting officer arising out of (b)(i) above or an independent decision of the Government as to the existence of a claim of illegality or erroneous assessment, including cooperation with and for the benefit of the Government to (A) determine the legality of such assessment or, (B) secure a refund of such taxes."

Meritt H. Steger
Deputy General Counsel

cc: Mr. W. H. Moore
Mr. Harry R. Van Cleve

DEPARTMENT OF THE ARMY
OFFICE OF THE ASSISTANT SECRETARY
WASHINGTON 25, D. C.

IN REPLY REFER TO:

JUN 5 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (S&L)

SUBJECT: Contract Cost Principles

The Department of the Army concurs in the draft of Section XV, Contract Cost Principles and Procedures, dated 12 May 1959, referred to in your memorandum of 15 May 1959, subject as above.

Courtney Johnson
Assistant Secretary of the Army
(Logistics)

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

COMPTROLLER

5 June 1959

MEMORANDUM FOR COMMANDER MALLOY
OASD (S&L)

SUBJECT: Cost Principles

Pursuant to our conversation of yesterday concerning the Air Force's position on paragraph 15-205.22(c), page 30 of the cost principles, I talked with Bob Benson this morning. While he would much prefer to use the wording which the Air Force suggested in order to make it clear on the record that we would not accept costs relating to write-downs of material values, he would go along with not raising official objection to the proposed wording which everyone else has agreed upon. However, he suggested that we retain someting in the way of "legislative history" to indicate that Defense policy generally is not to accept such costs. I agreed that this would be a satisfactory solution since it would avoid either (1) the possible inconsistency of the proposed revised wording or (2) the necessity for going into a long explanation of our position. If we run into any difficulty on this score after issuance of the principles, we can take another look with the view to clarification. I am furnishing a copy of this memorandum to Mr. Benson.

K. K. Kilgore

Copy to:
Mr. Benson

DEPARTMENT OF THE AIR FORCE
WASHINGTON

COPY

Office of the Assistant Secretary

June 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 15 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

2. We note the deletion in paragraph 15-205.22(c) of the prohibition relating to "write downs" or "write ups" of material values which had appeared in earlier drafts and which now appears, in part, in current ASPR 15-202.1. We understand that discussions on this point have taken place between the top Comptroller people in the Air Force and the Department of Defense. We also understand that agreement in principle has been reached to the effect that it is our common understanding that Department of Defense policy generally is not to accept such costs. Apparently this understanding is to be made a matter of record so that, should the problem arise, such an understanding could be relied upon to give a common answer. As you know, such an understanding cannot form the basis of a contractual obligation. Accordingly, we would urge for consideration the inclusion in the Cost Principles of appropriate language covering the point.

(Signed)
P. B. TAYLOR
Assistant Secretary of the Air Force

DEPARTMENT OF THE AIR FORCE
WASHINGTON

OFFICE OF THE ASSISTANT SECRETARY

JUN 11 1959

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

SUBJECT: Contract Cost Principles

1. Reference is made to your memorandum dated 15 May 1959 on the above subject. We have reviewed the latest draft attached to your memorandum and recognize the compromises that have been made in several items to accommodate divergent views among the Departments as well as with industry. Accordingly, we think it should be clearly understood that if actual experience under the proposed principles reveals any deficiencies, we will seek reconsideration of the matters involved. Since the proposal seems to offer an acceptable basis for early adoption, we concur subject to the comments noted below.

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P. B. TAYLOR
Assistant Secretary of the Air Force

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

CR

SUPPLY AND LOGISTICS

30 June 1959

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

SUBJECT: Contract Cost Principles

We have concluded our staff efforts with respect to the contract cost principles and a fully coordinated draft, ready for publication, is attached as Tab A. There remains, however, the problem of determining what action, if any, the Department of Defense should take with respect to the General Accounting Office and discussion with Dr. Saulnier of the Committee on Government Activities Affecting Costs and Prices. (Tab C)

It appears to us that there are 4 alternatives with respect to the GAO which are enumerated below:

1. Formal Coordination. This would entail submission of our draft to GAO, the receipt of their written comments, the evaluation of these comments, and the probable need for further coordination among all interested parties. Previous correspondence with the GAO on this subject is attached as Tab B. Our last previous communication to the GAO was dated 22 October 1957 in which we indicated that it was "our intention to consult with your office prior to publication." The GAO responded on 3 April 1958 indicating that "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."

2. Staff Level Discussions. This would entail a meeting between Mr. Powers, GAO Audit Chief, and Mr. Kilgore and Cdr. Malloy. Previous informal discussions lead us to the conclusion that Powers would seek Mr. Campbell's reaction prior to making any GAO commitment. If this alternative is adopted, the effort would be to convince GAO that our current draft represents an acceptable compromise among the many differing points of view which are involved in this project. Hence, we would endeavor to

convince GAO that the success of this entire effort might be jeopardized and, in any event, would be seriously delayed, if the many controversial points were opened up for discussion.

3. Publish Without Prior Reference to GAO. This alternative would have the obvious advantage of obviating detailed discussions with GAO and would save many months, even years, in consummating this project. It is our understanding that this alternative was adopted by the Munitions Board in 1948 when the current ASPR provisions were published. GAO immediately responded in a strong manner and caused a change of the newly published regulation in several particulars.

4. Secretarial Level Discussions. This would entail a meeting by Secretaries McGuire and McNeil with Mr. Campbell. The effort here would be to endeavor to convince Mr. Campbell of our immediate need for these cost principles. We could assure GAO of our willingness to re-appraise the validity of our principles after they had been in effect for a reasonable period of time.

It is our feeling that we should either publish the principles without reference to GAO or we should initiate discussions at the Secretarial level. Were it not for the commitment to the Comptroller General referred to in 1. above, we would recommend publication without reference to the GAO. However, in view of this commitment, we believe that a high level discussion with Mr. Campbell of the broad considerations offers the best solution. We are of the opinion that detailed consideration by the GAO, either by staff level discussion or by correspondence, will result in ultra-conservatism in the individual principles, and will jeopardize our concept of applicability of the principles to fixed-price type contracts. The result would be violently objected to by industry and by many elements of the Department of Defense. In effect, we would either have to arbitrarily publish the principles as revised or start the project all over again.

With respect to Dr. Saulnier, we believe that a discussion citing the improved control resulting from application of the principles to fixed-price type contracts and the complaints of industry that we are being too restrictive in cost allowances will satisfy his group. Participation in this discussion by the Assistant Secretaries would be desirable, but might be handled by the staff.

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

KENNETH K. KILGORE
Director, Audit Policy Division
Office of Accounting, Finance
and Audit Policy

COPY

CR

December 10, 1959

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE ARMY (LOGISTICS)
THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

SUBJECT: Implementing Regulations With Respect to ASPR Section XV, Contract Cost Principles

While the recently published contract cost principles are a substantial step forward, there are many additional areas connected with this task which remain to be accomplished. In this connection, progress is already underway to provide a mechanism for a tri-service approach to implement the research and development cost principle. Additionally, I expect to provide you with more definitive guidelines in the near future with respect to the problem of cutting over to the new principles, particularly as they might apply to existing contracts.

I feel sure that you will agree that it is rather critical for us to ensure a unified approach to the actual implementation of the cost principles. In order to ensure this uniformity, I would like to have any implementing regulations in each of the Departments cleared by my office prior to their issuance. This will provide a centralized clearing house and will be the best method of ascertaining such changes or clarifications as may be indicated by our combined experience.

/Signed/

PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

Copy to:
ASD (Comp)

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

Coordinated: Mr. Bannerman_____
Mr. Kilgore (OASD Comp)_____

COPY

COPY

CR

December 10, 1959

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THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

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PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

Copy to:
ASD (Comp)

Prepared by: JMalloy/jm/3 Dec 59
3D774 X-72026

Coordinated: Mr. Bonnerman_____
Mr. Kilgore (OASD Comp)_____

COPY

C O P Y

CR December 10, 1959

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THE ASSISTANT SECRETARY OF THE NAVY (MATERIAL)
THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL)

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/s/ Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)

C O P Y

C O P Y

December 15, 1959

MEMORANDUM FOR THE UNDER SECRETARY OF THE NAVY
THE ASSISTANT SECRETARY OF THE ARMY (FM)
THE ASSISTANT SECRETARY OF THE AIR FORCE (FM)

SUBJECT: Implementation of Revised ASPR Section XV, Contract Cost Principles and Procedures

Attached for your information is a recent memorandum from the Assistant Secretary of Defense (S&L) which stresses the need for a unified approach to the actual implementation of the new cost principles and requests that any implementing regulations in each of the Departments be cleared by his office prior to issuance.

The need for a unified approach to this matter obviously extends to the activities of each of the audit agencies of the Army, Navy and Air Force. Accordingly, any instructions or procedures prescribed by the Departments for use by contract auditors in application of the new cost principles should be cleared by my office prior to issuance.

/s/ Franklin B. Lincoln, Jr.
Assistant Secretary of Defense

Attachment

C O P Y

C O P Y

December 15, 1959

MEMORANDUM FOR THE UNDER SECRETARY OF THE NAVY
THE ASSISTANT SECRETARY OF THE ARMY (FM)
THE ASSISTANT SECRETARY OF THE AIR FORCE (FM)

SUBJECT: Implementation of Revised ASPR Section XV, Contract Cost Principles and Procedures

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/Signed/

FRANKLIN B. LINCOLN, JR.
ASSISTANT SECRETARY OF DEFENSE

Attachment

Prep: JLucas/ak/12/11/59
OASD(COMPT)AUDIT POLICY DIV 3?352 76321

C O P Y

COPY

December 15, 1959

MEMORANDUM FOR THE UNDER SECRETARY OF THE NAVY
THE ASSISTANT SECRETARY OF THE ARMY (FM)
THE ASSISTANT SECRETARY OF THE AIR FORCE (FM)

SUBJECT: Implementation of Revised ASPR Section XV, Contract Cost Principles and Procedures

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FRANKLIN B. LINCOLN, JR.
ASSISTANT SECRETARY OF DEFENSE

Attachment

Prep: JLucas/ak/12/11/59
OASD(COMPT)AUDIT POLICY DIV 3B852 76321

COPY

ASSISTANT SECRETARY OF DEFENSE
Washington 25, D. C.

CR
Supply and Logistics

February 10, 1960

MEMORANDUM FOR The Assistant Secretary of the Army (Logistics)
The Assistant Secretary of the Navy (Material)
The Assistant Secretary of the Air Force (Materiel)

SUBJECT: Uniform Procedures for the Implementation of Contract Cost Principles and Procedures, ASPR, Section XV, Part 2, as Revised by Revision No. 50 dated 2 November 1959

1. Purpose. The purpose of this memorandum is to establish uniform procedures for the implementation of the Contract Cost Principles and Procedures, ASPR, Section XV, Part 2, as set forth in ASPR Revision No. 50, dated 2 November 1959, with respect to new and existing contracts with commercial organizations. Procedures with respect to new and existing contracts with colleges and universities under the revised ASPR Section XV, Part 3, are contained in my memorandum dated October 12, 1959.

2. Background. The Notes and Filing Instructions of ASPR Revision 50 provide that the principles and procedures set forth in that Revision are mandatorily effective 1 July 1960, but that compliance therewith is authorized upon receipt of the Revision, and that existing cost-reimbursement type contracts may be amended to include the revised principles, but only if the amendment will not be to the disadvantage of the Government.

3. Procedure. Set forth below are guidelines to be followed in implementing the revised cost principles.

(a) Existing Cost-Reimbursement Type Contracts.

(1) Total costs measured under the revised cost principles and procedures applicable to cost-reimbursement type contracts may differ from total costs measured under the cost principles and procedures now incorporated in existing cost-reimbursement contracts. Furthermore, while it is probable that such differences would not be substantial in most cases, an accurate appraisal of the differences in each case would, in most instances, require an unwarranted amount of time and effort on the part of both the Government and the contractor, particularly in connection with evaluating the cost impact on subcontracts and in the case of a particular concern when it is acting as a prime contractor and also as a subcontractor to another prime contractor.

(2) In view of the above circumstances, existing cost-reimbursement type contracts shall be costed out as a general rule in accordance with the Allowable Cost, Fixed Fee, and Payment clause (ASPR 7-203.4) of the contract and the cost principles presently incorporated therein by reference. For purposes of ascertaining the cost principles in effect upon the date of the contract, the effective date of the revised cost principles shall be 1 July 1960 unless the contract has been written or amended to specifically incorporate the revised cost principles. An existing cost-reimbursement type contract may, however, be amended to provide for the use of the revised cost principles when resolution of the administrative problems above does not require an unwarranted amount of time and effort, where such action would not be to the disadvantage of the Government and where the contractor agrees to such amendment. The following factors will be taken into consideration in those limited situations where the amendment of existing cost-reimbursement type contracts is being considered:

(i) anticipated increased or decreased costs, if any;

(ii) administrative savings expected to be gained by costing cost-reimbursement prime contracts with a given contractor on the basis of one set of cost principles;

(iii) the effect on subcontracts under the prime contract (see ASPR 15-204(b));

(iv) absence or existence of specific contractual provisions or other arrangements affecting the treatment of certain costs, such as those for research;

(v) in consideration of (iv) above, the appropriate use of advance understandings (ASPR 15-107) as for example, where it may not be appropriate to allow independent research costs under the revised cost principles in instances where such costs have not been allowed heretofore under the existing contracts;

(vi) other advantages or disadvantages to the Government.

Contractors should be required to furnish any data deemed necessary in connection with the evaluation contemplated above. The cognizant audit activity should be requested to provide an advisory report for use in determining the proper action to be taken.

(3) Where existing contracts are amended to incorporate the revised cost principles, such amendments should normally be made effective as of the date of the beginning of the contractor's fiscal year nearest the date of the amendment.

(b) New Cost-Reimbursement Type Contracts.

(1) In the case of contractors having existing cost-reimbursement type contracts all of which are being costed under the old cost principles, new contracts shall provide for the use of the revised cost principles, but may carry a proviso for the use of the old principles for the period between the date of the contract and the end of the contractor's current fiscal year.

(2) In the case of contractors having existing cost-reimbursement type contracts with a particular Department or procuring activity, any of which are being costed under the revised cost principles, any new contracts of such Department or procuring activity should provide from the beginning for the determination of costs in accordance with the revised cost principles.

(3) In the case of contractors having no existing cost-reimbursement type contracts, the new contracts shall provide from the beginning for the use of the revised cost principles.

(c) Contract Clauses. The following clauses are examples which may be used, as appropriate, in accordance with the guidance stated above.

(1) For use in amending old contracts and in new contracts where it is desired to provide for a delayed effective date for the new principles.

USE OF REVISED CONTRACT COST PRINCIPLES

Subparagraph (a) (i) (A) of the clause of this contract entitled "Allowable Cost, Fixed Fee, and Payment" which reads "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as in effect on the date of this contract; and" is hereby deleted and the following substituted therefor: "(A) Part 2 of Section XV of the Armed Services Procurement Regulation in effect prior to ASPR Revision 50 dated 2 November 1959 until _____, and thereafter in accordance with Part 2 of Section XV of the Armed Services Procurement Regulation as revised by Revision No. 50 dated 2 November 1959; and";

(2) For use in new contracts entered into prior to 1 July 1960 in which the new principles are to be used from inception.

USE OF REVISED CONTRACT COST PRINCIPLES

Subparagraph (a) (i) (A) of the clause of this contract entitled "Allowable Cost, Fixed Fee, and Payment" which reads "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as in effect on the date of this contract; and" is hereby deleted and the following substituted therefor: "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as revised by Revision No. 50 dated 2 November 1959; and";

(d) Existing Fixed-Price Type Contracts. Contracting officers will use the revised cost principles as a guide, in accordance with revised ASPR XV, Part 6, in the administration of existing fixed-price type contracts. Such use, however, shall be only to the extent that it is not inconsistent with any contractual provisions, understandings, or agreements established in the negotiation of the contract.

(e) New Fixed-Price Type Contracts. Contracting officers will use the revised cost principles as a guide in accordance with ASPR XV, Part 6, in the negotiation and administration of new fixed-price type contracts as soon as practicable, but in no event later than 1 July 1960.

(f) Terminated Contracts. In fixed-price type contracts, settlements for convenience termination shall be made in accordance with the termination for convenience clause of the contract and the principles for consideration of costs set forth in or referred to in ASPR 8-302, as in effect on the date of the contract. For purposes of ascertaining the cost principles in effect upon the date of the contract, the effective date of the revised cost principles shall be 1 July 1960 unless the contract specifically incorporates the revised cost principles. Settlements of cost-reimbursement type contracts are governed by the allowable cost clause in the particular contract at the time of termination.

(g) Cost-reimbursement Type Subcontracts. Any amendment of an existing prime contract to incorporate the revised cost principles shall specifically cover the reimbursability of costs stemming from cost-reimbursement type subcontracts thereunder. If the amendment of the prime contract does not expressly provide otherwise, the reimbursability of such costs is automatically governed by the revised cost principles (see ASPR 15-204 (b)). If this result is not acceptable, the amendment to the prime contract shall provide that, notwithstanding ASPR 15-204(b), the reimbursability of such costs will not be affected by the amendment.

(h) Audit Services. In the conduct of audits and the submission of audit reports, auditors will use the cost principles incorporated in the contracts in the

case of existing and new cost-reimbursement type contracts. Auditors will use the revised cost principles immediately in the case of new fixed-price type contracts, except where such use under an audit already in process would unduly delay the submission of a report. In the case of existing fixed-price type contracts, auditors will use the revised cost principles, except where such use under an audit already in process would unduly delay the submission of a report or unless the contracting officer requests that the audit report be prepared on the basis of the old cost principles.

/s/
PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

ASSISTANT SECRETARY OF DEFENSE
Washington 25, D. C.

CR
Supply and Logistics

February 10, 1960

MEMORANDUM FOR The Assistant Secretary of the Army (Logistics)
The Assistant Secretary of the Navy (Material)
The Assistant Secretary of the Air Force (Materiel)

SUBJECT: Uniform Procedures for the Implementation of Contract Cost Principles and Procedures, ASPR, Section XV, Part 2, as Revised by Revision No. 50 dated 2 November 1959

1. Purpose. The purpose of this memorandum is to establish uniform procedures for the implementation of the Contract Cost Principles and Procedures, ASPR, Section XV, Part 2, as set forth in ASPR Revision No. 50, dated 2 November 1959, with respect to new and existing contracts with commercial organizations. Procedures with respect to new and existing contracts with colleges and universities under the revised ASPR Section XV, Part 3, are contained in my memorandum dated October 12, 1959.

2. Background. The Notes and Filing Instructions of ASPR Revision 50 provide that the principles and procedures set forth in that Revision are mandatorily effective 1 July 1960, but that compliance therewith is authorized upon receipt of the Revision, and that existing cost-reimbursement type contracts may be amended to include the revised principles, but only if the amendment will not be to the disadvantage of the Government.

3. Procedure. Set forth below are guidelines to be followed in implementing the revised cost principles.

(a) Existing Cost-Reimbursement Type Contracts.

(1) Total costs measured under the revised cost principles and procedures applicable to cost-reimbursement type contracts may differ from total costs measured under the cost principles and procedures now incorporated in existing cost-reimbursement contracts. Furthermore, while it is probable that such differences would not be substantial in most cases, an accurate appraisal of the differences in each case would, in most instances, require an unwarranted amount of time and effort on the part of both the Government and the contractor, particularly in connection with evaluating the cost impact on subcontracts and in the case of a particular concern when it is acting as a prime contractor and also as a subcontractor to another prime contractor.

