DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO DLA-AFC

12 March 1980

MEMORANDUM FOR DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, 15-205.23, Organization Costs

I. PROBLEM:

Review and analyze comments received from industry on a proposed change to DAR 15-205.23, Organization Costs.

II. RECOMMENDATION:

That DAR 15-205.23 be revised as shown in TAB A.

III. DISCUSSION:

A. Background

On 21 March 1979, this Working Group was assigned the task of reviewing a recommended change to DAR 15-205.23, Organization Costs, submitted by the Council of Defense and Space Industry Associations (CODSIA). CODSIA recommended that the last sentence of DAR 15-205.23 be deleted since, in their opinion, it has the potential for creating problems and is inconsistent with the current emphasis on reducing the burden and complexity of acquisition regulations. This sentence states, "Unallowable 'reorganization' costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised."

CODSIA contended that the addition of the last sentence in paragraph 15-205.23 is another in a series of cases where DoD, having been ruled against by the Armed Services Board of Contract Appeals on the basis of equity, has changed the rules. In addition, they believe the DoD is seeking to disallow a whole category of activities that are inherent and necessary in the normal activities of a business which are not related to the original purpose of 15-205.23. The sentence which CODSIA wanted deleted was developed under ASPR Case No. 74-98 to clarify the intent of the cost principle as it relates to the costs of any change in corporate financial structure.

12 .. .:ch 1980

EXECUTIVE SUMMARY

SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, DAR 15-205.23, Organization Costs

Initial Recommendation: Review and analyze comments received from Industry on a proposed change to DAR 15-205.23, Organization Costs. The proposed change is the elimination of the last sentence of the cost principle which reads as follows: "Unallowable reorganization costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised."

Findings:

- The DAR 15-205.23 should be revised as shown in TAB A.

Objective: The objective of the assignment was to determine whether the referenced sentence should be eliminated. Industry contended that the referenced sentence should be eliminated because it has the potential for creating problems and is inconsistent with the current emphasis on reducing the burden and complexity of acquisition regulations. The Working Group does not agree with the Industry position.

Section XV-2 Working Group

George H. Strouse

George H. Strouse, Chairman

20 MAR 1980

The Working Group concluded that the change proposed by CODSIA was not appropriate since administrative costs of corporate rearrangement are in fact reorganization costs. We believe that exceptions should be made in those instances where 15-205.23 would prohibit the use of Employee Stock Ownership Plans, Executive Compensation and Employees Savings and Investment Plans as a means of officer and employee compensation. The language in DAR 15-205.23 was revised to clarify this point.

On 5 September 1979, a letter was sent to industry and other Government agencies requesting their comments on the proposed revision.

B. Responses on Proposed DAR Revision Received from Industry and Other Government Agencies

Comments were received from the Council of Defense and Space Industry Associations (CODSIA) and the General Services Administration (GSA). Responses from the American Defense Preparedness Association, the Canadian Embassy, the United States General Accounting Office, and the National Aeronautics and Space Administration either concurred or offered no objection to the proposed change.

1. CODSIA

Although CODSIA concurs with the proposed addition, they still believe that DoD should delete the specific sentence added by DPC 76-9. This sentence states, "Unallowable reorganization costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised."

Working Group Comments

This same issue was addressed in our report dated 25 July 1979 along the following lines. We believe that transactions directly affecting capital accounts, regardless of whether additional capital is raised, should be classified as organization or reorganization costs. In the Boeing Company ASBCA Case No. 14370, the Board distinguished between an "adjustment" which modifies a corporation's capital structure without revaluation and raising of new capital, and a "reorganization" which significantly revamps the corporate capital structure by legal means. The Board held that a redemption of debt securities constituted an "adjustment" for which related administrative costs are allowable. It was the opinion of the Section XV, Part 2 Subcommittee that under ASPR Case 74-98, the distinction drawn by the Board was inappropriate, and its conclusion regarding the allowability of the costs of an "adjustment" was contrary to the original intent of 15-205.23. The last sentence of 15-205.23 was added specifically to disallow the costs of those transactions classified as "adjustments" or "rearrangements." The rationale for this position is as follows:

a. Historically, DoD has placed a prohibition on transactions increasing capital so as not to interfere with or subsidize, in any way, the financial mechanism of the private enterprise system. From a public policy viewpoint, it would be inappropriate for the Government to subsidize the cost of any company's capital acquisition at the expense of individual taxpayers. This position must, by nature, be viewed on a broad rather than a narrow scale. Therefore, the costs associated with the redemption or conversion of debt securities must be viewed in the same light as the initial acquisition of the debt. The cost principle should address the whole transaction and not only the initial acquisition of the debt.