(2) In view of the above circumstances, existing cost-reimbursement type contracts shall be costed out as a general rule in accordance with the Allowable Cost, Fixed Fee, and Payment clause (ASPR 7-203.4) of the contract and the cost principles presently incorporated therein by reference. For purposes of ascertaining the cost principles in effect upon the date of the contract, the effective date of the revised cost principles shall be 1 July 1960 unless the contract has been written or amended to specifically incorporate the revised cost principles. An existing cost-reimbursement type contract may, however, be amended to provide for the use of the revised cost principles when resolution of the administrative problems above does not require an unwarranted amount of time and effort, where such action would not be to the disadvantage of the Government and where the contractor agrees to such amendment. The following factors will be taken into consideration in those limited situations where the amendment of existing cost-reimbursement type contracts is being considered:

(i) anticipated increased or decreased costs, if any;

(ii) administrative savings expected to be gained by costing cost-reimbursement prime contracts with a given contractor on the basis of one set of cost principles;

(iii) the effect on subcontracts under the prime contract (see ASPR 15-204(b));

(iv) absence or existence of specific contractual provisions or other arrangements affecting the treatment of certain costs, such as those for research;

(v) in consideration of (iv) above, the appropriate use of advance understandings (ASPR 15-107) as for example, where it may not be appropriate to allow independent research costs under the revised cost principles in instances where such costs have not been allowed heretofore under the existing contracts;

(vi) other advantages or disadvantages to the Government.

Contractors should be required to furnish any data deemed necessary in connection with the evaluation contemplated above. The cognizant audit activity should be requested to provide an advisory report for use in determining the proper action to be taken.

(3) Where existing contracts are amended to incorporate the revised cost principles, such amendments should normally be made effective as of the date of the beginning of the contractor's fiscal year nearest the date of the amendment.

(b) New Cost-Reimbursement Type Contracts.

(1) In the case of contractors having existing cost-reimbursement type contracts all of which are being costed under the old cost principles, new contracts shall provide for the use of the revised cost principles, but may carry a proviso for the use of the old principles for the period between the date of the contract and the end of the contractor's current fiscal year.

(2) In the case of contractors having existing cost-reimbursement type contracts with a particular Department or procuring activity, any of which are being costed under the revised cost principles, any new contracts of such Department or procuring activity should provide from the beginning for the determination of costs in accordance with the revised cost principles.

(3) In the case of contractors having no existing cost-reimbursement type contracts, the new contracts shall provide from the beginning for the use of the revised cost principles.

(c) Contract Clauses. The following clauses are examples which may be used, as appropriate, in accordance with the guidance stated above.

(1) For use in amending old contracts and in new contracts where it is desired to provide for a delayed effective date for the new principles.

USE OF REVISED CONTRACT COST PRINCIPLES

> Subparagraph (a) (i) (A) of the clause of this contract entitled "Allowable Cost, Fixed Fee, and Payment" which reads "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as in effect on the date of this contract; and" is hereby deleted and the following substituted therefor: "(A) Part 2 of Section XV of the Armed Services Procurement Regulation in effect prior to ASPR Revision 50 dated 2 November 1959 until _____, and thereafter in accordance with Part 2 of Section XV of the Armed Services Procurement Regulation as revised by Revision No. 50 dated 2 November 1959; and";

(2) For use in new contracts entered into prior to 1 July 1960 in which the new principles are to be used from inception.

USE OF REVISED CONTRACT COST PRINCIPLES

Subparagraph (a) (i) (A) of the clause of this contract entitled "Allowable Cost, Fixed Fee, and Payment" which reads "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as in effect on the date of this contract; and" is hereby deleted and the following substituted therefor: "(A) Part 2 of Section XV of the Armed Services Procurement Regulation as revised by Revision No. 50 dated 2 November 1959; and";

(d) Existing Fixed-Price Type Contracts. Contracting officers will use the revised cost principles as a guide, in accordance with revised ASPR XV, Part 6, in the administration of existing fixed-price type contracts. Such use, however, shall be only to the extent that it is not inconsistent with any contractual provisions, understandings, or agreements established in the negotiation of the contract.

(e) New Fixed-Price Type Contracts. Contracting officers will use the revised cost principles as a guide in accordance with ASPR XV, Part 6, in the negotiation and administration of new fixed-price type contracts as soon as practicable, but in no event later than 1 July 1960.

(f) Terminated Contracts. In fixed-price type contracts, settlements for convenience termination shall be made in accordance with the termination for convenience clause of the contract and the principles for consideration of costs set forth in or referred to in ASPR 8-302, as in effect on the date of the contract. For purposes of ascertaining the cost principles in effect upon the date of the contract, the effective date of the revised cost principles shall be 1 July 1960 unless the contract specifically incorporates the revised cost principles. Settlements of cost-reimbursement type contracts are governed by the allowable cost clause in the particular contract at the time of termination.

(g) Cost-reimbursement Type Subcontracts. Any amendment of an existing prime contract to incorporate the revised cost principles shall specifically cover the reimbursability of costs stemming from cost-reimbursement type subcontracts thereunder. If the amendment of the prime contract does not expressly provide otherwise, the reimbursability of such costs is automatically governed by the revised cost principles (see ASPR 15-204 (b)). If this result is not acceptable, the amendment to the prime contract shall provide that, notwithstanding ASPR 15-204(b), the reimbursability of such costs will not be affected by the amendment.

(h) Audit Services. In the conduct of audits and the submission of audit reports, auditors will use the cost principles incorporated in the contracts in the

case of existing and new cost-reimbursement type contracts. Auditors will use the revised cost principles immediately in the case of new fixed-price type contracts, except where such use under an audit already in process would unduly delay the submission of a report. In the case of existing fixed-price type contracts, auditors will use the revised cost principles, except where such use under an audit already in process would unduly delay the submission of a report or unless the contracting officer requests that the audit report be prepared on the basis of the old cost principles.

/s/
PERKINS McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

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

NAVCOMPTNOTE 12410
NCT 131
NCT 5-61
19 Jul 1960

NAVCOMPT NOTICE 12410

From: Comptroller of the Navy
To: Distribution List

Subj: Navy Contract Auditors Training Course in Contract Cost Principles, ASPR, Section XV, Parts 1, 2, 3 and 6; additional data in connection with

Encl: (1) Changes in text of Navy Contract Auditors Training Course in Contract Cost Principles
(2) Questions and answers in training conference held 16-20 May 1960 in Contract Cost Principles, Parts 1, 2, 3 and 6

1. Purpose. This notice is for the purpose of distributing supplementary material in connection with the training course held 16-20 May 1960 on the new cost principles set forth in Parts 1, 2, 3 and 6 in Revision No. 50 to ASPR.

2. Discussion of Enclosures. Enclosure (1) contains changes to be made in the training manual recently furnished to the addressees. Enclosure (2) contains the questions raised at the training conference and the answers thereto. Other questions have been omitted due to nonpertinence, adequate coverage being in the manual, or recording and transcription difficulties. Some of the answers given in the conference have been revised as a result of further consideration of the question or for clarification. Sufficient copies of the enclosures are being furnished to permit insertion of one copy in each manual distributed to the addressees.

3. Copies of Training Manual. Several requests have been received for additional copies of the training manual in order that each auditor may be furnished with a copy. It was explained at the training conference that only enough copies had been printed to provide each area office with the number considered necessary to conduct similar training conferences. When the course has been given to all auditors in an area, the manuals may be redistributed within that area at the discretion of the Officers in Charge. It should be kept in mind, however, that these manuals were prepared for training purposes and they should not be cited as authority for approval or disapproval of cost items.

4. ASPR, Part 3, Training Charts. Charts have been furnished under separate cover for use in connection with the presentation of certain of the Part 3, Section XV, ASPR training material.

5. Cancellation. This Notice is canceled when the contents thereof have been noted or for record purposes on 31 August 1960.

J B KACKLEY
Assistant Comptroller

DISTRIBUTION:
SNDL E14 as follows:
Boston (17)
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COMPTROLLER OF THE NAVY
CHANGES IN TEXT OF NAVY CONTRACT AUDITORS COURSE
IN CONTRACT COST PRINCIPLES

FOREWORD

1. Remove the word "and" from line 8 of paragraph I.
2. Delete paragraph III.

Section I-B, page 2

Item III.A.1. - Change (15-201.9) to (15-205.9)

Section I-C, page 2

Item III.C. - Delete and substitute the following:

In the absence of advance understandings, it is the auditor's responsibility to make a determination of the allowability on the basis of information available. Where a contractor contends there was an advance understanding but presents no evidence in support thereof, the matter generally should be referred to the Contracting Officer via appropriate channels.

Section I-D, ASPR 15-205.7 thru 15-205.15, page 2

Paragraph 15-205.7 Contingencies

Change paragraph V to read:

"A proposed cost based upon contingent events which cannot be measured within reasonable limits of accuracy should not be considered in the evaluation of bid price."

Section I-D, ASPR 15-205.7 thru 15-205.15, page 14

Paragraph 15-205.14 Food Service and Dormitory Costs and Credits

Item II.A. - Change 15-502.14 to 15-205.14

Section I-D, ASPR 15-205.16 thru 15-205.25, page 12

Paragraph 15-205.23 Organization Costs

Item III.A.2. line 4 - Change "unallowable" to "allowable"

Section I-D, ASPR 15-205.16 thru 15-205.25, page 14

Paragraph 15-205.25 Overtime, Extra-Pay Shift and Multi-Shift Premiums

Item II.B. Add the following words at the end of the item:

"when required"

Section I-D, ASPR 15-205.26 thru 15-205.34, page 5

Paragraph 15-205.30 Precontract Costs

Item IV.A. - Change this item to read as follows:

Precontract costs which antedate the request for submission of the contractor's proposal should be subject to special scrutiny.

Section I-D, ASPR 15-205.35 thru 15-205.41, page 7

Paragraph 15-205.35 Research and Development

Item IV.C.(3) - Delete and substitute the following:

Where the auditor feels that he is unable to make a definitive determination, he should refer the matter to the NAAO, which in turn may either advise the auditor of the action to be taken or make a further referral to higher authority. In cases where report preparation deadlines do not permit time for such referral, the auditor should question such expenditures in his report and furnish information, brochures and other data to enable a decision to be made as part of the negotiations. In the case of actual overhead under cost-type contracts, the costs should be suspended and the matter referred to NavCompt for further action.

Paragraph 15-205.36 Royalties and Other Costs for Use of Patents

Item II.C. - Correct the spelling of "indicating" in line 2.

Section I-D, ASPR 15-205.35 thru 15-205.41, page 8

Paragraph 15-205.37 Selling Costs

Item I.B. - In line 3 between the words "fide" and "established" insert the following:

"employees and bona fide"

Section I-E, page 4

Item I.c.(4)(b) - Change "Sale" to "Sole"

Section I-F, page 1

Make a new item III as follows:

III. Situation in respect to subcontracts

Make the following changes in the present item numbers:

III to IV, IV to V, V to VI

Section II-C, page 15, sixth line from top of page

Delete the following words:

"and buildings"

Section II-C, page 27

Item (b)(1) - Change "10/12" to "50/52"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 2

Paragraph 15-307.3(s) Material

Item II. - Change "(ii)" to "(iii)"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 3

Item I. under Other Business Expense - In line 2 change "3" to "2"

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 5

Paragraph 15-307.3(v) Pension Plan Costs

Item IV.A.2.a. - Delete this item in its entirety

Section II-D, ASPR 15-307.3(n) thru 15-307.3(bb), page 8

Paragraph 15-307.3(bb) Public Information Services Costs

Item I. - Strike out "contractual coverage" and add the following:

"authorization by the contracting agency."

Section II-E, page 2

Item B.1.b.(1) - Strike out the words "advisory reports" and add the following:

"the concurrent use of the old and new principles."

Item B.2. - In line 3 change "b." to "a."

COMPTROLLER OF THE NAVY
QUESTIONS AND ANSWERS IN
TRAINING CONFERENCE HELD 16-20 MAY 1960
RE CONTRACT COST PRINCIPLES, ASPR
SECTION XV, PARTS 1, 2, 3 AND 6

Section I-A - Introduction - Mr. Cook

Q. Will the coordination of future cost interpretations involve both the audit and procurement personnel of the three Services or will it be restricted to personnel on the audit side?

A. The precise mechanism which will be set up in DOD for cost interpretation development is not presently known. However, since we are dealing with a procurement regulation, there would normally be some procurement representation. At the present time there is one cost interpretation in preparation by an ASPR Subcommittee. The procedure followed in this one case may serve as a guide for the future. This ASPR Subcommittee includes both procurement and audit representatives.

Q. Is the Navy's Contract Auditors' Handbook applicable to the new principles?

A. The statements as to the treatment to be accorded specific items of cost now in Chapter II, Section 4 of the Navy Contract Auditors' Handbook do not apply to the new cost principles. They apply only to the old principles. Consideration will be given to incorporating a statement to this effect in an early change to the Handbook.

Q. Will the Navy Area Audit Offices as a group receive information as a result of individual cost interpretations made within the Navy?

A. It is not expected that each individual cost interpretation issued on a specific case basis will be disseminated to all Navy Area Audit Offices. If this were to be done, it could be regarded as a semi-official or perhaps an official interpretation and implementation of the principles and, under those circumstances, would have to be cleared with DOD. It could very well be that the answer in a particular case might warrant consideration for general publication. In such an instance the matter will be brought to the attention of DOD for possible development of an official cost interpretation. If a question arises which appears to be extremely important and of widespread interest, it might be possible to get DOD permission to publish the answer on an interim basis but with the thought in mind that it would either be adopted as an official interpretation or dropped as not having broad enough applicability.

Q. How will cost interpretations be published?

A. Cost interpretations may be published as a separate part of Section XV, although no final decision on this question has been reached as yet. This has some troublesome aspects. Contracts are generally written to provide that costs shall be determined in accordance with a specific part or parts of Section XV as in effect on the date of the contract. Cost interpretations if included in another part of Section XV would have to be so worded as to indicate that they are nothing more than clarification or application of the test of reasonableness or allocability so that they in themselves will not be construed as having effective separate dates of their own. Any other course would present a very complicated contract referencing problem later on.

Section I-C - Value of Advance Understandings - Mr. Kuttner

Q. Can any consideration be given to any understandings reached prior to execution of a contract but which are not written into the contract?

A. Such an understanding takes on the complexion of an agreement or a contract and it is believed that it should not be ignored even though not written in the contract. If the understanding represents an inequitable arrangement, it would be advisable to alert the negotiator to the fact so that he will be careful about reaching such an understanding on other contracts.

Section I-D - Specific Cost Items - Mr. Ruttenberg - ASPR 15-205.1 thru 15-205.6

Advertising

Q. Does the ASPR Subcommittee which is considering the cost principle concerning advertising in trade and technical journals intend to come up with an acceptable list of trade and technical journals?

A. The answer is no. To put out such a list would create a storm of protest. Those companies who publish journals whose names would not be on the list might say that they were being discriminated against and there could arise many more problems than are already present.

Q. Can those advertisements which have just the two words "Help Wanted" in small letters in one corner of the advertisement be considered as falling in the category of Help Wanted Advertising?

A. This is an old device adopted by some companies in an attempt to get their advertising considered allowable. As a generalization the allowability in full of advertisements of this kind as Help Wanted ads because some small portion or a minor portion thereof contains the words "Help Wanted" does not appear warranted. However, in order to be fair, perhaps a reasonable portion of the advertisement should be considered as an allowable cost of Help Wanted Advertising or recruitment expense.

Q. Are not exhibits really for the purpose of promoting sales?

A. Companies are not altruistic and there usually is a sales motive behind their exhibits. While there may be some specialized knowledge which they are attempting to convey in an exhibit, they actually are not conveying it for one purpose only. They usually intend to promote sales as well as disseminate technical information. As the cost principles are now worded, costs of exhibits can be allowed if there is no product involved. However, there are not many exhibits that can completely conceal the product that the company developed. This is an extremely gray area and not clear-cut. The decision will have to be made in the light of the circumstances.

Q. What constitutes a trade or technical journal?

A. The ASPR Subcommittee is currently attempting to develop some guidance in this area. The guidelines issued may not give the specific and correct answer in every case. Discretion will have to be used.

Any questions that arise will have to be considered on a case-by-case basis and an attempt made to come up with the best decision within whatever guidelines are provided.

Bidding Costs

Q. Should the direct labor of bid and proposal expense go into the base for distribution of engineering overhead and then the total bid and proposal expense be included as part of G and A for distribution to all work?

A. Direct labor of bid and proposal expense should go in the base for distribution of engineering overhead and the total of the expenses-direct labor, direct material, plus the allocable engineering overhead-should go into an expense pool which will distribute the bid and proposal expense over all work of the contractor. This does not necessarily mean that the bid and proposal costs should be included as a part of G and A. If putting such costs in with G and A will accomplish distribution to all work of the contractor, then that is all right. However, contractors sometimes have different bases for distributing G and A which might not accomplish the result which is desired. In that event, some other base for distribution would have to be used.

Q. Does not the Kellett Aircraft ASBCA case establish a precedent that bid and proposal costs should be distributed only to the work resulting therefrom rather than distributed over all work?

A. No, the decision is not considered to be a precedent with respect to bid and proposal costs. The Kellett Aircraft case dealt with the question of whether or not certain amounts represented a loss under a contract and, therefore, under the provision of Section XV of ASPR would not be allowable as costs under other contracts. The costs in question were not originally incurred as bid and proposal expense. Basically the Board ruled that the amount in question was not a loss under a contract even though the contractor had charged the cost to the projects under the contract and the costs were involved in the performance of the contract. The Board said that these overruns of costs are similar to bid and proposal expenses that the contractor might have incurred under other projects, but in the final analysis the Board seemed to classify the overruns of cost as unsponsored research and development costs. The Board held that the costs were in connection with and represented a proper cost allocation to any contract which might involve the particular product with which the original contract was concerned. Under this reasoning the Board permitted an allocation of the overrun

to two contracts which involved the same product as that under the contract on which the overrun was incurred but did not allow any part of the overrun against a third contract. It is considered that the provisions of paragraph 15-205.19 of the new principles captioned "losses on other contracts" should prevent a decision similar to the Kellett decision in the future.

Q. Has any decision been reached as to the allowability of research and development expenses as related to the preparation of a bid and proposal particularly in those instances where the Government has asked a contractor to submit a bid?

A. No decision has been reached. However, in making a determination of allowability, there seems to be one factor which must be taken into account. This is whether or not the Government has asked a contractor to submit a bid. If a certain amount of investigation was necessary in order to submit the bid in response to the Government's request and what was undertaken was reasonably necessary in order to submit a proper bid, the cost of such investigation should properly be considered as bid and proposal expenses. Then there is the other situation where a contractor undertakes a research project, develops something he thinks is pretty good, and then goes to one of the Services and says, "Here is what I've developed. Don't you think you could use this?" In this particular case, there seems to be some difference in the sequence of events which would preclude the cost of investigation from being considered as bid and proposal expense. All of the circumstances would have to be examined carefully, however, before a proper determination could be made.

Q. What position should be taken in those instances where the Government asks a contractor to investigate the feasibility of a certain project or program without issuing a contract for such work and the contractor spends rather large sums of money pursuant to the request of the Government?

A. Whenever this involves a substantial amount which is clearly identifiable, it should be watched very carefully because even though the Government requests the contractor to do such work, it is questionable whether the costs are acceptable as bid and proposal expense in the absence of a specific contract. In these instances, it is considered that the costs should be questioned and advice sought from the technical inspector or the matter referred to NavCompt.

Q. Should all research and development costs which are included as part of bid and proposal expense be referred to the contracting officer?

A. No, they should not. The question to be resolved in this area is whether the research and development can properly constitute part of bid and proposal costs or is to be considered as research and development per se. If it is determined that the costs involved fall in the latter category, then the cost principles with reference to research and development will come into play and not those cost principles which have reference to bid and proposal expenses. This is proper in the light of the position of the auditor whereby under cost-type Navy contracts he is responsible for determining costs; whereas, under fixed-price contracts, if the auditor cannot make a determination on his own, he recommends items for the consideration of the contracting officer.

Q. Should not Government contracts be charged only with the bid and proposal expenses related to such contracts?

A. This would seem rather difficult because it leaves unresolved the question of where to charge unsuccessful bids. It would be possible, of course, and proper, too, that if a contractor chose to charge directly to contracts the cost of successful bids, he could, if he followed the proper system, put all unsuccessful bids in overhead for allocation to all work.

Civil Defense Costs

Q. The new principles allow the costs of Civil Defense measures for a contractor's own premises but do not allow the costs of Civil Defense measures for the area in general. Why is there this difference? Fundamentally there is no difference in the results to be obtained.

A. Actually there is a fundamental difference between the two situations. In the first instance, the contractor has his own property to consider and will want to protect that property. This is of direct interest to him and, of course, is directly related to any work performed in his plant. The other situation is of more general interest for the public welfare. Since taxes are expected to provide for the needs of the public and the contractor pays such taxes, any voluntary contribution in this respect is considered to be in the nature of donations or contributions. The Federal Government has generally followed a policy of not participating under cost-type contracts in the cost of donations, grants and gifts.

Compensation

Q. How do you determine the amount of reversionary credits due the Government in connection with a contractor's pension plan contributions

for terminated employees (other than mass terminations)?

A. Paragraph N2-4.010(f)(5) of NCAH contains information in this connection. Ordinarily it will not be necessary for the auditor to determine an amount due the Government for normal turnover since this contingency is generally factored out by the actuaries in determining current contributions under the plan or is credited to the next due contribution to the plan.

Q. How long a period of time does the Government have in which to attempt to recover any abnormal reversionary credits under a recapture agreement?

A. With respect to the assignment of credits and refunds under Navy cost-type contracts, the answer probably is "indefinitely." This is to say that at any time that it can be determined that the contractor has received a credit to which it is believed that the Government is entitled, or a portion thereof, the agreement can be invoked and the contractor asked to refund the proper amount to the Government. It is not known to what extent if any the statute of limitations applies. Any question as to the time element should be referred to NavCompt for resolution with Counsel.

Section I-D - Specific Cost Items - Mr. Anderson - ASPR 15-205.7 thru 15-205.15

Contingencies

Q. May a bonus based on earnings and determined at the end of an accounting period be considered in the evaluation of a bid price?

A. It will be observed that the changes to text of manual revised this item to read:

"A proposed cost based upon contingent events which cannot be measured within reasonable limits of accuracy should not be considered in the evaluation of bid price."

It is considered that where a contractor has an established plan or implied agreement to pay bonuses of this type and the costs can be estimated within reasonable limits of accuracy, the contingent cost may be considered in the evaluation of a bid price.

Depreciation

Q. If a negotiated use charge in connection with facilities, which have been fully depreciated and a substantial portion of such depreciation was recovered under Government contracts or subcontracts, is agreed to in advance and incorporated in contracts, what effect does ASPR 15-205.9(f) have thereon which states that no use charge shall be allowed on this type of fully depreciated asset?

A. The terms of any specific advance agreement or contract term would be controlling although such action would be contrary to the stated principle. Some extenuating circumstance may justify the charge in some given case. In any event, it would be up to the contracting officer to justify the agreement to allow the use charge.

Q. (a) May a contractor use one of the depreciation methods authorized by the Internal Revenue Code for tax purposes and another for costing purposes?

(b) Also, which basis should he keep his books on?

A. (a) Yes. Although it is necessary that normal depreciation be computed upon the property cost basis used for Federal income tax purposes, it is not mandatory that the same method of computing depreciation

expense be employed for costing and income tax purposes. The principles provide that "Normal depreciation . . . is an allowable element of contract cost; provided that the amount thereof is computed: . . . by the consistent application to the assets concerned of any generally accepted accounting method, and subject to the limitations of the Internal Revenue Code of 1954, as amended . . . ."

(b) As a general proposition the depreciation for costing purposes will be that reflected in the general books of account, but the principles do not specifically require it. However, if the method of computing depreciation for costing purposes differs from that reflected in the books, it is considered necessary that a satisfactory memorandum record, capable of being fully supported for costing purposes, be maintained.

Excess Facility Costs

Q. If 50 per cent of a contractor's equipment is idle, would the idle facilities be considered excess facilities?

A. It is necessary to consider all the facts in a particular situation. No categorical answer can be given based on a per cent. To the extent all or some portion of the equipment will be needed for foreseeable volume of business and other reasonable standby purposes, the costs of maintaining it may be allowable. All other excess equipment costs would be unallowable.

Section I-D - Specific Cost Items - Mr. Ahmann - ASPR 15-205.16 thru 15-205.25

Interest and Other Financial Costs

Q. Are costs incident to a stock dividend allowable?

A. Yes. It is considered that they are normal expenses of doing business.

Material Costs

Q. Is the term "commercial channels" to be interpreted as items for commercial end-use as opposed to military end-use as in the past?

A. It is our view that an item which has military end-use only does not meet the test of "sold through commercial channels."

Q. If an item is listed in a catalog, may it be considered as an item sold through commercial channels?

A. The fact that an item is a catalog item does not necessarily indicate its end-use. It could be listed so that other military suppliers would know of a source for the item.

Q. What is the position of NavCompt re off-the-shelf items?

A. The conclusion has been reached that "sold through commercial channels" refers to items for commercial end-use and not military products in the sense of specialized items. The basic idea or premise on which this concept of acceptance of items "sold through commercial channels" is based is that the prices of the items are controlled or lowered by effective competition for commercial end-use. If Navy contracts are charged at prices not in excess of the most favorable prices that may be given to commercial customers, we don't have to be too concerned about any small element of profit that might be included. However, a very large volume of this type of transaction would raise some question. In such a case, it might be well to suggest a special contract provision and consideration of those items. It is expected that normally the dollar amount for such commercial items utilized will be relatively small with respect to the size of the contract and that the acceptance on a commercial price basis is more economical and practical than attempting to determine the actual cost. We've had such cases in the past in connection with such items as lamp bulbs and small electrical motors. In such a case, it might

cost three times the price of the bulbs to perform special cost studies to determine the actual cost to the company. In that type of situation the use of the most favored customer basis is obviously preferable.

Q. If a contractor secured competitive bids on an item to be made according to specifications which is not a standard or off-the-shelf item and awarded the work to one of his divisions on the basis of low bid, what treatment would be accorded cost incurred in excess of the bid?

A. In determining the allowable cost of intra-company purchase of such nonstandard items, allowable cost is based on cost to the transferor unless the items are the same or substantially similar to items for which prices have been established by other suppliers. In the latter case the cost to the transferor or the prices of other suppliers, whichever is lower is allowable. Where the contractor, in connection with an item for which established prices do not exist, acted in good faith at the outset, secured competitive bids, sincerely analyzed them, and concluded they could do the work cheaper than the other bidders, the fact that they subsequently incurred costs in excess of the other bids would not be a good premise for disapproving these excess costs.

Q. Is the requirement for contracting officer's approval of purchase orders applicable to inter-divisional work (i. e., work within the same company)? Some contracting officers seem to think so!

A. While each case must be considered on its own merits, generally the answer is "no."

Q. When a company writes off obsolete stock, is it appropriate for the loss to be included in inventory adjustment?

A. As a generalization, it is not appropriate for Government contracts to be charged for losses or share in gains from adjustments on account of obsolete stock.

Section I-D - Specific Cost Items - Mr. Kuttner - ASPR 15-205.26 thru 15-205.34

Plant Protection

Q. What criteria should be used in determining whether the expenses of plant protection should be charged directly to a contract or a group of contracts in lieu of being allocated to all work through overhead?

A. If a particular contract or a group of contracts have security requirements significantly in excess of those of the contractor's remaining activities, it is only equitable that the contract or contracts necessitating the increased expense bear the cost thereof. On the other hand, if the contractor's operations are completely devoted to the defense effort requiring the security measures, and more especially if the contracts are mostly of the cost-reimbursable type or are subject to repricing, the expense involved in plant protection may be charged to overhead, because no practical purpose would be served by attempting a precise allocation of the expense. No hard and fast rule can be formulated. Whether the costs should be treated as direct or indirect can best be determined by an evaluation of the specifics of the case.

Precontract Costs

Q. Situations arise in which a contractor may have to perform work which, but for the absence of a contract, would constitute work required under the contract just to be able to submit a bid. Should the costs incurred in doing this work be considered precontract costs or bid and proposal expenses?

A. In a situation of this kind all facts must be considered. The nature of the costs and the contractor's normal treatment of like costs will have a bearing on the matter. If the costs are in the nature of research or investigations to determine whether the pursuit of a certain field of endeavor is feasible or has potential for accomplishment, it may well be in the area of unsponsored research and development. If it is done so that a meaningful bid can be presented, although at the request of the Government, it normally would be to the contractor's advantage to treat it as bid and proposal expense so that it may be recovered in accordance with its normal treatment of bid and proposal expense in the event the bid is unsuccessful. While there may be instances where the formal bid or quotation is submitted after considerable work and negotiations have taken place, ordinarily it is believed that precontract costs would be costs incurred after a proposal or bid was received and after there was an informal understanding that a contract would be awarded.

Professional Services

Q. Should outside professional services be allowed if a contractor has his own staff? Wouldn't this be a duplication of effort?

A. The key word in this question is "duplication." It may be difficult to prove that there is duplication of effort even though it looks as though there is. If a contractor has a competent legal staff on his payroll, care should be exercised before approving retainers for outside legal counsel. However, since there are degrees of specialties involved in the legal and accounting professions, it may be desirable to have available certain talents which would not be present in the contractor's own staff. There is no categorical answer to the question except to say that special care should be exercised to see that, if a contractor does retain outside professional help, his own staff is not capable of performing whatever services might reasonably be expected of the outside firms.

Rental Costs (Including Sale and Leaseback of Facilities)

Q. Assume that a contractor began construction of a building and sold the partially completed building with the understanding that it would lease the building upon its completion. Would the rentals paid under such a lease be treated in the same manner as those under a sale and leaseback of a completed facility?

A. This is also a sale and leaseback. As far as the application of the rule contained in ASPR 15-205.34(c) is concerned, it makes no difference whether the facility was or was not suitable for use when it was sold. The important point is that the contractor had title to the property; the property was sold and then leased back.

Q. If the sale and leaseback occurred in a period before the contractor was engaged in defense work, would there be any difference in the treatment of the rentals?

A. The rule set forth in ASPR 15-205.34(c) is unequivocal and applies to any sale and leaseback regardless of the period in which the transaction occurred. If a contractor is paying rent under a sale and leaseback which was consummated 10 years ago, any portion of the rent in excess of the normal costs of ownership would not be allowable. This is an item for which the contractor should seek an advance understanding if he does not want ASPR 15-205.34(c) to be operative.

Q. What treatment will be accorded the rentals paid under a sale and leaseback if the transaction was undertaken by a predecessor organization, which was merged into or with the contractor?

A. It is not possible to give a categorical answer to this question because it may involve a study of the manner in which the merger and sale and leaseback were accomplished. The term merger is used in some states to refer to all types of consolidations, including those where a new corporation is brought into existence, rather than being limited to those cases in which one or more corporations become absorbed into an existing corporation. The problem may become a legal matter or a determination of the primary motivation for the merger, i. e., whether it was effected for some reason other than avoidance of the cost principle here involved. If the auditor is confronted with a problem in this connection, it is suggested that all the facts be submitted for study by this office and consultation with counsel if deemed appropriate.

Q. Are the rentals made in connection with agreements which permit them to be applied against the purchase price of the asset allowable under the present regulation?

A. Where it is clearly evident that the transaction is in substance a conditional sales contract providing for payment on the installment basis, any payment made pursuant to such an agreement is not rent but a portion of the cost of acquisition. Hence, the payment is not an allowable cost. The asset should be accorded depreciation accounting. The facts relating to all such leases must be carefully considered.

Q. Would there be any effect upon the allowability of cost if the sale and leaseback contained an option permitting the contractor to repurchase the facilities after the expiration of a stated period?

A. Since this situation is only a variant of the more usual form of a sale and leaseback, the portion of the rentals not in excess of the cost of ownership would be allowable. Under this interpretation, the contractor could not be reimbursed by the Government for any portion of the rental which represented consideration for the option.

Section I-D - Specific Cost Items - Mr. Dawson - ASPR 15-205.35 thru 15-205.41

Research and Development

Q. Would you clarify the position taken with respect to the significance of the last sentence of ASPR 15-205.35(e)?

A. It is the view of the Office of the Comptroller that the significance of the last sentence of ASPR 15-205.35(e) is that it supports the position that the first sentence permits an allocation of independent development only to Government production contracts and not to Government R&D contracts. If this were not the case, then the second sentence would be unnecessary because the first sentence would then apply not only to a contractor engaged only in R&D work but also to a contractor performing both production and R&D work. The fact that the second sentence has been included means that additional specific language was necessary so that contractors who were engaged only in R&D could allocate some portion of their independent development work to Government R&D contracts.

Q. In order to qualify under the exception in ASPR 15-205.35(e), must a contractor do no production work at all, or could he perform some production work, for example, 1%, 5%, 10%?

A. The Office of the Comptroller is of the opinion that the exception in ASPR 15-205.35(e) is intended for those organizations whose basic effort is research and whose hardware is limited to a working model, prototypes or processes, with any sales of products being incidental, as distinguished from items manufactured for sale to customers whether or not the production is carried on in a pilot plant or regular manufacturing facilities.

Q. Does the last sentence of ASPR 15-205.35(e) apply only to nonprofit organizations?

A. No. Any research company, profit or nonprofit, could qualify if research work is its basic effort.

Q. In ASPR 15-205.35(f), how shall the word "practices" in the phrase "accounting practices consistently applied" be construed?

A. The word "practices" is to be construed as a course of action continuously followed. A "practice" cannot be established on and off purely for convenience; it is established over a period of time.

Q. How can you change an accounting "practice?"

A. Since a "practice" represents first a certain course of action, the course of action must first be changed. The mere change does not constitute a changed "practice," however. The "practice" becomes changed only after the changed course of action has been continuously followed for a period of time so as to establish the course of action as the normal method of accomplishing a desired result.

Q. Is it not dangerous to condone an accounting principle or practice which we do not agree with for the sake of expediency?

A. Yes. Any such instances should be thoroughly documented with complete understanding with the contractor that this is being done solely for the sake of expediency. Unless this is done, and the mix of work at a contractor's plant changes at some future date with nonemphasis on Government work, we may be saddled with a precedent contrary to what we think is proper, or what the principles intended.

Q. If we have accepted a contractor's method of accounting for certain costs that does not conform to a sound accounting practice, could not the contractor use this as an argument in justification of changing another of his accounting procedures from one which we consider conforms to sound accounting to one that does not?

A. Yes. However, where a contractor wants to change a practice which conforms to the principles to one which does not conform, no agreement should be entered into for the sake of expediency or otherwise.

Q. Is it true that, if a contractor has been consistently applying accounting practices which are contrary to the principle laid down in ASPR 15-205.35(f), such practices are acceptable?

A. Yes, this is the effect of ASPR 15-205.35(f), but this applies only to R&D.

Q. In some instances, a contractor may change his method but a year or two may elapse before a disapproval is issued or before a case gets before the ASBCA. Could it still be contended at the time of the disapproval that the contractor does not have a new accounting practice?

A. Under these circumstances, we would probably have to admit that the contractor now had a changed accounting practice. The way to prevent this from happening is to be prompt in reviewing the accounting system and going on record at an early date as to the acceptability thereof so that the passage of time will not enable the contractor to assert that its changed method has become its practice.

Q. Won't it be difficult for the auditor to make a determination that a particular project is basic research, applied research, or development?

A. Yes, and this was probably recognized by the military departments when they established the Tri-Departmental Committee. However, since all contractors are not on the list for consideration by the Committee of their research programs there may be instances where we will have to ask assistance from the Committee in the case of other contractors if we are unable to make a definite determination as to whether the contractor's activity falls in the category of research or development.

Q. Will the Tri-Departmental Committee involve itself with accounting matters?

A. It is our understanding that the Committee will not concern itself with the accounting aspects of a contractor's research and development program. Its efforts will be confined to a contractor's research and development program as such, type of endeavor, budgeted effort, and matters of that kind. However, if they should approve dollar amounts rather than projects or percentages of a contractor's research program, it would appear desirable that they obtain audit advice.

Q. Will it not be difficult in some instances to make a determination as to what constitutes a product line?

A. Yes. The determination as to a product line can be narrow or so broad as to include almost anything. Judgment will have to be exercised to keep the determination within reasonable limits. Technical assistance should be solicited. If a contractor persists in taking a broad view of what constitutes his product line, it may be necessary to resort to formal disapproval and have the issue decided through the appeal procedure.

Q. In the case of a contractor who is not on the list to be considered by the Tri-Departmental Committee, should the auditor attempt to make his own determinations regarding the contractor's research and development programs?

A. Yes. If the auditor is unable to make a determination at the field level, then the matter should be referred to NavCompt together with the same type of information that the contractor would have to submit to the Committee.

Q. What happens if an advisory report has to be released and no decision from NavCompt has been received?

A. The auditor will have to do the best he can even if it means setting the costs out for further consideration. Sufficient information will have to be presented, however, to enable the negotiator to have something to work with so that he can make a determination.

Q. Will the auditor be called upon to assist the Tri-Departmental Committee through the submission of accounting advisory reports?

A. It is not presently known whether this will happen or not. If so, we should think in terms of total costs of the projects rather than in terms of cost of individual elements, such as, labor, material, and overhead.

Q. Must the principles be followed even though contrary to good accounting practice?

A. Yes. If the principles provide leeway for any action contrary to sound accounting principles, then no exception can be taken.

Q. Will the Tri-Departmental Committee police the contractor's program?

A. Our impression is that the Committee will not police the programs and that the ultimate determination of the amount of allowable costs will be left up to the auditor and the technical inspector. There should be no particular problem if the Committee picks out special programs and has indicated the degree to which the Government will share in the cost thereof and the contractor's methods of accounting for the costs and controlling the planning and execution of research projects is acceptable. However, if the program is discontinued and a new type of program is instituted, it is not considered that the original Committee approval would continue; a new approval would have to be secured.

Royalties

Q. What is the auditor's position with respect to handling claims for royalties?

A. The auditor should make every attempt to determine if the royalties that are claimed are or are not allowable. If this cannot be done, an advisory report should set such costs out for further consideration in the case of a fixed price contract. In the case of a cost type contract the matter should be referred to NavCompt for further action.

Severance Pay

Q. If an adjustment for severance pay is carried back over a number of years, isn't there a good chance that a contractor would be barred from recovery if he had submitted unqualified releases on completed contracts?

A. This is true. However, since the new Principles, in the case of abnormal severance pay, specifically state that the Government recognizes its obligation to participate in such cost, the period to be covered by the adjustment should not be one that will enable the Government to evade this obligation.

Q. Although the new Principles state that normal severance pay is to be allocated to all work of the contractor, would it be permissible to allocate the payments to all work within the department where the charges originate?