b. In Case 74-98 (18 Feb 76), the Subcommittee stated:

> The provisions of 15-205.23 preclude the allowability of costs incident to the organization or reorganization of a contractor's corporate structure. This caveat has been in Part 2 since, at the least, July 1960; and possibly prior. Although the case history on this particular provision was not available for the Subcommittee's review, the reasons for its inclusion in the cost principles appear fairly obvious. The costs of organizing, reorganizing or, for that matter, "adjusting" a corporation are capital in nature, in that the benefit derived therefrom is long term, i.e., from the time the action is completed until dissolution of the corporation. In addition, if the DoD were to participate in the cost of establishing or enhancing a contractor's financial structure, regardless of whether the action was denominated as an organization, reorganization or adjustment, (i) such participation could be deemed discriminatory in terms of those contractors who underwrote this type of expenditure on their own and (ii) contractors might well be influenced to reorganize their capital structures when their business mix was such that the Government would absorb a large share of the cost.

2. GSA

GSA pointed out that the proposed coverage appears to require the words "acquisition of stock" to apply to both 15-205.23(b)(i) and (ii), but the words only appear in (i).

Working Group Comments

We agree and have revised the coverage accordingly.

Minority Position

The Navy Representative disagrees with the Majority argument that the original words in 15-205.23 have been fairly obviously intended to disallow "adjustments." It can certainly be argued that the words were litigated and that the ASBCA, in the case cited, found that "adjustments" were not to be disallowed under the original words. What evidence is presented to support the majority opinion of original intent?

But there is a deeper policy question here. That is, whether the cost of following through on obligations to maintain capital, that ensue as a result of transactions that raised capital, are to be disallowed. The Navy Representative agrees with the ASBCA decision that allowing costs of follow-through transactions such as redemption of convertible securities and administration of borrowings represent equity for the simple reason that such transactions do not raise one cent of capital.

Every time capital is raised in any way there is a follow-through corporate obligation. In the extreme, it could be argued that the issuance of common stock carries with it the implicit obligation to earn profits so that dividends may be paid and thus every activity of the corporation could be disallowed as associated with the original capital acquisition. The minority believes that administering such transactions as stock splits, quasi-reorganizations, convertible redemptions, etc. should be allowable as a matter of policy because they simply do not raise capital, but are only the corporate responsibilities that result from originally raising capital. The minority believes that the elimination of the last sentence of DAR 15-205.23(a) would restore this section to a more equitable policy position.

Majority Rebuttal to the Minority Position

The last sentence of DAR 15-25.23(a) is not intended to be an all inclusive definition of unallowable reorganization costs. The fourth word in the sentence, "include," means that the unallowable reorganization costs covered by this last sentence are but an example of such costs. There are other kinds of unallowable reorganization costs. The majority believes that the cost of any nonrecurring transaction of a capital nature regardless of whether the transaction resulted in the raising of capital is an unallowable reorganization cost.

The majority also is of the opinion that the costs of recurring transactions of a capital nature such as stock certificate transfer charges have been intentionally excluded from DAR 15-205.23, Organization Costs. Such costs of recurring transactions of a capital nature are specifically covered in DAR 15-205.24, Other Business Expenses and are allowable. In our opinion, the placement of the coverage on costs of recurring transactions of a capital nature in DAR 15-205.24 was done to make it more clear that costs of nonrecurring transactions of a capital nature are covered by DAR 15-205.23, Organzation Costs and are unallowable.

The majority, contrary to the minority position, believes that nonrecurring follow-through transactions such as redemption of convertible securities and administration of borrowings are unallowable reorganization costs. It is irrelevant whether such transactions raise capital as stated by the minority position. For the same reason the majority disagrees with the minority position that administering such transactions as quasi-reorganizations, convertible redemptions, etc. should be allowable because they do not raise capital.

IV. CONCLUSIONS:

A. That the proposed revision to 15-205.23, Organization Costs, as set forth in TAB A be incorporated into DAR.

B. All members of the Working Group, with the exception of the Navy representative, concur in the contents of this report.