A. Technically, this would seem to be a deviation from the Principles but there would not seem to be any great objection to such a procedure since the net result is more precise costing.

Section I-F - Concurrent Use of the New and the Old Principles - Mr. Cook

Q. May a prime contractor insert the new Principles in new subcontracts entered into under prime contracts which contain the old Principles?

A. No categorical answer can be given to this, but there would not seem to be any restriction by implicit directive which would prevent a prime contractor from so doing from the date they were issued. However, it is considered that reimbursement to the prime contractor for the subcontract costs would have to be determined on the basis of the old Principles regardless of the commitment on the part of the prime contractor to reimburse the subcontractor on the basis of the new Principles. This would seem to be the case because the language of paragraph 15-200 of Part 2 of the old Principles makes such Principles applicable to the determination of cost type subcontract costs for which the prime contractor seeks to be reimbursed. It is believed that this phase of the matter may require further clarification if it becomes a problem.

General Questions in Connection with ASPR, Section XV, Parts 1, 2, and 6
Mr. Ruttenberg

Q. What consideration, if any, should be given to contracts for research, investigations, etc., at no cost to the Government or at the most a very nominal sum such as $1.00?

A. Although no payments, or any payments beyond the nominal sum stipulated in the contract, could be made under the contract for the work performed, it is not considered that it is intended that the contractor should be denied recovery of the cost of performance as an independent research program. In this event, the principles applicable to research and development costs could be applied. However, it may be advisable to obtain clarification of the intent of the agreement from the contracting officer if it is not evident from the contract since the project may be cost sharing with the Government furnishing the facilities.

Q. Is the negotiator bound by the recommendations in an advisory accounting report submitted for the purpose of negotiating overhead rates?

A. Strictly speaking he probably is not, but it would seem that any negotiator would have to have positive proof to the contrary before overruling an auditor's recommendation that a particular item of cost should not be accepted.

Q. Why are negotiated overhead rates still being used, particularly since the overhead is now on an historical rather than prospective basis?

A. It is true that the need for negotiating an overhead rate is considerably lessened since the rates now reflect historical costs and actual experience. There still remain certain advantages, however. One advantage is that there will be uniformity of treatment of similar costs under like circumstances by all the Services of the Department of Defense. Another advantage is that the requirement to submit a report and negotiate a rate within a specified period of time tends to get the overhead audit on a more current basis.

Section II-C - Categories of Direct and Indirect Costs - Mrs. Niedling

Direct Costs - Salaries and Wages

Q. Is it not possible that institutions may budget a certain amount of time for instruction and a certain amount of time available for research work for each professor and establish different rates of pay for each category of work with the rate for research being greater than for teaching? The principles state ". . . that the excess of salary and wage rates paid to personnel working on Government research agreements over salary and wage rates paid to personnel working on the institution's departmental research or other research will not be allowed unless specifically provided in the agreement or approved by the contracting officer."

A. This may be possible, but the institutions have contended that there is no way to segregate certain research performed by professors from instruction. They refer to this type of research as nonbudgeted departmental research. It would not appear that any estimate they make of over-all research performed by a professor which includes departmental nonbudgeted research would be too realistic. Furthermore, since it is contended that it is not separable from instruction, there would be no justification for paying different rates for time devoted to teaching and this type of research.

Q. Does the fact that employee benefits, such as pension costs, are not calculated on summer salaries paid to faculty members justify exclusion of such salaries from the salary and wage base?

A. Without all the details, a definite answer cannot be given. However, it may be appropriate to make a special allocation of certain employee benefits and include the salaries and wages in question in the base for apportionment of those G&A expenses which do benefit the work involved.

Indirect Costs - Departmental Expense

Q. Is it not possible that the reason indirect departmental expenses are much greater than the expenses they were intended to offset under the Blue Book is that the indirect departmental expenses now include a share of O&M, G&A, employee benefit expense, etc?

A. This may be true. It is possible also that certain expenses now being included in this pool previously were included in direct charges. If this is the case, the advisory report should point up these facts and indicate approximately how much other factors have been reduced so that the effect on over-all costs can be evaluated.

Section II-D - Specific Cost Items - Mr. Kiser - ASPR 15-307.3(a) thru 15-307.3(m)

Depreciation

Q. Is it possible for an institution to claim depreciation on certain of its building and equipment and use charges on the balance?

A. Yes, I believe this would be possible where they maintain actual records of usable buildings and equipment as distinguished from original complement or reasonable estimates. However, there would have to be consistency of treatment once an election was made. When an item, for which depreciation allowances have been claimed, is fully depreciated use charges would not be allowable thereon.

Q. Where there has been special agreement between the Government and the institution to amortize the cost of a building or laboratory over a given period, could the institution claim a use charge on the building or laboratory after the amortization period has expired?

A. It would not appear proper. However, consideration is presently being given to some ASPR coverage in this connection in order to effect some uniformity of treatment of costs of this nature.

General Questions in Connection with ASPR, Section XV, Parts 1, 3, and 6
Mr. Kiser

Q. Is difficulty being experienced in the application of BuBud Circular A-21 to cost type contracts that are being audited for other governmental agencies, such as, Federal Aviation Administration, National Science Foundation, Department of Health, Education and Welfare, Atomic Energy Commission, etc., and ASPR, Section XV, Part 3, as implemented by Department of Defense Joint Letter No. 41?

A. The members of the training class indicated that no difficulties were being encountered.

Q. Will we be able to make recommendations regarding revisions to BuBud Circular A-21 by 30 June 1960?

A. We are required, in accordance with the directive of BuBud and the ASPR Committee, to recommend, by 30 June 1960, revisions of BuBud Circular A-21 that we feel are desirable. It is indicated that we have not had enough audit experience to make positive recommendations to BuBud, through the ASPR, Part 3 Subcommittee by this date. At present we are in a vacuum, so to speak, with regard to such recommendations and will possibly request a delay of six months to a year. We expect to convene our ASPR Subcommittee soon to plan for future action.

Since recommendations submitted to BuBud will be based largely on information received from auditors, it is incumbent on the auditors to furnish information on problems that are being encountered in administering the revised Part 3. Auditors have a responsibility for recommending changes where principles are unrealistic. It is impossible for Headquarters to visualize all circumstances. Auditors are in a better position to formulate ideas for solving a problem since they are continually applying these principles in their daily work.

We will welcome recommendations as to those areas where Part 3 should possibly be changed for purposes of audit approach simplification, clarification of expense treatment, and elimination of unnecessary detail. If you have any suggestions, send them to us. Your assistance will be very helpful. Since any changes to BuBud Circular A-21 will be largely dependent upon our experience, it is considered that suggestions and information originating with the auditors will constitute the major source of recommended revisions. It is requested that such information be furnished in timely fashion, that is, promptly after you have reached a conclusion on a particular aspect or item of Circular A-21.

Q. What is the purpose of the College and University Federal Committee?

A. The National Association of Colleges and Universities has established a federal committee, with an office in Washington, D. C., to maintain close liaison with and to work with the Department of Defense, ASPR Subcommittee and BuBud on problems arising in the application of Circular A-21, gathering information from member schools, consolidating views of the association, and distributing information to the association members. This committee may be helpful in improving our relations with the group of educational institutions and individual members of the association. The ASPR Subcommittee has informally suggested to the federal committee that in submission of their problems to the ASPR Subcommittee, the problems be based on an actual case, or cases, and not on generalities, and, to the extent practicable, the problem be presented via the military auditor cognizant of the educational institution where the case arose.

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD SECTION XV, ASPR

Cost Item	New Section XV Paragraph	Old Section XV Paragraph
Pension Plans	15-205.27	15-601
Plant Protection Costs	15-205.28	15-204(q) 15-502(n)
Plant Reconversion Costs	15-205.29	15-502(l)
Precontract Costs	15-205.30	15-502(a)
Professional Service Costs - Legal, Accounting, Engineering and Other	15-205.31	15-204(i) 15-205(l)
Profits and Losses on Disposition of Plant, Equipment, or Other Capital Assets	15-205.32	15-205(m)
Recruiting Costs	15-205.33	15-204(r)
Rental Costs (Including Sales and Leaseback of Facilities)	15-205.34	-
Research and Development Costs	15-205.35	15-204(s) 15-205(j) 15-502(m)
Royalties and Other Costs for Use of Patents	15-205.36	15-204(o) 15-502(i)
Selling Costs	15-205.37	15-205(d)(q)
Service and Warranty Costs	15-205.38	-
Severance Pay	15-205.39	15-204(x)
Special Tooling Costs	15-205.40	15-204(h) 15-502(s)
Taxes	15-205.41	15-204(v) 15-205(i) 15-205(r)

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD SECTION XV, ASPR

Cost Item	New Section XV Paragraph	Old Section XV Paragraph
Termination Costs	15-205.42	ASPR Sec. VIII 15-502(r)
Trade, Business, Technical and Professional Activity Costs	15-205.43	15-204(l)
Training and Educational Costs	15-205.44	15-204(r)
Transportation Costs	15-205.45	15-204(f)
Travel Costs	15-205.46	15-204(w) 15-502(j) 15-502(t)

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD SECTION XV, ASPR

Cost Item	New Section XV Paragraph	Old Section XV Paragraph
Advertising Costs	15-205.1	15-204(a)(r) 15-205(a)
Bad Debts	15-205.2	15-205(c)
Bidding Costs	15-205.3	-
Bonding Costs	15-205.4	15-204(b)
Civil Defense Costs	15-205.5	-
Compensation for Personal Services	15-205.6	15-202.2 15-204(p)(t)(x) 15-204(e)(c) 15-601; 15-603 15-502(u)
Contingencies	15-205.7	15-205(e)
Contributions and Donations	15-205.8	15-205(f)
Depreciation	15-205.9	15-204(d) 15-205(b)(c) 15-502(k) 15-602
Dividends	-	15-205(g)
Employee Morale, Health, and Welfare Costs and Credits	15-205.10	15-204(g)
Entertainment Costs	15-205.11	15-205(h)
Excess Facility Costs	15-205.12	15-205(o)
Fines and Penalties	15-205.13	-
Food Service and Dormitory Costs and Credits	15-205.14	15-502(g) 15-502(q)

CROSS REFERENCE TABLE OF SELECTED COSTS IN NEW AND OLD SECTION XV, ASPR

Cost Item	New Section XV Paragraph	Old Section XV Paragraph
Fringe Benefits	15-205.15	-
Insurance and Indemnification	15-205.16	15-204(b) 15-205(p) 15-502(d) 15-502(f)
Interest and Other Financial Costs	15-205.17	15-205(k)(r)
Labor Relations Costs	15-205.18	-
Losses on Other Contracts	15-205.19	15-205(n)
Maintenance and Repair Costs	15-205.20	15-204(q) 15-205(o)
Manufacturing and Production Engineering Costs	15-205.21	15-204(j)
Material Costs	15-205.22	15-202.1 15-204(k)(u) 15-502(e)
Material Handling	-	15-204(f)
Miscellaneous Office and Administrative Services and Supplies, Including Communication Expenses	-	15-204(m)
Organization Costs	15-205.23	15-205(l)
Other Business Expenses	15-205.24	15-204(e)
Overtime, Extra-Pay Shift and Multi-Shift Premiums	15-205.25	15-204(n) 15-502(h)
Patent Costs	15-205.26	15-204(o) 15-502(i)

Headquarters
U. S. Army Audit Agency
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MAJOR AREAS OF DIFFERENCE BETWEEN THE "NEW" AND "OLD" COST PRINCIPLES AND PROCEDURES APPLICABLE TO CONTRACTS WITH COMMERCIAL ORGANIZATIONS

Expiration Date: 30 June 1961

1. PURPOSE

This bulletin highlights for the attention of auditors certain of the major areas of difference between the contract cost principles set forth in ASPR Section XV Part 1, 2 and 6, ASPR Revision No. 50 dated 2 November 1959 and those principles in the previous edition of ASPR Section XV dealing with corresponding matters. These major differences relate, for the most part, to the applicability of the principles, and to the treatment of certain items of cost under supply and research contracts with commercial organizations. For the purpose of identification, the revised cost principles contained in ASPR Section XV, Parts 1, 2 and 6, Revision No. 50, will be referred to as the "new principles". The edition of ASPR Section XV dated prior to 2 November 1959 will be referred to as the "old principles". With minor exception the new principles become fully effective for all applicable-type contracts issued after 1 July 1960. The information contained in this bulletin is not intended as a substitute for a thorough reading and understanding of the new principles by each auditor.

2. APPLICABILITY OF THE NEW PRINCIPLES

a. General

The new principles represent the introduction of a comprehensive set of contract cost principles and procedures which are applicable for use under both fixed-price type contracts and cost-reimbursement type contracts for supply and research with commercial organizations. In accordance with the implementation referred to in paragraph 3 below, the new principles will ultimately supersede both the old principles prescribed for use in determining reimburseable costs under cost-reimbursement type contracts and the separate set of cost principles previously applicable to termination settlements (ASPR Section VIII).

b. Cost-Reimbursement Type Contracts

The applicability and use of a definitive set of cost principles for cost-reimbursement type contracts does not represent any change from that previously in effect. The new principles are prescribed to be incorporated by reference in all cost-reimbursement type contracts for supplies and research with commercial organizations. They serve as the basis for (1) the determination of reimburseable costs under such contracts and cost-reimbursement type subcontracts thereunder;

(2) the negotiation of final overhead rates under ASPR 3-700; (3) the determination of costs of terminated cost-reimbursement type contracts where the contractor elects to voucher out its costs or where settlement is made by determination; and (4) the determination of reimburseable costs under the cost-reimbursement portion of time and material contracts.

c. Negotiated Fixed-Price Type Contracts

No definitive set of cost principles was previously available for the evaluation of cost data in connection with the pricing of negotiated fixed-price type contracts. The applicability and use of a definitive set of cost principles for negotiated fixed price type contracts as prescribed in Part 6 of the new principles therefore represents a significant change. The new principles are not expected to be incorporated in fixed-price contracts. Pursuant to ASPR XV Part 6 however, the principles are prescribed for use as a guide by contracting officers in the evaluation of cost data in connection with the negotiation of fixed-price type contracts when costs are to be considered for the purpose of establishing a fair and reasonable price. Under such circumstances, the evaluation of cost data is to be made in conjunction with other pertinent considerations as set forth in ASPR III Part 8.

d. Negotiated Settlements of Terminated Contracts

The new principles are prescribed for use as a guide (see paragraph c above) in the settlement of advertised and negotiated contracts terminated for the convenience of the Government where settlement is made by negotiation.

3. IMPLEMENTATION OF THE NEW PRINCIPLES

DOD Memorandum dated 10 February 1960 from the Assistant Secretary of Defense (Supply and Logistics) to the corresponding Assistant Secretaries of the Military Departments provides guidelines for the implementation of the new principles in the areas of (a) existing and new cost-reimbursement type contracts and fixed-price type contracts; (b) terminated contracts; (c) cost-reimbursement type subcontracts; and (d) audit services. Supplementary implementing instructions have been issued by the three military departments. (See USAAA Bulletin 316-6 dated 17 February 1960).

4. EXPANDED COVERAGE OF THE NEW PRINCIPLES

a. The old principles did not contain any definitions of reasonableness or allocability. By contrast, the new principles contain overall definitions of reasonableness and allocability as well as guidelines for selecting base periods for allocating indirect costs. More extensive treatment is also given to the general subject of direct costs and indirect costs. The importance of advance understandings between the

contractor and contracting officer on particular cost items prior to award continues to be stressed as a means of avoiding possible subsequent disallowances and disputes regarding those cost items whose reasonableness or allocability may be difficult to determine.

b. Individual items of cost were listed in the old principles only as allowable or unallowable. Expanded coverage is accorded in the new principles to definitions of individual items of cost and to explanations of the criteria and special tests for determining their allowability.

5. DIFFERENCE IN TREATMENT OF INDIVIDUAL COST ITEMS

Some of the major differences between the new and the old principles in the treatment of individual cost items are set forth below:

a. Advertising Costs

With the exception of the items enumerated below the basic treatment to be accorded to advertising costs is essentially the same under the new and old principles. In providing for the allowability of advertising in trade and technical journals the old principles required that such advertising be placed for the purposes of offering financial support to such journals. The old principles also did not specifically provide that advertisements which offered specific services for sale were unallowable. In contrast thereto, the new principles (a) do not require that advertisements in trade and technical journals be placed for the purposes of offering financial support; and (b) provide that advertisements which offer specific services for sale are unallowable. The new principles also (a) define the term "advertising media"; (b) describe the conditions under which costs of exhibits are allowable; and (c) specify that advertising is allowable when placed for the exclusive purpose of obtaining scarce materials, plant or equipment, or disposing of scrap or surplus materials in connection with the contract.

b. Compensation

This item receives detailed coverage in the new principles, not only as concerns the various forms of compensation which may be encountered but also as concerns specific criteria and tests of allowability to be applied to the general subject of compensation and to the individual forms thereof. Of particular significance is the treatment in the new principles accorded to (1) compensation of owners of closely held corporations, partners, sole proprietors, etc., (2) incentive compensation for management employees, and (3) the unallowability of the cost of stock options. These items were either not covered in the old principles or were referred to in Part 5 thereof as a subject affecting costs which may require special consideration.

Under the new principles, compensation for personal services may be paid in any form whatever. Except as otherwise specifically provided in ASPR 15-205,6, such costs (compensation) are allowable to the extent that the total compensation of an individual employee is reasonable for the services rendered and is not in excess of those costs which are allowable by the Internal Revenue Code and regulations thereunder.

Thus, compensation paid in the form of profit-sharing plans is allowable if it meets the above general criteria and any other criteria specifically applicable per ASPR 15-205.6.

c. Depreciation

The computation of the allowable cost of "normal depreciation" and "true depreciation" under the new principles represents essentially the same considerations which were applicable under the old principles and the interpretation thereof in ASPR 15-602. Use or rental charge for fully depreciated facilities was set forth in the old principles as an item requiring special consideration. The more definitive coverage for rental or use charges under the new principles provides that a reasonable use charge for fully depreciated facilities may be agreed upon or allowed provided a substantial portion of the depreciation previously recovered was not recovered on a basis that represented, in effect, a charge against Government contracts and subcontracts.

d. Interest and Other Financial Costs

Contrary to the general rule set forth in the old and new principles regarding the unallowability of interest expense, interest expense was previously allowable under contract termination settlements made pursuant to ASPR Section VIII. Interest expense is unallowable under contract termination settlements made under the new principles. The new principles also definitively specify as unallowable certain financial costs in connection with financing operations which were previously stated to be unallowable in broad general terms. Interest which is assessed by state or local taxing authorities as a result of the non-payment or lack of timely payment of taxes under the special situations set forth in ASPR 15-205.41(b) and (c) is allowable under the new principles.

e. Losses on Other Contracts

This item is unallowable under the old principles and continues to be unallowable under the new principles. The new principles specifically designate a contractor's contributed portion under a cost-sharing contract as an unallowable item within the definition of "losses on other contracts".

f. Material Costs

In the old principles, inter and intracompany transactions were listed in Part 5 as an example of subjects affecting cost which may require special consideration. The new principles provide that charges for materials, services, and supplies sold or transferred between plants, divisions or organizations under a common control are allowable to the extent of the lower of cost to the transferor or current market price. However, a departure from this basis is permitted under the conditions set forth in

subparagraph 15-205.22(e) for items regularly manufactured and sold by the contractor through commercial channels. The new principles specifically provide that where the contractor can demonstrate that the failure to take cash discounts was due to reasonable circumstances, such discounts need not be credited to allowable costs.

g. Precontract Costs

Precontract costs, are specifically made allowable under the new principles to the extent such costs would have been allowable if incurred after the date of the contract. By a cross reference to paragraph 15-107, however, it is stated that an advance agreement with respect to these costs would be particularly desirable. Coverage in the old principles was limited to a reference to this item in Part 5 thereof as a subject affecting costs which may require special consideration.

h. Professional Service Costs - Legal, Accounting, Engineering and Other

This paragraph includes certain criteria to be considered in determining the allowability of these costs in any particular case. Retainer fees are specifically designated as allowable but such fees must be reasonably supported by evidence of bona fide services which are either rendered or available. Paragraph 15-204(l) of the old principles was so worded as to create a doubt whether allowable costs for professional services could include those services which were available in addition to those actually rendered.

l. Rental Costs

No specific coverage of this item was contained in the old principles. Coverage in the new principles is now broken down into four major categories: (i) rental costs in general; (ii) charges in the nature of rent between plants, divisions, or organizations under common control; (iii) rental costs specified in sale and leaseback agreements; and (iv) rental costs under unexpired leases in connection with terminations as covered in ASPR 15-205.42(e). Guidelines with respect to the extent of allowability of rental costs are set forth for each category.

j. Research and Development Costs

The treatment of the cost of research and development activities represents one of the principal changes in the new principles. The old principles provided for the allowance of the cost of research and development specifically applicable to the supplies or services covered by the contract. General research was listed as an unallowable cost unless specifically provided for elsewhere in the contract.

Under the new principles, the terms research, (which comprises basic and applied research), and development are separately defined for the purpose of cost allowability. As part of the definition research and development activities are further categorized as either (1) independent or (2) as sponsored by a contract, grant, or other

arrangement. The costs incurred for independent research and independent development are allowable as indirect costs in accordance with the separate conditions and allocation bases set forth in subparagraphs (d) and (e) respectively of ASPR 15-205.35.

The remaining subparagraphs of ASPR 15-205.35 discuss (1) the treatment of indirect and administrative costs applicable to independent research and development; (2) the unallowability of research and development costs incurred in prior periods except where allowable as precontract costs; (3) the criteria for determining the overall reasonableness of the contractor's research and development program; and (4) the approaches which may be followed where it is desirable that the Government bear less than an allocable share of the total cost of the contractor's independent research and development program.

k. Selling Costs

Although the old principles appeared to indicate under ASPR 15-203(b) that reasonable and properly allocated selling and distribution expenses are an allowable cost, the specific listing of "selling and distribution activities not related to the contract products" and "commissions and bonuses in connection with obtaining or negotiating for a Government contract" as unallowable costs under ASPR 15-205 tended to result in some difficulty in determining the allowability of this item of cost. The new principles define selling costs and state that selling costs are allowable to the extent they are reasonable and allocable to Government business in light of the reasonable benefit to the Government from the technical, consulting, demonstration, and other services related to application or adaptation of the contractor's products to Government use. Notwithstanding the latter statement, salesmen's or agents' compensation, fees, commissions, etc., are allowable only when paid to bona fide employees or bona fide established commercial or selling agencies.

l. Severance Pay

The new principles make a distinction between normal turnover severance payments to employees who leave or are dismissed on an individual basis and abnormal or mass severance payments made by reason of the cessation of operations or plant closures. Normal turnover severance pay is allowable on an actual payment basis or reasonable accrual basis where it is required by law, agreement, established policy of the contractor that constitutes in effect an implied agreement, or by the circumstances of the particular employment. Such pay must be allocated to all work performed in the contractor's plant. Accruals for mass severance pay are unallowable because of the conjectural nature of this item. The new principles provide that the allowability of mass severance payments will be considered, however, on a case by case basis in the event of occurrence. The old principles briefly mentioned severance pay as an allowable cost. Recommended disallowances of accruals for mass severance pay under the old principles were based on the inability to determine the reasonableness of the amounts accrued.

30 August 1960

SUGGESTED QUESTIONS ON COST PRINCIPLES FOR USE AT THE FEDERAL BAR ASSOCIATION MEETING ON 6 OCTOBER 1960.

1. What is the attitude of the Congress and the General Accounting Office toward cost principles in general and the new Department of Defense cost principles in particular?

2. Will the new Defense cost principles eventually be used throughout the Federal Government; specifically, will they be used by the Atomic Energy Commission and the National Aeronautics and Space Administration?

3. Industry has argued that all normal and necessary costs of doing business should be allowed under defense contracts. The new cost principles are not in accord with this principle. Why?

4. Were the new cost principles coordinated with industry? If so, how? Will future revisions of the cost principles be coordinated with industry?

5. In view of the obvious need to increase our research effort, why does the Department of Defense restrict the allowability of contractors' independent research and development expenses?

6. The expense of recruiting personnel, particularly technical personnel, has been increasing steadily. This often results in excessive competition, with the Government paying most of the cost. How can excesses in this area be isolated and stopped?

7. Bidding costs are allowable. Would it not, however, be a good idea to allow bidding costs only in those cases where the Government has solicited bids? This would prevent abuses in this area and would cut down on a lot of wasted effort.

8. Should not the cost principles be more specific with respect to travel, per diem, and moving expense? If not, how can contractors be afforded uniform treatment in this area?

9. What is the role of Government auditors in connection with the use of cost principles; specifically, can a contracting officer overrule the recommendation of an auditor?

10. Does the Department of Defense plan to issue cost interpretations as the need may develop?

11. Cost principles should remain static to the maximum practicable extent to obviate administrative difficulties. Does the Department of Defense have any plan for the issuance of future changes, particularly as to the timing of these changes?

12. The cost principles provide that rental costs specified in sale and leaseback agreements are allowable only to the extent that any such rentals do not exceed the amount which the contractor would have received had he retained legal title to the facilities. How does this affect a bona fide sale and leaseback arrangement established prior to the publication of the new cost principles?

13. How much of the total Department of Defense contract dollar will be affected by the new cost principles?

14. The new cost principles provide a big stick to those elements who believe in formula pricing. How does the Department of Defense plan to prevent formula pricing?

15. What type of internal controls does the Department of Defense have to prevent each Military Department from issuing multitudinous and conflicting implementations of the new cost principles?

16. Does the Department of Defense have any changes to the cost principles under active consideration now?

17. What has been the general reaction of industry to the new cost principles?

18. How does the Department of Defense insure that the cost principles are administered in accordance with the philosophy and intent of the drafters of the principles? It is a long way from policy to execution.

19. Why did the Department of Defense find it necessary to come out with so many unallowable items of expense and so many other restrictions on allowability?

20. Why is it not sufficient to establish cost rules of a general nature and trust that a fair and equitable result will flow from the exercise of good judgment on the part of both Government and contractor representatives?

21. In connection with the research and development cost principle, is cost-sharing appropriate unless there has been a preliminary finding that the overall research cost is unreasonable?

22. Does the Department of Defense make any distinction between contractors whose business is primarily governmental and those whose business is primarily commercial?

23. Do contractors have to submit price proposals (including cost breakdowns) in accordance with the new cost principles?

24. Can you segregate the major unallowable items into categories and indicate why they are not allowed?

25. Is it possible to negotiate an advance understanding which would provide for the allowability of an item listed as unallowable in the cost principles?

26. In connection with independent development expense, what is meant by the term "product line?"

27. May a prime contractor insert the new cost principles in subcontracts entered into under prime contracts which contain the old principles?

28. When a contractor and the Department of Defense cannot agree on an advance understanding for independent research and development costs (or any other cost) -

(a) Will the Department of Defense make a unilateral determination at that time? or

(b) Will the matter be left open for negotiation after the fact?

29. What will be the attitude of the ASBCA toward use of the cost principles - - basis?, guide?, or not at all, particularly in connection with fixed price contracts?

30. In applying the test of "reasonableness," from whose standpoint will it be considered? For example, from a contractor's standpoint it might be reasonable to spend large sums on research and development over a short period in order to establish himself at the forefront in a new area of technology. At the same time, however, allocation of such costs to an end product for which the Government is contracting might appear to make the cost of that product unreasonable.

TOPICAL INDEX

T O

PRINCIPLES

GOVERNING THE DETERMINATION OF ALLOWABLE COSTS

UNDER

DEFENSE DEPARTMENT

RESEARCH AGREEMENTS

WITH EDUCATIONAL INSTITUTIONS

ISSUED BY THE OFFICE OF NAVAL MATERIAL

AUGUST 1960

Compiled by
Lewis Lever, C.P.A.
Pittsburgh, Pennsylvania

FOREWORD

This index has been compiled to facilitate reference to the principles for the determination of cost currently incorporated in Department of Defense research agreements with educational institutions. These principles are indexed as of the text current on the bases indicated:

Section XV, Part 3 - Revised	Armed Services Procurement Regulation, Change No. 50, dated 2 November 1959
Department of the Army, Department of the Navy and Department of the Air Force Joint Letter No. 41	Dated 26 August 1959
Section XV, Part 3 (and applicable portions of Parts 5 and 6) - Original	Appendix H, Department of Defense Contract Audit Manual, Change 2, dated 7 May 1956
Blue Book	Explanation of Principles for Determination of costs under Government Research and Development Contracts with Educational Institutions War Department - Navy Department August 1947

When this topical index was originally contemplated, there was some doubt concerning the value of indexing the latter two documents. However, it now appears that many research agreements may continue to completion utilizing these documents as the basis for the determination of allowable costs. Accordingly, it is not unlikely that institutions may be performing research agreements under the original and revised principles simultaneously. It is hoped that the index as prepared will prove useful to both Government and institution personnel confronted with this situation.

The indexing process disclosed certain variations in terminology among the several documents. The following are some of the more important differences:

Section XV, Part 3 - Revised and Joint Letter No. 41	Section XV, Part 3 - Original	Blue Book
Allowable costs	Allowable costs	Admissible costs
General administration and general expenses	General administration General expense	General administration General expense
Indirect costs	Indirect costs	Indirect expense
Material costs	Materials Materials and supplies	Materials and supplies
Operation and maintenance expenses	Operation and maintenance of physical plant	Operation and maintenance of physical plant
Other institutional activities	Noneducational activities	Non-educational activities
Research agreements	Contracts	Contracts
Unallowable costs	Unallowable costs	Inadmissible costs
Use allowance	Use charge in lieu of depreciation	Use charge

For purposes of uniformity, the main captions utilized coincide with the terminology in the revised principles. For example, all references in the original principles to the subject "Contracts"are indexed under "Research agreements." Similarly, references to "Indirect expense" in the Blue Book will be found in the index under "Indirect costs." In order to avoid any confusion, the index has been completely cross-referenced to show the captions superseded.

	Revised Section XV, Part 3	Joint Letter No. 41	Original Section XV, Part 3	Blue Book
D				
DEANS OF COLLEGES, SCHOOLS, DEPARTMENTS OR DIVISIONS				
. salaries and related expenses				
. allocation	15-306.3(b)(vi)			
. simplified approach	15-306.4(b)(i)			
. as direct charges			15-305(1)	38(a)
. as indirect departmental expenses	15-304(vi)			
. distributed on basis of reasonable estimates		15-304(vi)		
. unallowability			15-305(1)	24
				38(a)
DEANS OF FACULTY AND GRADUATE SCHOOLS				
. allowability of costs	15-307.3(h)			
DEANS OF MEN AND WOMEN				
. as general administration and general expenses				24
DEANS OF STUDENTS				
. inapplicability of costs to research agreements	15-307.2(iv)			
DEATH BENEFITS				
. paid by institution				
. as general administration and general expenses				24
DEFINITIONS	15-302	15-302		
DENTAL CLINIC				
. as extension service				35 Note 4
DEPARTMENTAL ADMINISTRATION				
. as indirect departmental expenses	15-304(vi)			
DEPARTMENTAL EXPENSES, INDIRECT				
. see Indirect departmental expenses				
DEPRECIATION				
. see Use allowance				
DESIGNS, PURCHASED				
. see Purchased designs				
DETERMINATION OF INDIRECT COSTS				
. see Indirect costs, determination of				
DINING HALLS				
. as auxiliary enterprises and activities				35 Note 1
. as other institutional activities	15-302.6	15-302.6		
. losses and gains from operations, as staff benefits		15-302.6		
DIPLOMA EXPENSE				
. as general administration and general expenses				24
DIRECT COSTS	15-303	15-303		8-22
. allowable			15-302	
. constituting part of research agreement costs			15-301	4
. defined	15-303			
. other				
. see Other direct costs				
. project level "indirect" costs		15-303		
DIRECT DEPARTMENT CHARGES				
. basis for allocation of library expenses				27(b)
. basis for apportionment of library expenses			15-303.1(c)	
DIRECT MATERIAL COSTS				
. defined	15-303(ii)			
. see also Material costs				

	Revised Section XV, Part 3	Joint Letter No. 41	Original Section XV, Part 3	Blue Book
INSURANCE AND INDEMNIFICATION				
. actual losses not covered by insurance	15-307.3(m)(3)(v)			
. allowability of cost	15-307.3(m)		15-304(a)	22(c)
. matter requiring special consideration			15-502(d)	
. on lives of executives, unallowability of cost			15-305(k)	
. on lives of officers or trustees, unallowability of cost	15-307.3(m)(3)(iv)			
. other than that required by research agreement, limitations governing allowability	15-307.3(m)(3)			
. property				
. as operation and maintenance expenses				28
. self-insurance				
. allowability of cost	15-307.3(m)(3)(iii)		15-304(a)	19
. as direct charge				4
. see also Accident insurance; Workmen's compensation insurance				
INTERCOLLEGIATE ATHLETICS				
. as auxiliary enterprises and activities				35 Note 1
. as other institutional activities	15-302.6			
INTEREST COSTS				
. unallowability	15-307.3(n)		15-305(f)	38(g)
INTEREST ON TAXES REFUNDED				
. as credit to research agreement	15-307.3(jj)			
INVENTION DISCLOSURES				
. preparation of, as patent costs	15-307.3(u)			
INVESTMENT COUNSEL AND STAFF COSTS				
. unallowability	15-307.3(o)			
INVESTMENTS				
. losses on sales or exchanges, unallowability			15-305(g)	38(l)
. profits and losses on disposition, excluded from research agreement costs	15-307.3(z)			
J				
JANITORIAL SERVICES				
. as operation and maintenance expenses	15-304(iii)			28
L				
LABOR RELATIONS				
. allowability of cost	15-307.3(p)			
LEASES				
. rentals as termination costs	15-307.3(mm)(5)			
LEAVE OF ABSENCE				
. inapplicability of cost to research agreements	15-307.2(ii)			
LECTURES EXPENSE, GENERAL				
. as general administration and general expenses				24
LEGAL EXPENSE				
. as general administration and general expenses				24
. collection of bad debts, unallowability	15-307.3(b)			
. see also Professional service costs				
LIABILITY TO THIRD PERSONS				
. see Insurance and indemnification				
LIBRARY BOOKS				
. use allowance	15-304(iv)		15-303.1(c)	27(a)
. as indirect cost				4
. not computed on Government-owned or donated books		15-304(iv)		

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

Rear Admiral Jas. D. Boyle, USN (Ret)
National Security Industrial Association, Inc.
1107 - 19th Street, N. W.
Washington 6, D. C.

PRICE WATERHOUSE & CO.

SEVENTEEN TEN H STREET, N. W.

WASHINGTON 6, D. C.

September 23, 1960

Mr. John Marschalk
2850 Belden Drive
Hollywood 28, California

Dear John:

Your list of ten questions, and Captain Malloy's list of thirty, seem to me to provide the basis for a thorough and constructive panel discussion. I have no further questions to propose.

If it fits in with your idea of the discussion, I would like to direct my remarks on these various questions primarily toward the manner in which the trend of events is being influenced by accounting and auditing considerations, and toward what seem to me to be probable consequences of the trend of events. Major consequences, of course, include those which have their impact on profit. I think I can give the discussion this kind of a twist without invading the areas reserved for the 10:30 session on the Theory and Practice of Profit and the other sessions which deal with auditing and cost accounting. As a matter of fact I feel that, ours being the lead-off session, we have some obligation to lay the groundwork for developing the relationship between the Procurement Regulation and the various other subject matters which will be dealt with in other meetings.

As you may know, it is my feeling that the position the Government has taken in the development of the cost principles is one which does some degree of violence to the basic conception of cost and it therefore does violence also to the basic conception of profit, neither being very meaningful in the business world without the other. You probably will recall also that I see a chain of inter-connected concepts with cost definition at the front-end and severely detailed regulation of business activity at the tail-end. Whoever defines costs has thereby defined profit, and whoever has the custodianship of the measurement of profit reasonableness holds also the power of affecting economic life and death. These may sound like abstractions but I think I can give them a practical turn in the panel meeting as the various individual questions come up for consideration.

A particular aspect of these things which has interested me lately has been the development of governmental controls over subcontractors and their exercise through prime contractors. In the final analysis there is not much difference between a subcontractor and any other supplier, and accordingly, the development of this trend, under pressure from the Government's auditors, is a matter which should be examined very closely by many more businesses than simply those engaged directly in Government contracting at the present time. I think this aspect of the general question of subcontractors' affairs should be brought out into the open for consideration. It may very well be that this is an avenue through which the general business community will ultimately be affected by the things we will be talking about with the thought that they are now the special problems of a special group.

I realize that we are very close to our deadline date and that I have not given you much time to respond to these general ideas. However, I have confidence in your moderating ability and in my willingness to be moderated.

See you in Monterey.

Ted Hetzel

cc: Captain J. M. Malloy, Staff Director
ASPR Division, Office of Procurement Policy
Assistant Secretary of Defense (S&L)
Washington 25, D. C.

QUESTIONS PRESENTED AT MONTEREY, CALIFORNIA - 10/6/60

1. Today's practice for auditor and analyst recommendations and contracting officers' decisions is to treat cost as the sole basis for pricing fixed price business and to apply it by formula. Is this the intent of the regulations? If not, what steps do you suggest for both government and contractors to make practice conform to intent?

2. You say that if a procurement is competitive, that you don't give a "hoot and a damn" what costs make up the low bidder's price. Maybe you don't, but negotiators do. This is an obsession with most negotiators. If your statement is the Government's philosophy, why isn't this philosophy passed on to the negotiator's level, and to those who review his negotiations before the contract can be approved?

3. Contractor's Resident Auditor always comments on what he thinks the contractor's profit ought to be on an audit report of a fixed price or redeterminable proposal. Isn't it the function of the Audit agency to audit costs, period?

4. Audit Agency insists that audits of fixed price on redeterminable proposals must be performed according to CPFF principles and reports to Government negotiators are prepared on this basis, regardless of the ASPR language regarding the use of CPFF principles as a guide. Contractor is advised that reinstatement of disallowed overhead items must be made by negotiator or contracting officer. Negotiators take the position that they must accept auditors' reports as submitted and that they cannot allow an item in overhead which the auditor has disallowed. Contractor is told to "go home and work out your problems with your auditor." What can the contractor do? (Aside from giving up and going broke)

5. When will the DOD recognize that interest is a normal cost of doing business and recognize it as such in definitions of allowable costs? Or, will DOD ever concede allowability of interest when necessary to perform on a specific contract? This latter situation can easily develop where a major contract is awarded to a company which contract is large relative to the company's other normal business.

6. Allowability of interplant, division and affiliate charges - Ref. - ASPR - 15-205.22(e) Material Costs. Heretofore charges by one plant or division against another have been generally acceptable to the Services if on a cost basis (excluding any question of profit). Under the latest cost principles apparently these costs must also be in line with competitive or current market prices to be acceptable. Is this correct? If so, does this same interpretation apply to affiliates (organizations under common control, i.e. subsidiaries, i.e. separate corporate entities, etc.? Of one type or another - minority interest but controlling, etc).