George H. Strouse

Encl

GEORGE H. STROUSE
Chairman
DAR Section XV, Part 2 Working Group

DLA-AFC
SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, 15-205.23, Organization Costs

DAR SECTION XV, PART 2 WORKING GROUP MEMBERS

DoD Representatives

Floyd W. King, DARCOM
Robert W. Lynch, NAVMAT
Paul V. McCarthy, HQ AFSC
William F. Edwards, DCAA
Orland L. Sollom, OASD(C)
Charles E. Deardorff, OUSDR&E

Other Agency Representatives

Albert Dumas, NASA
Frank Van Lierde, GSA
G. L. Allen, DOE(P&C)
Rudy J. Schuhbauer, DOE(FMRB)

Other Participants

Karen Richardson, DLA-G

TAB A
Case 78-119
12 Mar 80

PROPOSED CHANGES TO DAR 15-205.23

15-205.23, Organization Costs.

[(a) Except as provided in (b) below,] expenditures in connection with (i) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, or (ii) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowing for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised.

[(b) The cost of the activities primarily designed for the purposes of providing compensation will not be considered organizational costs subject to this part, but will be governed by 15-205.6. These activities include the acquisition of stock for (i) executive bonuses, (ii) employee savings plans, and (iii) employee stock ownership plans.]

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO DLA-AFC

30 August 1979

MEMORANDUM FOR DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, 15-205.23, Organization Costs

I. PROBLEM:

Draft an appropriate letter to be sent to Industry and other Government agencies requesting comments on the proposed revision made to DAR 15-205.23 under subject case.

II. RECOMMENDATION:

That the letter enclosed as an attachment to this report be utilized as the transmittal letter to Industry and other Government agencies.

III. DISCUSSION:

At its regular meeting on 15 August 1979, the DAR Council approved the revision to be made to DAR 15-205.23, Organization Costs. The DAR Council then requested the Working Group, by memorandum dated 16 August 1979, to draft an appropriate letter to transmit the changes to Industry and other Government agencies for comment.

IV. CONCLUSION:

The attached letter, drafted by the Working Group, is recommended as the transmittal letter.

George H. Strouse
GEORGE H. STROUSE
Chairman
DAR Section XV, Part 2 Working Group

DLA-AFC
SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, 15-205.23, Organization Costs

DAR SECTION XV, PART 2 WORKING GROUP MEMBERS

DoD Representatives

Harry E. Hindman, DARCOM
Dennis E. Modesitt, NAVMAT
Paul V. McCarthy, HQ AFSC
Charles L. Cipolla, DCAA
Orland L. Sollom, OASD(C)
Charles E. Deardorff, OUSDR&E

Other Agency Representatives

Al Dumas, NASA
Frank Van Lierde, GSA
G. L. Allen, DOE(P&C)

B A
Case 78-119
30 August 1979

The DAR Council is considering a revision to DAR 15-205.23, Organization Costs. This proposed revision was developed ~~as a result of partial acceptance of~~ in response to a recommendation by the Council of Defense and Space Industry Associations (CODSIA).

~~It was determined~~ We propose to clarify ~~that~~ the provisions of DAR 15-205.23 ~~should~~ to not limit or inhibit ~~the~~ methods or amounts paid as compensation. The proposed revision specifies that costs, such as bona fide Employee Stock Ownership Plans, Executive Compensation and Employee Savings Plans are allowable ~~and are to be~~ subject to the provisions of DAR 15-205.6, Compensation for Personal Services.

Your comments (25 copies), if any, on the proposed coverage are requested within 60 days from the date of this letter.

Sincerely,

25 July 1979

EXECUTIVE SUMMARY

SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, DAR 15-205.23, Organization Costs

Initial Recommendation: Review the proposed changes to DAR 15-205.23, Organization Costs, that were recommended by the Council of Defense and Space Industry Associations (CODSIA), and after analysis submit appropriate recommendations.

Findings:

- Revise the language in DAR 15-205.23 as indicated in TAB A and notify CODSIA of the action taken.

Objective: CODSIA indicated that the coverage in DAR 15-205.23 should be changed to specifically make allowable the costs applicable to activities that relate to debt and equity securities that are for purposes other than raising capital. CODSIA contends that since the corporation's total capital is not affected by these activities, there is no reorganization and, therefore, the costs should be allowable. After review of CODSIA comments and the examples of the activities they cited, it was determined that those pertaining to organizational activities, regardless whether capital was raised or not should remain unallowable. However, some of the examples cited by CODSIA could be considered as being compensation. It was never intended that the provisions of 15-205.23 should limit or inhibit the methods or amounts paid as compensation. Therefore, 15-205.6 is recommended to be changed to make it clear that costs pertaining to compensation are subject to the provisions of 15-205.6 and this includes such activities as Employee Stock Ownership Plans, Executive Compensation and Employee Savings Plans.