7. Could you briefly state the cost problem areas in which Advance Understanding Agreements have been negotiated to date under the new ASPR-15?

8. Contracting Officers often require the application of learning curves in arriving at prices before beginning production of a follow on contract, and in other situations. Why are they reluctant (or refuse) to permit the application of these same learning curve computations in arriving at the starting costs of a terminated contract for termination settlement purposes? Why aren't auditors for the government more familiar with learning curve computations and agreeable to covering these problems in all audits, i.e. for procurement and terminations alike?

9. Is an Advance Understanding - as contemplated by ASPR Committee -
   (a) to be covered by special language, on a contract by contract basis?
   (b) "res judicata," in later contracts -
      (i) in some service
      (ii) let by other military services
   (c) to be negotiated on a single-service basis (like overhead rates)

10. Advance Understandings -
   1. Is it not the general intent of "Advance Understandings" to bind both the contractor and <u>all</u> DOD procurement agencies with which the contractor does business?
   2. What is the feeling of the ASPR Committee as to the incorporation of "Advance Understandings" into contracts by amendment?

11. In the case of a contractor which received its first government contract between Nov 1959 and June 30, 1960, what is the operating policy of the Defense Department in amending CPFF contracts to incorporate the new cost principles? Is an amendment of this type wholly at the discretion of the contracting officer? Does the letter issued by the Department of Defense in Feb 1960 mean there is an obligation on the part of the contracting officer, whether it benefits the Government or not, to amend contracts let after Nov. 2, 1959, where the contractor received his first contract of a CPFF nature?

12. Capt. Malloy, in view of the fact that you are Chairman of the ASPR Committee, could it be possible to get a ruling on this condition? For example: A corporation who has a large diversification of products has a division holding a prime contract. This prime division (A) has requested competitive fixed price bids on a piece of hardware to all companies willing to bid. This corporation has another division (B) that has the capabilities to produce this piece of hardware and enters into this competition and wins the award. Would the Government allow the division (A) to include in its cost the price that the division (B) won the award on and take a profit on this price?

13. 1-309 Solicitations for Informational or Planning Purposes. It is the general policy of the Department of Defense to solicit bids, proposals or quotations only where there is a definite intention to award a contract or purchase order. However, in some cases solicitation for informational or planning purposes may be justified. Invitations for bids and requests for proposals will not be used for this purpose. Requests for quotations may be issued for informational or planning purposes only with prior approval of an individual at a level higher than the Contracting Officer. In such cases, the request for quotation shall clearly state its purpose and, in addition, the following statement in capital letters shall be placed on the face of the request: "THE GOVERNMENT DOES NOT INTEND TO AWARD A CONTRACT ON THE BASIS OF THIS REQUEST FOR QUOTATION, OR OTHERWISE PAY FOR THE INFORMATION SOLICITED."

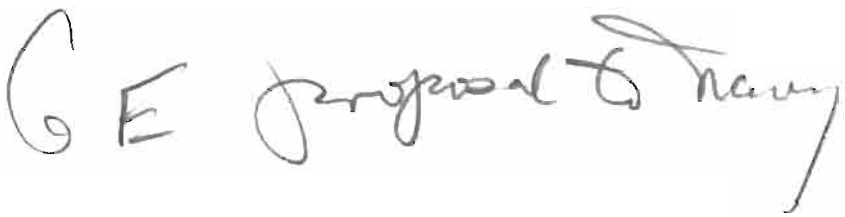
Question - Will this Regulation be revised to clearly state that costs generated by these requests will be allowed in burden?

ASPR - 1 July 1960 - Will ASPR ever eliminate other instructions that are issued by other Services, such as AFPI by the Air Force and NPD by the Navy?

1/4/61

15-205.22 e

"Recognizing that it is the Contractor's long established practice to price interorganization transfers at other than cost for commercial work, in connection with the work under this contract, the Contractor shall be free, but not obligated, to use any article or service customarily produced, assembled, or provided by the Contractor in the regular course of its business, provided such articles or services are billed at the lowest commercial prices charged to an outside user purchasing in similar quantities."



RAYTHEON COMPANY

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12 January 1961

Mr. Kenneth K. Kilgore
Director, Audit Policy Division
Office of the Assistant Secretary of Defense
Washington 25, D. C.

Dear Mr. Kilgore:

The following are a group of questions which occurred to me after reading your letter which might be worth discussing in the NSIA Cost Principles Symposium Panel:

1. What is the proper base for the distribution of the Contractor's Independent Development costs? There are apparently two different points of view in the Department of Defense: (1) That it can be distributed only to the overhead bases applicable to production contracts, (2) That it may be distributed to all of the costs of a given product line, including product line oriented-sponsored Research and Development contracts.

2. I have heard some interpretations to the effect that that portion of a Contractor's Independent Research and Development which is not shared by the Government should become part of the cost base for the distribution of the Government's share of Research and Development as well as other G & A costs.

3. Machinery exists for the negotiation of Advanced Understanding in the areas of Research and Development. Certain other costs mentioned in 15-107 should be negotiated on a contract-by-contract basis with individual contracting officers, e.g. pre-contract costs, royalties, and possibly travel costs as related to special or mass personnel movement. Would it be appropriate for ASPR to establish machinery for the negotiation of Advanced Understanding on other areas relating purely to general and indirect costs?

4. What is meant by the phrase "Product Advertising"? Is an institutional advertisement displaying a Missile System in a trade or technical journal properly considered product advertising?

5. In order to avoid formula-pricing on negotiated fixed-fee price contracts, would it be appropriate to expand Part 6 to include a complete listing of all the considerations other than cost which should govern the pricing of a fixed-price contract?

6. Is an amendment to Section XV required to recognize the cost of excess facilities and personnel resulting from "stop work orders"?

7. Section XV -205.26 makes the statement that patent costs in connection with the filing of a patent application where title is conveyed to the Government are allowable. Is it the intent of this section to consider all filing costs where the Contractor retains title but gives the Government a non-exclusive royalty fee license, unallowable?

8. Why is a modest subsistence stipend for full time graduate trainees considered unallowable especially when in most cases this stipend constitutes the trainees only means of support for himself and his family?

9. Is this a correct interpretation of Section XV 205.22 (e):

   That a Contractor who chooses, because of the need for close Engineering liaison, better delivery, quality, and reliability, to buy an item from a division within his Company cannot charge the Government his cost if a similar item is available on the outside at a lower price?

10. Since Independent Research is distributed to approximately the same base (i.e. cost of sales, or cost of manufacturing) as G & A expenses, is it practical to apply G & A to Independent Research?

11. 15-205.35 recognizes Independent Research and Development to be an allowable cost for which an advance understanding is recommended but not required. Why is the Government unwilling in many cases to bear its full allocable share of these programs in the light of the following premises:

    (1) that the same competitive restraints exist in the prices of government contracts as on most commercial products.

(2) satisfactory criteria for the reasonableness of Research and Development expenditures exist or can be established

(3) a contractor who is forced to share the cost of his Research and Development is at a competitive disadvantage on his Commercial products which must absorb the unrecovered costs allocable to Government Contracts on his commercial products.

(4) A contractor who chose the disputes route can probably recover 100% of his Research & Development on after-the-fact pricing actions.

I am not sure that these questions are actually pertinent to the panel discussion to which we have been assigned, nor would I object violently if you eliminate most or all of them. I am sending you sufficient copies to distribute these questions to Colonel Blattau and Mr. Jones, if you should choose to do so. I am also sending Mr. Beall a copy directly. I would appreciate receiving the questions suggested by the other members of the panel and I would also appreciate further opportunity to raise additional questions as they occur to me.

I am attaching to this letter, a copy of the brief biographical sketch which I mailed to Mr. Youngblood of NSIA. I look forward to meeting you and the other members of the panel at the end of Tuesday's session.

Very truly yours,

Charles A. Dana, Manager
Government Accounting Controls

Excerpt from Transcript of Eisenhower's News Conference on Domestic and Foreign Affairs

New York Times, January 19, 1961 - Page 18 C

* * *

For Informed Citizenry

A. - I know nothing here that is possible, except - or useful - except the performance of the duties of responsible citizenship. It is only a citizenry, an alert and informed citizenry which can keep these abuses from coming about. And I did point out last evening that some of this misuse of influence and power could come about unwittingly but just by the vary nature of the thing, when you see almost every one of your magazines, no matter what they are advertising, has a picture of the Titan missile or the Atlas or solid fuel or other things, there is becoming a great influence, almost an insidious penetration of our own minds that the only thing this country is engaged in is weaponry and missiles. And, I'll tell you we just can't afford to do that. The reason we have them is to protect the great values in which we believe, and they are far deeper even than our own lives and our own property, as I see it.

MCPF

19 January 1961

Mr. Aaron Racusin
6512 Kenhowe Drive
Bethesda, Maryland

Dear Aaron

1. So sorry that we were delayed in furnishing you the answers to questions which may come up during the panel discussions at the NSIA Seminar. The following comments are based on our evaluation and feel for these questions and are as follows:

Question No. 1

Can consistency of implementation and interpretation ever be achieved by all Services? What steps are being taken to attain this goal?

Answer

Several years ago, the Air Force decentralized to Administrative Contracting Officers at Air Force Plant Representative Offices and Procurement Districts the responsibility for negotiating overheads with contractors who are on negotiated rather than on actual overhead rate basis. Our experience under this arrangement indicated that there were more problems with respect to lack of consistency in implementation and interpretation even within the Air Force. Consequently, steps were taken in 1959 to recentralize this responsibility. At the present time a small group of negotiators, headed by Mr. Dale Babione of my office, is charged with the responsibility for either negotiating or delegating negotiation responsibility for all contractors on negotiated overhead rates. As a practical matter with respect to large divisionalized multi-plant contractors, the negotiation is conducted by one of the people here at Hq AMC. This practice, plus the fact that close coordination is maintained between Mr. Dale Babione and Mr. Les Todd, who has succeeded Mr. Christenat in the Navy, tends to make what we believe is reasonable consistency of implementation and interpretation as pertains to the negotiation of questioned costs which are related to overhead. Of course, as a practical matter, the questioned costs are developed by the DOD auditors and submitted in their audit reports pertaining to contractor overhead proposals. Inasmuch as the audit organization is decentralized, there was always the probability that there will be some lack of consistency in interpretation made by auditors. This lack of consistency is minimized by

the fact that the audit organizations frequently coordinate with each other at the Washington level. I understand that the DOD under Ken Kilgore is sponsoring a revision and re-write of the Contract Audit Manual. This in itself would be a positive factor in reducing lack of consistency insofar as audit interpretation is concerned.

Question No. 2

How do the new Cost Principles affect the role of the auditor vs contracting officer in (a) price negotiations, (b) price redeterminations, (c) overhead allowance? Can a contracting officer overrule the recommendation of an auditor?

Answer

Insofar as the Air Force is concerned the new Cost Principles do not affect or change the role of the auditor vs the contracting officer. As far as I can determine the new Cost Principles have not had any discernible effect on the approach or reporting by auditors. In some areas, the support for items which auditors have been questioning is strengthened by the new Cost Principles. This is especially true with reference to items, such as sale and lease-back which are more definitively covered in the new Cost Principles as compared with the old Principles. With respect to contracting officers, there probably has been some change although it is difficult to definitively establish what the nature of this change has been. Even under the old Cost Principles, contracting officers were using in the main these principles as guides in the review, evaluation and development of negotiation objectives. Under the old Principles where there was no definitive policy statement that these Principles would be a guide for fixed price contracts, Government contracting officers were probably more willing to compromise during negotiations under the old Principles than they are now under the new Principles. There are some types of costs, such as contributions, donations and advertising where greater consideration is probably given in the negotiation of fixed price contracts than will be the practice under the new Principles. Some of these costs were recognized at least to some degree. Such recognition was appropriate inasmuch as some of the costs were regular and necessary costs of doing business even though they were unallowable insofar as cost type contracts are concerned. Some contracting officers have indicated to us their approach since obtaining of the new Cost Principles. It is fundamentally the same as when the old Principles were in effect. As indicated above, however, we believe that there probably has been some change because of greater requirement for justifying departure from the application of Cost Principles now that they are specifically prescribed for guidance in fixed price contracts. We believe that this would apply whether or not we are concerned with price negotiations, price redeterminations or overhead allowances.

There is, however, no change with respect to the responsibility and authority of the contracting officer. He is still charged with negotiating and as such definitely does have authority to depart from such recommendations as may be furnished by auditors.

Question No. 3

Discuss reasoning behind disallowance of certain recognized and unavoidable costs of doing business. For example, contributions, donations, cost of borrowings, most advertising.

Answer

We agree with you that it would be redundant to at this point in time to further discuss all of the factors and reasoning behind the policies contained in Section XV. These were gone over in the many frequent discussions between DOD and contractor organizations. Our previous letter to you included our thoughts on these types of costs and with your experience, you are undoubtedly more knowledgeable regarding the reasoning behind certain provisions of the new Cost Principles than we are.

Question No. 4

Are the new Cost Principles intended to place a premium on increased direct costing?

Answer

I have discussed this question with Mr. George Frost, who is the Chairman of the NSIA Contract Finance Subcommittee and who is to make the welcoming talk at the Seminar. George says that this question was included because it was raised by some member. He believes that it is fundamentally based on the interpretation made by some people that the language of the new ASPR favors direct costing as compared with indirect costing. We have re-read paragraph 15-202 on Direct Costs and paragraph 15-203 on Indirect Costs and are unable to ascertain the basis for a conclusion that these paragraphs favor direct costs as compared to indirect costs. Our attitude and interpretation is that the present Section XV is defined to give recognition to the various and varying methods followed by contractors with respect to direct and indirect costing and as such is not designed to either favor one or the other. As a practical matter, however, we recognize that most of the arguments regarding the application of Section XV revolve around overhead and applications and allocation of overhead. Seldom are there arguments regarding direct cost in relationship to Section XV provisions.

For this reason, rather than any particular provision in Section XV, we believe that there could be a premium on direct costing. We do not, however, advocate the development of expensive and refined accounting methods and procedures merely to increase the number of cost categories that are costed directly. Instead, we recommend reasonable business-like methods of accounting and costing in relationship to the type of business organization methods of manufacture, types of contracts, and other factors.

Question No. 5

In connection with internal transfers what constitutes a "market price"? Does it mean your own or your competitor's market price?

Answer

There has been what seems to be a growing practice in Industry, especially in the electronics industry, for contractors to put items under so-called catalog prices. We are not sure whether this represents a trend consistent with the developing nature of the electronics business or whether it is a reaction to the fact that the Services, especially the Air Force, had placed considerable emphasis on negotiating and supporting reasonable prices. The practice is that contractors tend to classify items as falling within the market price category on one or more of the following bases:

a. Items regularly sold on both the military and non-military markets with definitely published price catalog.

b. Items regularly sold on military and non-military markets with published markets but not published price catalogs.

c. Items sold substantially for military end use with either published price catalogs or published catalogs without prices where there is more than one contractor capable of providing items to perform similar functions.

d. Items which are manufactured for stock on the basis of economical production runs and estimates of potential markets, whether such items are actually cataloged, price cataloged or even in competition. Obviously, such practices have created problems in negotiating reasonable prices, especially where the contractor can only allege that the item is competitive and is unable to demonstrate the existence of price competition. We have not in public speeches to Industry made reference to this problem simply because we were afraid that some contractors who are now furnishing cost data might develop the bright idea of putting items in the catalog category. In our discussions of

this problem with contractors, we have taken the position that the public nature of our business is such that we cannot live with any system whereby the contractor unilaterally establishes prices. We are ready to recognise market prices where contractors can reasonably demonstrate that the prices are established under conditions of price competition. We now have under consideration for publication in the AFPI the following statement:

> "The Government will accept the price of an item identified as a catalogue or standard commercial item without a cost breakdown only where the contractor can demonstrate the price of the item is determined by effective competition on each procurement. Effective competition is presumed to exist whenever an item has been sold regularly in the markets where other products, capable of performing the same or similar functions or otherwise usable in place of the item, are available from other sources and where competitive pricing can be demonstrated. In theabsence of such a demonstration the price of such items will be negotiated on the basis of actual and estimated cost data furnished by the contractor on each item."

We believe that the above approach is better than an attempt to define catalog price, market price, standard commercial, semi-commercial and other terms. The question as to whether the market price is your own or your competitor's market price is really a new one to us. Where we recognise market prices, it is normally the contractor's market price rather than the competitor's market price. However, we do visualise that if the buying activity, whether it be the Government or a prime contractor, was aware that a competitor's market price was lower, then the buyer would most likely refuse to accept the supplier's market price which is in excess of his competitor's. This is, of course, on the assumption that the items were very similar and that there were not other factors, such as reliability, maintainability, delivery schedules or others involved.

2. We hope that the above will be of help to you. In the event that you have further questions, please call either Dale Babione, whose home phone number is AX 3-7586 or me. I can be reached at TR-85664.

3. We will look forward to seeing you next week.

Sincerely yours

PHILIP J. BLATTAU
Colonel, USAF
Chief, Pricing & Negotiation Division
Directorate of Procurement & Production

OL 6 2597

SPEECH BY MR. AARON J. RACUSIN, DEPUTY FOR PROCUREMENT AND PRODUCTION, OFFICE OF THE ASSISTANT SECRETARY OF THE AIR FORCE (MATERIEL) AT THE NATIONAL SECURITY INDUSTRIAL ASSOCIATION (NSIA) SEMINAR ON DEPARTMENT OF DEFENSE PROCUREMENT ON 24 JANUARY 1961 AT THE SHERATON-PARK HOTEL, WASHINGTON, D. C.

Gentlemen:

Thank you for giving me an opportunity to address a few remarks to your seminar. This is the kind of forum where an exchange of views cannot help but result in a better understanding of our common problems to our mutual benefit.

I should like to consider my remarks as a part of the continuing assault by the military departments on the cost of defense programs. I am certain that most of you have heard this theme repeated by our representatives in speeches at gatherings such as this in various parts of the country in recent times past. Yet it is of such importance that it demands repetition.

The reasons are quite obvious. The magnitude of the Defense procurement program is about $25 billion a year--three times the combined purchasing volume of General Electric, General Motors, and U. S. Steel. It is 30% of the total Government budget. Its impact on our economy is enormous. Accordingly, our management of a program of such magnitude and importance is quite naturally a subject of close and continuing scrutiny by the Congress. And the attitude of Congress toward our procurement operations is a matter of great significance to the Department of Defense, and, I am sure, to industry as well.

Congress has called for a general improvement in our procurement practices and procedures and for renewed efforts to reduce the constantly rising cost of defense materials. It expressed its views in a most significant manner in the last session--an across-the-board reduction in appropriations by three percent.

As you know, the Department of Defense, during the past year, adopted several significant changes in the Armed Services Procurement Regulation relating to our pricing practices at the prime and subcontract levels. They concern our review of "make or buy" decisions, the review of subcontract prices and the provision for two-step formal advertising, to name a few. We believe they will have a salutary effect. But in large measure, the benefits to be derived depend upon our mutual diligent efforts to give meaningful effect to the printed word.