Section XV-2 Working Group

George H. Strouse

George H. Strouse, Chairman

DEFENSE LOGISTICS AGENCY
HEADQUARTERS
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO DLA-AFC

25 July 1979

MEMORANDUM FOR DIRECTOR, DAR COUNCIL

SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, DAR 15-205.23, Organization Costs

I. PROBLEM:

Review a proposed change to DAR 15-205.23, Organization Costs, submitted by the Council of Defense and Space Industry Associations (CODSIA) and after analysis submit appropriate recommendations.

II. RECOMMENDATIONS:

A. That DAR 15-205.23 be revised as shown in TAB A.

B. That CODSIA be notified as to action taken by the DAR Council.

III. DISCUSSION:

A. Background:

On 21 March 1979 this Working Group was assigned the task of reviewing a recommended change to DAR 15-205.23, Organization Costs, submitted by CODSIA. CODSIA recommended that the last sentence of DAR 15-205.23 be deleted since, in their opinion, it has the potential for creating problems and is inconsistent with the current emphasis on reducing the burden and complexity of acquisition regulations. This sentence states "Unallowable 'reorganization' costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in the alterations in the rights and interests of security holders whether or not additional capital is raised."

CODSIA contends that the addition of the last sentence in paragraph 15-205.23 is another in a series of cases where DoD, having been ruled against by the Armed Services Board of Contract Appeals on the basis of equity, has changed the rules. In addition, they believe the DoD is seeking to make unallowable a whole category of activities that are inherent and necessary in the normal activities of a business which are not related to the original purpose of 15-205.23. The sentence, which CODSIA would like deleted, was developed under ASPR Case No. 74-98 to clarify the intent of the cost principle as it relates to the costs of any change in corporate financial structure.

B. CODSIA Position:

CODSIA has provided examples of specific types of activities relating to debt and equity securities which are for purposes other than raising capital and which are unallowable under the present 15-205.23 language. They contend that since the corporation's total capital is not affected there is no reorganization. Set forth below are examples provided by CODSIA. The Working Group comments follow each grouping of examples.

Redemption of Debt Securities

Debt securities may be retired at maturity, or at some earlier time, for cash or other tangible (or intangible) property. Such transactions do not affect the corporate capital, although they do affect the securityholders' interests. If a company has two or more classes of debt outstanding and retires the senior issue, the holders of the junior issue or issues obtain rights not previously enjoyed. Therefore, there has been an alteration in the rights and interests of the securityholders but the corporation's capital is not affected.

Conversion of Convertible Securities

When convertible securities are converted (either as a result of a call provision or at the securityholders' option) new securities are subsequently issued. Although no new capital is raised by such transactions, the securityholder's interests are affected.

Adjustment of Purchase/Conversion Prices of Convertible Securities and Warrants

Antidilution provisions of warrant and convertible security agreements require price adjustments in order to prevent the dilution of the related securityholders' interests. No new capital is raised as a result of these adjustments, although securityholders' interests are affected.

Exchange of Securities

Both debt and equity securities may be exchanged for other like securities, which would affect the securityholder's interests without raising new capital.

Working Group Comments

The Working Group believes that transactions directly affecting capital accounts regardless of whether additional capital is raised, should be classified organization or reorganization costs. In ASBCA Case No. 14370, the Board distinguished between an "adjustment" modification of a corporation's capital structure without revaluation and raising of new capital and a "reorganization" as a significant revamping of corporate capital structure by legal means. The Board held that the redemption constituted an allowable "adjustment." It was the opinion of the Section XV, Part 2 Subcommittee that under ASPR Case No. 74-98 the distinction drawn by the Board was unrealistic and its conclusion regarding the allowability of the costs of an "adjustment" was contrary to the original intent of 15-205.23. The last sentence of 15-205.23 was added specifically to make unallowable those transactions classified as "adjustments" or "rearrangements." The rationale for this position is as follows:

1. Historically, DoD has placed a prohibition on transactions increasing capital so as not to interfere or subsidize, in any way, the financial mechanism of the private enterprise system. From a public policy viewpoint, it would be inappropriate for the Government to subsidize the cost of any company's capital acquisition at the expense of individual taxpayers. This position must, by nature, be viewed on a broad, rather than a narrow scale. Therefore, the costs associated with the redemption or conversion of debt security must be viewed in the same light as the initial acquisition of the debt. The cost principle should address the whole transaction and not only the initial acquisition of debt.