Since I am in the Department of the Air Force, I cannot, of course, give you the details of the accomplishments of the Army and Navy in their efforts to achieve cost savings. I am certain, however, that they have excellent programs in effect and have attained significant dollar reductions. I am in a better position to describe our own course of action. We embarked on a vigorous cost reduction program with our contractors. The response of many of them has been most gratifying. Major cost reductions are being realized through increased management attention given to this subject. Significant savings have been made

through such measures as improved purchasing techniques, better management of subcontracts, greater use of value engineering, closer control of overhead, and a generally tightened cost control. We have found excellent examples of aggressive action by our contractors to establish a general climate of cost consciousness. They have concentrated on expanding competition through the development of new sources of supply, elimination of sole source situations, and use of more and broader competition. Further economies have been achieved through quantity procurement, consolidation of orders, use of blanket purchase agreements, special handling for high value items and maintenance of surveillance teams in major subcontractors' plants.

One department of an Air Force contractor has produced over 2500 cost reduction ideas over a three-year period resulting in documented savings of $17,700,000. Another reports annual savings of $20 million as a result of a formal cost reduction program. Still another reports savings of $2.4 million over an 18-month period as result of value analysis techniques. Yet another, through vigorous measures in the field of overhead expenses has achieved savings in such expenses of $3,600,000 annually, or 20% of total expenditures. These are but a few of the instances of cost reduction brought about through well designed, vigorously executed plans put into effect by our contractors. A canvas of less than half of the contractors involved shows tangible cost reductions of about $575 million. This is something about which both the Department of Defense and industry can both be rightfully

proud. But it is not enough. Much remains to be done. Public confidence in our departments as well as your industries is at stake. We are under a continuing obligation to buttress that confidence by eliminating cases of poor procurement practices and preventing their recurrence.

At this point it would be well for me to bring to your attention some areas which we have noted that give us concern.

(1) Spiraling Engineering Costs--As most of you know, we have in the recent past been grappling with contractors' independent research and development effort. ~~This has increased during the past three years by 10%.~~ But there is an infinitely greater problem about which we are now gravely concerned and that is the vastly increased amount of dollars devoted to design, preproduction, production and field engineering effort on our contracts. The cost of this effort has increased by approximately 45% over the past three years. Expressed in dollars, this is an increase of approximately $1 billion. We are faced with an example such as at one major contractor's facility where less than $1 million was spent on independent general research and development, while during the same time period the contractor spent nearly 200 times this amount on false starts in production engineering charged directly to the contract. While we recognize that such false starts are not unusual in any technological development of a new weapon system, the magnitude of this high cost area emphasizes the need for closer management control. We are giving this subject a searching

review and will take whatever practicable means are available to assure tighter control. We expect industry to take similar action.

(2) The Manpower Utilization Subcommittee of the House Committee on Post Office and Civil Service published a report in September 1960 entitled "Personnel Procurement Costs of Selected Defense Contractors for Recruitment of Engineers and Scientists, FY 1959." The data included in the report was developed by the departmental audit agencies. FY 1959 recruitment programs for the 102 companies in the report cost approximately $21 million. The report also indicated an overall recruitment cost average of $1,022 per new hire for "predominantly Defense" contractors as against $751 for "predominantly commercial" firms. In three cases the cost per new hire for "predominantly Defense" contractors was well over $2,600. The report is clear that recruitment costs represent a significant expenditure of funds and I can assure you that this matter will be given particularly close review in the pricing and administration of contracts. In this connection, some questions you should ask yourselves are:

What analysis has our firm made of recruitment costs to justify the procurements made?

What controls do we have in respect to recruitment expense and what do we plan in this area for the future?

Are elaborate help wanted ads really necessary to hire engineers and scientists?

I submit that efficient management dictates that these matters be accorded serious attention.

(3) Another area that must be reviewed is that of the use of overtime. Because of the high priority assigned the ballistic missile and space programs, they have been exempted from overtime restrictions set forth in ASPR. Appropriate guidance, I am sure, has been disseminated to all procurement field activities as well as applicable contractors regarding the exemption, controls and usage of overtime for ballistic missile contracts. On the basis of the high contract overtime performed at missile sites, it appears to us in the Air Force, that this exemption has evidently been construed to mean that any and all overtime is permissable. Continuous use of overtime on the same task is indicative that other basic factors may be at fault. Generally, high overtime usage reflects adversely on the quality of management resulting in unnecessary costs. We have suggested that this matter be reviewed by all the military departments to determine the appropriate measures required to assure proper control of the use of overtime in the performance of contracts involving high priority programs.

(4) There is another area which I think requires your prompt attention. I am sure you will agree that a business of approximately $100 million has a direct and vital bearing on the costs of Air Force programs. This is the amount involved in our procurement of technical data such as manuals, handbooks and other technical guides that relate directly to hardware. While we are naturally concerned about the editorial quality and accuracy of that technical data, I would point out to you the need for reducing technical paper work costs without compromising the operation and maintenance functions related thereto.

We have recently conducted extensive surveys in order to find out what our technical data weaknesses are and what steps are necessary to correct these weaknesses. We have taken corrective actions to strengthen our managerial responsibility in this area. We urge you to subject this function to a thorough management review at the top level of your organizations to eliminate existing or potential weak spots. Of particular importance in this area are the cost and accounting procedures related to technical data. All too often, the actual costs of specific publications related to individual systems are difficult to identify and isolate. The Air Force is moving in the direction of inserting clauses in contracts, which will require industry to identify these costs and enable us to know exactly what we are paying for.

These are some of the soft spots which we think require close review by you gentlemen and those at all levels of your corporate management. I assure you we intend to give them our closest attention.

I should like to turn now briefly to two other subjects listed for discussion on the program. The first relates to types of contracts in use in the Department of Defense. As you know, the various types of contracts we use were the subject of an intensive review by Congressional committees during the last session. This was undertaken as part of a study required by the Statute which extended the Renegotiation Act. Special attention was devoted to the incentive type contract. The previous shortcoming in the negotiation of those contracts as revealed in several Comptroller General Reports raised significant questions in

Congress as to their efficacy. We believe that, if properly used, and I emphasize the work properly, such contracts serve a very valid purpose in obtaining reduced costs to the Government and increased profits to industry where true economy and efficiency are practiced in the procurement of our complex weapon systems. Certain corrective measures have been taken to assure the accuracy, currency and completeness of cost information which is used as the basis of negotiating target costs. An additional change, designed to eliminate a weakness by providing for a contractual right to amend the price where incorrect cost information has been used, is being adopted. For our part, we are exploring the application of incentive features to performance criteria, without waiving consideration of the very vital cost aspect. Here is an excellent technique where greater emphasis on the use of the incentive approach should be applied in your own purchasing procedures. I suggest that this can be a truly effective way that cost consciousness in your suppliers can be stimulated through opportunities for increased profits attributable to efficient performance and control of costs.

There are those, however, who contend that the incentive contracts contain the seeds of unwarranted higher profits without commensurate efficiency and economy on the part of the contractor. The continued use of the incentive contract will depend, in large measure, upon how well representatives on both sides discharge their responsibilities.

Our procurement practices are rightly of continuing interest on the "Hill". In its deliberations on such matters, Congressional committees are confronted with the difficult task of evaluating a mass of conflicting advice in an effort to reach sound decisions. Those deliberations are made even more difficult by the fact that the committees are removed from the day-to-day operations of this gigantic procurement program. We must be able to demonstrate conclusively that our joint efforts have brought about meaningful results, in improving procurement practices. Armed with such evidence, we feel confident we will be in an excellent position to convince the majority of our legislators that existing legislation is sound; that it is being soundly administered.

The second point is that relating to profits. This is a matter which could probably be the subject of an address in itself. I should merely like to emphasize that in this field we are confronted with the problem of trying to avoid the establishment of rigid levels of profits for application to all contractors for similar items, irrespective of the efficiency and economy and know-how of the individual contractor. Fixed patterns of profits are inequitable in that they reward the least efficient more favorably than the most efficient. Similarly, we have avoided attempting to establish a common profit level applicable to all types of work and to all types of contracts. We believe that profits should be negotiated based upon the application of sound judgment, taking into consideration the many factors outlined in the ASPR to be used in determining the appropriate level to be allowed in a particular case.

Without going into a lengthy discussion, I think I can state our fundamental philosophy succinctly in this fashion: we want to see you make a reasonable profit based upon demonstrated superior timely performance, and cost reduction.

If it seems that I have neglected a fuller treatment or any treatment of some of the items which appear in the printed program, you're right. I have done so deliberately in an effort to focus your attention on a subject which I feel is of utmost importance in our mutual desire to attain our common objective of obtaining a maximum military posture at minimum necessary cost. I can think of no more apt language to highlight what I have sought to stress earlier than to paraphrase some remarks made by General Anderson, the Commanding General of the Air Materiel Command, in a recent address to the Washington Chapter of your Association. He said: "Unless we--the Department of Defense and industry--do a better job of curtailing costs, the reflection of arbitrary percentage cuts will continue to be the cutback or elimination of urgent projects. We, in effect, have been told that so long as we don't exert maximum pressures for best cost result, then what we consider to be the very minimum dollars for our procurement will be further reduced."

I trust this seminar opens new avenues for our mutual improvement in an area that has so much significance to all of us today.

CONTRACT COST PRINCIPLES

By

Captain John M. Malloy, SC, USN

Chairman, Armed Services Procurement Regulation Committee
Office of the Assistant Secretary of Defense (Supply and Logistics)

at the

NSIA Seminar on Department of Defense Procurement
Under the Revised Contract Cost Principles and Procedures

Washington, D.C.

January 24, 1961

I would like to congratulate the National Security Industrial Association for its sponsorship of this seminar on cost principles. This exceptionally large turnout is ample evidence that interest in cost principles has not diminished.

I think it is a particularly good idea to have this type of meeting from time to time to talk about our common problems. However, this poses certain fundamental problems for the Government representatives. We are here today to trade experiences with you and to listen closely to what the industry spokesmen have to say. We will be particularly interested in the type of questions which you put to us as this should be a good barometer with respect to trouble spots in the application of our cost principles. The Government representatives who are here today, including myself, are not authorized to speak officially for the Department of Defense. In fact, we have had only a minimum of advance coordination with respect to our presentations. However, we intend to provide you with our best informal views and, realistically speaking, this should be quite helpful to you. As you are aware, the subject of cost principles is an area in which opinions vary widely. This is true obviously within the Department of Defense and it would not surprise me to hear conflicting views expressed by individual Government representatives. This, however, is the nature of the beast and it is our feeling that the full expression of individual views is the most practical way of reaching the right decision with respect to any particular cost item or cost interpretation.

It has been our experience that it is not possible to provide formula or book solutions to every costing problem. From time to time, we are asked by contracting officers for such neat solutions and, oddly enough, we get just as many requests from individual company representatives for such automatic solutions. Everyone, of course, wants these neat packages when it suits his own particular purpose, but I am rather certain that our discussion over the next two days will amply demonstrate the fallacy of this approach.

Our goal, during this meeting, it seems to me, should be to isolate any possible soft spots that may come to light, so that we in Government

may study the particular area further. While we have found that there are often no easy answers to some problems associated with the cost principles, particularly insofar as changing the Armed Services Procurement Regulation is concerned, we frequently are able to take other administrative action to advise our contracting officers and negotiators of the underlying purposes of some of the ASPR provisions.

In any event, please be assured of our good intentions and motivations in connection with our continuing study of contract cost principles. Above all, I suggest that you not develop a feeling of frustration just because easy solutions are not forthcoming on the spur of the moment. After all, I need not remind you of the problems that remain in your own companies from week to week.

I do not feel that any good purpose would be served by re-hashing the many arguments and counter-arguments which were fully explored and evaluated prior to publication of our cost principles. Rather, I intend today, to cover briefly the basic underlying purposes which motivated us to adopt so-called comprehensive cost principles and some of the current problems that we face in implementing any regulation, particularly one as complicated and as far-reaching as is involved in cost principles. I will cover the use of cost principles and cost breakdowns in the pricing and negotiations of contracts as I am sure that this subject will bubble to the surface several times during our discussions. I believe that you may be particularly interested in some of the areas of the cost principles that we are currently studying and, hence, I will outline these areas for you.

Most of you are aware of the fact that the cost principles were in the process of consideration within the Department of Defense for a period of several years prior to their publication on 2 November 1959. When finally adopted, they had been considered, in some detail, at high levels within the Department of Defense. We had several basic purposes in mind in this exercise. We had the obvious problem of updating our then existing cost principles, which were originally published in 1949, and which remained essentially unchanged over the years. Also, we were seeking to achieve a greater degree of uniformity on costing matters within the Department of Defense and among our various contractors. I recall a discussion which I had about two years ago with the Congressman from my own District who was an active member of the House Armed Services Committee. For some reason, he just could not understand why, for example, the cost of incentive bonus plans was not allowed by one military department, while the other two departments had testified before the Committee that they could see nothing wrong with this type of expense per se, and that it was being allowed to the extent that over-all compensation was reasonable. His rather pointed question to me was, "Why doesn't the Department of Defense make up its mind with respect to this area of cost and put all contracting officers on the same team?"

In addition to seeking uniformity, we were also attempting to provide a framework so that a particular cost would be treated, policy-wise at least, the same way, regardless of the type of contract employed. We could see no

reason why our policy should be different on an item -- such as contributions and donations -- under a cost-type contract as against a follow-on contract of a fixed-price type. In other words, we feel that a cost is a cost regardless of the type of contract involved. In making this generality, however, we do not intend to lose sight of the inherent differences which are reflected in the particular type of contract used. However, these inherent differences, such as degree of risk, for example, should be looked at squarely, and evaluated on the merits, rather than be buried in a different cost treatment.

In connection with the individual elements of cost, we adopted what we consider the best result possible under all of the circumstances. By this, I mean that other elements of the Government, such as the General Accounting Office and the Congress, have long held strong views in some areas, and these views could not be ignored. Up to the present time, we have been successful in defending several of the allowable cost items against critics who feel strongly that the Government should not pay for certain particular types of cost.

Many of you have bent my ear privately to convey the word that the implementation of these cost principles throughout the Department of Defense has been rather harsh. There are inherent problems of implementing policy decisions in any organization, particularly one as large as the Department of Defense. This is probably the most difficult problem that we face in developing any important part of the Armed Services Procurement Regulation. We attempt to develop policy which is at once applicable to the large contractor and to the small contractor, and to the contractor doing a large volume of business with the Department of Defense and a contractor whose total volume of business includes only a small portion devoted to the Department of Defense. Interestingly enough, during the development of our cost principles, one of the strongest industry objections was concerned with the degree of specificity and detail which we insisted was a necessary part of the cost principles package. We are now finding that industry representatives are complaining that our regulation is not specific enough. In other words, industry, on the one hand, argues for general policy guidelines with maximum reliance on the application of individual judgment to specific situations while, on the other hand, industry seeks specificity in the cost principles as a protection against the application of the wrong kind of judgment (from their point of view) being exercised by a contracting officer.

In any event, the military departments have issued very little in the way of implementing instructions. All of the departments are in complete agreement that it would be unwise to allow extensive unilateral implementation of the cost principles. This is not to say that there have been no suggested implementations. For example, many contracting officers feel that our coverage on travel per diem, and moving expenses is too broad. They want yardsticks, such as suggested per diem rates, or maximum limitations on the weight of household effects such as are applicable to Government personnel. For the moment at least, we are of the opinion that these matters are best left for individual evaluation against the over-all test of reasonableness.

I would like to turn now to the use of cost principles in pricing. I have found that feeling often runs high whenever this subject is broached. As a matter of fact, the applicability of our new cost principles in the fixed-price area was the most significant area of discussion within the Department of Defense in our consideration of the cost principles. Many knowledgeable people within the Department were genuinely concerned that any cost principles developed for use outside of the cost reimbursement contract area would inevitably result in formula pricing, or the automatic resolution of pricing problems strictly along accounting lines. Others felt just as strongly that it was essential to sound pricing that the parties have a clear understanding of the cost base, and that the peculiarities of the contracting situation should thereafter be handled through appropriate types of contracts or special contract provisions.

We have set forth our policy direction on the application of cost principles to other than cost type contracts in Section XV, Part 6. Here we have done our level best to come at this problem in a realistic fashion. We made what I consider to be a valid distinction between retrospective pricing and forward pricing. We very carefully indicated that our basic pricing policies and procedures, which are contained in Section III, Part 8 of the Regulation, are governing and shall be followed in the negotiation of fixed-price contracts. We have indicated, in a straightforward manner, that the cost principles are to be used as a guide in the evaluation of cost data, when such evaluation is required to establish fair and reasonable prices.

I have often been asked to elaborate on the term "shall be used as a guide." Here we simply mean that our cost principles should be followed in the usual situation, and that a contracting officer who departs from the cost principles assumes the burden of justifying his action. This seems only fair, and is the type of compliance which you would expect from the employees of your company in carrying out stated company policies. However, we mean what we say when we indicate that 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 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.

I am aware of the industry contention that, however well intended our policy pronouncements in this area, the actual fact is that defense contracting officers are engaging in formula pricing on a large scale. It is most difficult for us to objectively evaluate this contention. I think it safe to say that we are paying a great deal more attention to cost analysis now than we did in the past. We are also requiring our major prime contractors to do the same thing. This greater attention to cost on our part is not necessarily attributable to the publication of the cost principles. We have a great deal of evidence, particularly from reports issued by the General Accounting Office, that we and our prime contractors have not been attentive enough to the cost aspects of our negotiation procedures.

We fully intend that our people pay more attention to cost, but only in those areas where such attention is essential to sound pricing. We make no apology for this, and consider it to be a sound step in our determination to tighten up all along the line in our pricing and administration of large contracts.

I would like to change direction slightly at this point in order to advise you of some of the actions which we have recently taken in the area of cost principles, and to outline some of the specific matters which we have under active study at the present time.

We have completed drafts of cost principles applicable to the acquisition of facilities and to construction contracts. These cost principles will appear in Parts 4 and 5 of Section XV. Both of these new Parts incorporate the basic principles found in Part 2, and set forth only those particulars which are peculiar to facilities or construction. Appropriate industry associations are currently being afforded the opportunity of reviewing and commenting on these new Regulations.

The Bureau of the Budget has very recently revised its circular A-21, which prescribes cost principles applicable to research contracts with educational institutions. ASPR Section XV, Part 3 will be changed in the near future to reflect the changes directed by the Bureau of the Budget. These changes are, for the most part, of a clarifying nature, although the cost of the Sabbatical leave will be allowable, whereas this item is unallowable now.

We firmly believe that changes in Section XV, Part 2 should be kept to the absolute minimum. Other speakers on today's program will elaborate on the difficulties that are encountered when different sets of cost principles are being used by a particular contractor. We have been thinking seriously of establishing a new Part 7 in Section XV, which would contain so-called cost interpretations. Here we might include additional guidelines as to reasonableness or allocability in connection with a particular cost item, even though the cost principle itself remains undisturbed. This may sound like an easy solution to the problem of minimizing changes in the cost principles themselves, but we have found, on analysis, that the creation of a part on cost interpretations might well introduce a myriad of additional problems, particularly of a legal nature. While we have not necessarily abandoned this idea, we have not as yet come upon a specific situation which would lend itself to this treatment.

Now, for some specific areas that have been, or are currently occupying our attention. We are making a change in Paragraph 15-205.6 which concerns the reasonableness of location allowances -- sometimes called "supplemental pay" or "incentive pay." The effect of this change is that these costs will be recognized only where, and so long as, the isolation or unfavorable environment of a particular site makes such payments necessary to the accomplishment of the contract work without unacceptable delays. This change which will be published in Revision 3 on 31 January 1961 should have a minimum of effect on most contractors, and will be applicable only to certain situations where abuses have developed.

The total cost involved in the area of recruiting expense continues to be a matter of concern to us. A recent study by the Department of Defense indicates that the level of recruiting expense for defense contractors is considerably in excess of that being experienced by contractors engaged in civilian business. While we might logically expect higher costs, in the less stable area of defense business, we can all recognize the potential abuses which are possible. The Military Departments will continue to administer this particular category of expense with a heavy hand. We do not, however, contemplate any change in the cost principles covering this item.

Advertising in trade and technical journals is presenting some very difficult problems of administration. This area involves a small fraction of the total cost picture, but there is, nevertheless, a substantial amount of money involved. Our cost principle is couched in general terms, and we have been faced with different applications within the Department of Defense in this area. We are also aware that the number of trade and technical journals is increasing at a fast clip. We have attempted to develop an amplification and clarification of our cost principle, but without much success. We are now undertaking a basic study to determine just what our defense policy in this area should be. I am unable to predict the outcome of this study at this time.

A question has arisen with respect to whether independent development expense can be allocated to all work of the contractor in the contract product line (including research and development work), or whether independent development expense can be allocated only to production contracts. While the problem arose with respect to the interpretation of the provisions of the cost principles as now worded, we are studying the matter to seek the right solution. In other words, a de novo look. This is a close question and we hope to have this matter clarified in the near future.

A problem has arisen with respect to the allocation of certain personal property taxes. This problem is aggravated in states where the applicability of state taxes to defense material is in dispute. The question is whether such taxes should be segregated and allocated directly to each class of customer, i.e., Government work and commercial work, or whether these taxes should go into an overhead pool for allocation in the usual manner. It is our tentative view that these taxes, when significant in amount, should be handled as direct costs. We are in the process of studying the appropriate method of implementing this conclusion. This may result in a change to the cost principles and to our standard tax clauses, as well.

We are beginning to hear that some contractors are seeking to gain a liberalization of the cost principle concerned with charges for material transferred between plants or divisions under a common control. Our present ASPR coverage on this subject represents a liberalization from the prior treatment. Many of you will recall that industry recommended a more liberal policy in this area. However, the present regulation is essentially one of compromise between the industry and Government positions. Some companies

have indicated that they do not want to give the Government the "most favored customer" price. Problems have also arisen with respect to the term "sold by the contractor through commercial channels." Problem areas arise here in connection with an item that has only a military application, and is sold as a subcontract item exclusively to other defense contractors. I think it safe to say that we are not disposed to make any basic change in this particular cost principle at this time.

One final item concerns itself with bidding expense. Several abuses have been reported in this area, such as extensive research and development effort that is improperly labelled as bidding expense. There are also problems in the area of unsolicited proposals. We are receiving a great many unsolicited proposals which are submitted in great detail -- that is, they are completely engineered to the final line on the blueprint, rather than being presented in broad framework for evaluation. The costs of this effort go into overhead and are, of course, reimbursable through our contracts. We feel that there is an area of excess cost involved here and, more important, there may be a waste of critical engineering talent. This is an area in which we have very little control today. Obviously, we want to continue to receive unsolicited proposals for evaluation, but we definitely do not need such extensive engineering detail, and we definitely want to cut down on needless cost in this area. Our appropriation situation is such that we can only fund a small fraction of the proposals which are received. Continued lack of restraint in this area will inevitably require that we impose additional restrictions in our Regulation.

It has been my purpose this morning to provide you with some background material with respect to the contract cost principles. We do not claim that everything is perfect. We recognize that both Government and industry are still acquiring experience under the new cost principles. However, we have heard nothing yet to indicate that any basic or major changes are necessary or desirable in our current Regulation. We are most anxious, however, to take such steps as may be necessary to clarify and improve our Regulation. We most certainly are desirous of preventing the misuse of the cost principles. I have indicated to you the areas that are currently causing some difficulties and are requiring our attention. I am looking forward with anticipation to a discussion in depth over the next two days on this important subject. It will surely produce good results -- if only to make everyone, on both the Government and industry sides, more precisely aware of the ground rules.

QUESTIONS PRESENTED AT NSIA COST PRINCIPLES SEMINAR
24 and 25 January 1961

1. Although you have said that it may be necessary for the Services to issue implementing instructions - why does the Department of Defense permit conflicting instructions to be issued on interpretations of the ASPR?

2. Why doesn't the Department of Defense require that all implementing instructions by the three Services be cleared by the Department of Defense to assure that the instructions are in compliance with ASPR?

3. Why is it that one branch of the Government (Internal Revenue Service) allows a contractor's expense and another branch of the Government (DOD) does not?

Examples: Advertising
Interest

4. Entrance into an advance understanding on independent R&D expense must be done with full knowledge of all the particulars involved. If patent rights to independent R & D inventions are not requested at the time of the advance understanding but are requested during the negotiation of individual contracts subject to the advance understanding, a contractor does not know the full cost of the advance understanding entered into.

What is the Government's intent on requesting patent rights to independent R&D inventions and when will it request such rights?

5. In quoting on Fixed-Price contracts, why is it necessary to prepare cost breakdowns, bills of materials, tabling lists, etc. when the contracting agency admits frankly it is only interested in the low bid? This adds considerable costs to our operations when the information is not used unless one is low.

6. Is the Statement of Cost Principles the only published or unpublished statement of policy (or interpretation of policy) on "Pre-Contract Costs?"

7. Use of contingencies in contract pricing. Why should contingencies, properly used, be frowned upon and cost questioned by auditors and negotiators? Contingencies can be effectively used to both increase or decrease a basic price proposal, or any element thereof.

8. In the implementation of Section XV of the ASPR, many people expect contracting officers to use sound business judgment in determining reasonableness, yet every day most of the problems result from a difference of opinion on reasonableness. What is being done to insure C. O. development in this sould business judgment?

9. On the question of mortgage interest - Should steps be taken to distinguish this cost from other kinds of interest thereby removing the present penalty of realty ownership?

10. Let's face the fact that all DOD procurement is running from difficulties with GAO and Congress. Why, as you lay awake nights worrying about new ways to squeeze the contractor, do you not also seek ways to pay for fair costs incurred? Money which you are, in effect, borrowing from the contractor - not even GAO could argue that this is a fair cost.

11. With the development of different approaches to cost recovery as implied by the issue of separate set of cost principles by AEC, what efforts are being exerted to achieve a common set of cost principles for all Government agencies?

12. Has Bureau of Budget authority to dictate changes in ASPR cost principles? If so, on what authority - statute, executive order, or what?

13. Re ASPR-15-205.44(b). Costs of part-time education relative to job requirements of bona fide employees. The words "related to job requirements" are subject to different interpretations. Could you discuss the intent of the paragraph, ASPR 15-205.44(b)?

14. Location Allowances at Field Test Sites. Expense allowances and/or bonuses for living at field test sites must be considered along with total salary in determining reasonableness of over-all compensation to personnel. How does DOD propose to control (through ASPR Cost Principles) the payment of expense allowances or site bonuses without also controlling over-all salary? Is it proper for the DOD to attempt control of salaries? (I think not). How do contractors meet competition in payments to employees when controls on method of payments are imposed?
I would like to have some discussion on this subject.

15. Lawyers and the problem of "consideration" are blamed for the DOD refusal to permit wholesale substitution of the new principles for the old. Couldn't this be done under Title II residuary authority - "without consideration" - on the Secretary's finding that it would facilitate the national defense (in administering controls)?

16. The 10 February 1960 memo of the Assistant Secretary of Defense to the Assistant Secretaries of the Army, Navy and Air Force relative to uniform procedures for the implementation of the revised cost principles provided that contracts entered into after the effective date for the "new" cost principles (1 July 1960) could provide for the extension of the applicability of the "old" principles through the end of the contractor's current fiscal year. Where the extension has been granted, do the "new" cost principles automatically come into effect at the close of the contractor's fiscal year or does it remain as a requirement that the shift from the "old" to the "new" cost principles may be allowed only if there is no disadvantage to the Government?

17. In the absence of an amendment to an "old" contract to provide for the application of the "new" cost principles, is it proper for contracting officers to seek the incorporation of the "new"cost principles to amendments or supplemental agreements to such contracts where the scope of the work or procurement is significantly increased?

18. What is the real intent of the new Sale and Leaseback Provision? Is Mr. Landesco's interpretation correct?

19. Re: Sale and leasebacks:

1) Is rule different when lease used as a means of original financing - (i.e., where contractor never had title) - as opposed to when contractor had title, then calls a lease-back?

2) Is contractor prohibited from realizing legitimate product so long as rental fixed is fair, reasonable and competitive?

20. Why should <u>any</u> costs be disallowed?
Why not allow all costs to be spread proportionately over <u>all</u> types of business, and apply the rule of reasonableness, plus acceptability of the contractor's accounting system?

21. ASPR III, Part 9, apparently intends that (a) contractor's Purchasing Systems and (b) Major INdividual Subcontracts will be reviewed and approved on basis of new ASPR XV (i.e., in pricing and cost analysis) among other bases.

a. What is the ASPR Committee planning to do regarding some of the "cost audit and transfer" (from subs to primes) problems mentioned by Mr. Cook of Westinghouse?

b. In the meantime, what can procuring activities do to meet such problems?

REMARKS
by
CAPTAIN JOHN M. HALLOCK, SC, USN
BEFORE THE
BRIEFING CONFERENCE ON GOVERNMENT CONTRACTS
SPONSORED BY
THE FEDERAL BAR ASSOCIATION
PHILADELPHIA, PENNA.
Feb 9, 1961

It is always a pleasure for me to participate in these briefing conferences. They provide an excellent forum for the public discussion of the really important issues of the day in the field of Government contracting.

This afternoon we will be engaged in a discussion of defense cost principles -- their content, administration, and use. Costs always seem to remind one of profits, so it is only natural that our discussion include this most important and interesting subject.

I don't intend to discuss the cost principles in much detail today. You are all aware of the fact that the Department of Defense published its new cost principles in November 1959. This was the culmination of many years of effort to resolve conflicting views within the Department of Defense and with industry. While we were able to resolve our differing views internally, I am afraid that some segments of Industry remain in the opposition to cost principles which deny recovery of certain costs, irrespective of the rationale supporting the disallowance. Secretary McGuire once observed that he expected the epitaph on his tombstone to read like this: " Here lies the man who published the new cost principles."

In any event, they were published and we all survived -- and, strangely enough, so has Industry. The new principles were generally effective on 1 July 1960, although many large companies did not cut over to the new principles until 1 January 1961. This was possible under our ground rules in line with

our determination to make the transition from old to new as painless as possible. In effect, we provided the flexibility to have the effective date coincide with the contractor's fiscal year.

The Department of Defense has been watching the actual application of the new cost principles very closely. Our contracting officers and auditors report that no insurmountable difficulties have developed so far, although all recognize that we are still acquiring experience under the new cost principles. However, we have heard nothing yet to indicate that any basic or major changes are necessary or desirable in our current Regulation.

This is not to say that there are no problems being encountered. We have many of the usual problems of interpretation of the printed word. Many contractors have been searching diligently for loopholes, while the Government representatives on the firing line have been trying to stay one jump ahead of the opportunists.

Much remains to be done in the area of advance understandings. Many contractors are seeking advance understandings where no solid reason exists for the use of this technique. On the other hand, some Defense contracting officers seem to be reluctant to make use of this provision in the cost principles. Mr. Steger will pursue this interesting area in greater depth today.

The research and development principle was the most difficult of all the cost principles for us to develop. In making a contractor's independent research and development costs allowable, we were aware that our biggest problem would be one of administration. An increasing amount of Defense business must be awarded on the basis of technical superiority.

This situation provides a substantial incentive to many companies to get the jump on their competition. This type of industrial competition is, of course, not bad in itself. In fact, it is the kind of free enterprise drive that has made our country great. However, we were quite aware of the dangers inherent in this area if some type of reasonable restraint and surveillance was not imposed on the enthusiasm of our contractors. These potential dangers involve both money and technical manpower. The problem we faced, then, was one of control - - to avoid extremes and to avoid providing competitive advantages through our support. We found no easy solution for across the board application. Rather, we determined that it would be necessary to examine each situation involving significant expense on a case by case basis. We established the administrative mechanism to handle this program on a defense wide basis. Many contractors have already been through the mill on this one. The results have been generally satisfactory for both sides. Some companies have received approval of their total program. Others have been approved in part only. There is no automatic answer to every case. Particular emphasis is placed on the degree of excellence of the contractor's program and the amount of effort previously devoted to this area. For example, one company asked us to approve a seven million dollar independent research program. The company had previously devoted about one-half million dollars to this area. We did not intend that our cost principle have this effect on costs. This company has agreed to a cost-sharing formula.

Other problems have arisen in the subcontract area. These involve the control of costs, advance understandings, and the audit of subcontractor costs.

In connection with the latter, our Government auditors are making every effort to assist prime contractors by providing audit reports, particularly in instances where we have a Government auditor in residence at a particular contractor's plant.

As most of you are aware, the new cost principles are applied to future periods on a contract by contract basis. Many existing contracts will continue for months, some for a period of years. This situation results in the use of both the old and new principles at the same time by many contractors. We did the best we could to prevent this situation, but the problems were unsurmountable. We are hopeful that at some time in the future, perhaps by the end of this year, we will be in a position to provide practical guidelines that will enable us to amend existing contracts to provide for the use of the new cost principles across the board.

It is our hope that changes in our cost principles can be kept to the absolute minimum. While certain clarifications may well be in order, we realize that the problem of different sets of cost principles would be compounded if we made important changes frequently. We also intend to control rigidly the issuance of implementing regulations. You have seen few, if any, such implementations so far. In fact, any implementation, by either the procurement or audit elements of the military departments requires the advance approval and authorization of the Office of the Secretary of Defense.

We have completed drafts of cost principles applicable to the acquisition of facilities and to contruction contracts. These cost principles will appear in Parts 4 and 5 of Section XV. Both of these new Parts incorporate the basic principles found in Part 2, and set forth only those particulars which are peculiar to facilities or construction. Appropriate industry associations are currently being afforded the opportunity of reviewing and commenting on these new Regulations.

The Bureau of the Budget has very recently revised its circular A-21, which prescribes cost principles applicable to research contracts with educational institutions. ASPR Section XV, Part 3 will be changed in the near future to reflect the changes directed by the Bureau of the Budget. These changes are, for the most part, of a clarifying nature, although the cost of Sabbatical leave will be allowable, whereas this item is unallowable now.

Now, for some specific areas that have been, or are currently occupying our attention. We are making a change in Paragraph 15-205.6 which concerns the reasonableness of location allowances -- sometimes called "supplemental pay" or "incentive pay." The effect of this change is that these costs will be recognized only where, and so long as, the isolation or unfavorable environment of a particular site makes such payments necessary to the accomplishment of the contract work without unacceptable delays. This change, which will be published in Revision 3 of ASPR, should have a minimum of effect on most contractors, and will be applicable only to certain situations where abuses have developed.

We are continuing to watch the area of recruiting expenses. This cost element is of particular interest to the Congress. The potential abuses in this area need no elaboration.

Advertising in trade and technical journals is presenting some very difficult problems of administration. We are in the process of studying this item closely to determine just what our defense policy should be.

We are also working on the cost principles dealing with the allocation of independent development expense, certain personal property taxes, and charges for material transferred between plants or divisions under common control.

This review on our part is occasioned by problems which have arisen in the application of the cost principles over the past year.

The use of cost principles in pricing is a very interesting and important area. I have found that feeling often runs high whenever this subject is broached. As a matter of fact, the applicability of our new cost principles to fixed-price contracts was the most significant area of discussion within the Department of Defense in our consideration of the cost principles. Many knowledgeable people within the Department were genuinely concerned that any cost principles developed for use outside of the cost reimbursement contract area would inevitably result in formula pricing, or the automatic resolution of pricing problems strictly along accounting lines. Others felt just as strongly that it was essential to sound pricing that the parties have a clear understanding of the cost base, and that the peculiarities of the contracting situation should thereafter be handled through appropriate types of contracts or special contract provisions.

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I have often been asked to elaborate on the term "shall be used as a guide." Here we simply mean that our cost principles should be followed in the usual situation, and that a contracting officer who departs from the cost principles assumes the burden of justifying his action. This seems only fair, and is the type of compliance which you would expect from the employees of your company in carrying out stated company policies. However, we mean what we say when we indicate that 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 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.

I am aware of the industry contention that, however well intended our policy pronouncements in this area, the actual fact is that defense contracting officers are engaging in formula pricing on a large scale. It is most difficult for us to objectively evaluate this contention. I think it safe to say that we are paying a great deal more attention to cost analysis now than we did in the past. We are also requiring our major prime contractors to do the same thing. This greater attention to cost on our part is not necessarily attributable to the publication of the cost principles. We have a great deal of evidence, particularly from reports issued by the General Accounting Office, that we and our prime contractors have not been attentive enough to the cost aspects of our negotiation procedures. We fully intend that our people pay more attention to cost, but only in those areas where such attention is essential to sound pricing. We make no apology for this, and consider it to be a sound step in our determination to tighten up all along the line in our pricing and administration of large contracts.

I would like to turn now to a brief discussion of profits. One often hears the statement that profits generated on Government business are too low. Depressed profit levels, it is said, discourage companies from doing business with the Government. It is drying up investment funds and making it impossible to replace ageing plant and equipment. Government personnel, it is alleged, do not take into consideration that the profit or fee must absorb most of the unallowable costs that must be incurred by contractors, even though not allowed as costs by the Government. Some have estimated this area to be as high as 2%. So the argument goes.

The generality of this argument is of serious concern to the Department of Defense. It goes to the very heart of the incentive problem. It is an area that we in Government should be aware of on a continuing basis. The fact is, however, that we have not experienced any lack of interest in our business on the part of American industry. In fact, the line at the door of contracting officers is getting longer each day. As you are fully aware, we endeavor to instill as much competition into our procurements as is possible. In these situations, we in Government do not depress profits. We buy at a price, a good tight price we hope, and the profit element is governed by conditions in the market place. This is as it should be in the best tradition of the American free enterprise economy. I submit that it would be improper for Government buyers to be other than hard-headed businessmen in acquiring the goods needed for the Defense of this country. We strive to buy at a good price and to insure that profits thereafter are earned -- - - by the application of management efficiences and tight control of costs. Profit should not be guaranteed - - it should be earned.

There is, of course, a large segment of our business that must necessarily be non-competitive as to price. In these instances, we use the criteria set forth in ASPR Section XIV, Part 8. These, I submit, are good criteria. They provide for certain plus and minus considerations in relation to the relative risks involved, and in relation to assistance provided by the Government, such as when facilities and financing are provided. We intend that these criteria be applied on a case by case basis, depending on the individual situation. We don't like to see the automatic application of a fixed percentage as the fee. We are aware that this is sometimes the case --- sometimes by our own people and sometimes by contractors. The real problem here, as I see it, is not to raise the general level of everyone's fees, but rather, to reward the efficient contractor, or recognize the difficult job, by allowing higher fees. And, of course, it follows that we should reduce the currently allowed fees when such conditions do not exist. In other words, I think there are too many instances today where the best, the routine, and the poor contractor are receiving the same recognition in the fee area by the routine application of so-called standard fees. If we can find a way to break up these current practices, we will surely introduce sound incentive to do business with the Government.

One final thought. While I have talked to you today about cost principles and their use, and of profits, I suggest that all of us not become so engrossed in this type of discussion that we lose our perspective with respect to the most important area of all - - - the mounting cost of Defense. I would like to see us all more concerned with finding ways to reduce costs - - perfectly legitimate costs in themselves (such as overtime) instead of spending so much of our time [illegible] and debating the relatively minor items which are listed in our [illegible]les as being unallowed.