2. In ASPR Case No. 74-98 (18 Feb 76) the Subcommittee stated:

> The provisions of 15-205.23 preclude the allowability of costs incident to the organization or reorganization of a contractor's corporate structure.

This caveat has been in Part 2 since, at the least, July 1960; and possibly prior. Although the case history on this particular provision was not available for the Subcommittee's review, the reasons for its inclusion in the cost principles appear fairly obvious. The costs of organizing, reorganizing or, for that matter, "adjusting" a corporation are capital in nature, in that the benefit derived therefrom is long term, i.e., from the time the action is completed until dissolution of the corporation. In addition, if the DoD were to participate in the cost of establishing or enhancing a contractor's financial structure, regardless of whether the action was denominated as an organization, reorganization or adjustment, (i) such participation could be deemed discriminatory in terms of those contractors who underwrote this type of expenditure on their own and (ii) contractors might well be influenced to reorganize their capital structures when their business mix was such that the Government would absorb a large share of the cost.

Forgiveness of Indebtedness

Under certain circumstances, such as in parent and subsidiary relationships, the forgiveness of indebtedness does not affect the combined debt and capital of a corporation. The transaction of the subsidiary's books would be recorded as a decrease in debt and an increase in capital surplus.

Quasi-Reorganization

With the approval of its board of directors, a corporation may eliminate its deficit in retained earnings by zeroing it out and recording the offset in capital surplus. This is called a quasi-reorganization and does not affect total capital.

Working Group Comments

The Working Group does not envision that the above types of transactions will involve material amounts of cost. However, if any significant costs are involved, they do represent nonrecurring capital transactions which are not proper charges to Government contracts in line with the rationale previously presented.

Employee Stock Ownership Plans

Corporations may purchase their own stock and provide employees the opportunity to purchase these shares at certain given prices. Although the securityholders' interests may change, the corporation's capital is not affected.

Executive Compensation

Corporations may also acquire stock for executives' bonuses and other forms of compensation affecting the shareholder's individual interests without raising any new capital.

Employees Savings and Investment Plans

Various expenses are incurred in the organization and administration of an employee savings and investment plan without affecting a corporation's total capital.

Working Group Comments

Although the Working Group believes that 15-205.23 is proper as written, we recognize that there might be some activities that fall within this section which could conflict with other cost principles. In the examples provided by CODSIA three categories of costs--Employee Stock Ownership Plans, Executive Compensation and Employees Savings and Investment Plans could be in conflict with the cost principles on compensation. The latest revision of 15-205.23 was not intended to dictate the type or form of compensation paid. We would, therefore, recommend that the costs of activities involving compensation be made exceptions to 15-205.23. This has been accomplished in TAB A.

IV. CONCLUSIONS:

A. The Working Group has concluded that the change proposed by CODSIA is not appropriate since administrative costs of corporate rearrangement are in fact reorganization costs. We do believe that exceptions should be made in those instances where 15-205.23 would prohibit the use of Employee Stock Ownership Plans, Executive Compensation and Employees Savings and Investment Plans as a means of officer and employee compensation.

DLA-AFC
SUBJECT: DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, DAR 15-205.23, Organization Costs

B. That the proposed revision to DAR 15-205.23, Organization Costs, as set forth in TAB A, be incorporated into DAR.

C. All members of the Working Group concur in the contents of this report.

2 Encl

George H. Strouse
GEORGE H. STROUSE
Chairman
DAR Section XV, Part 2 Working Group

DAR SECTION XV, PART 2 WORKING GROUP MEMBERS

DoD Representatives

Harry E. Hindman, DARCOM
Dennis E. Modesitt, NAVMAT
John H. Lynskey, HQ AFSC
Charles L. Cipolla, DCAA
Orland L. Sollom, OASD(C)
Charles E. Deardorff, OUSDR&E

Other Agency Representatives

Lamar Massey, NASA
Frank Van Lierde, GSA
G. L. Allen, DOE (P&C)

PROPOSED CHANGES TO DAR 15-205.23

15-205.23 Organization Costs. (CWAS-NA)

[(a) Except as provided in (b) below,] expenditures in connection with (i) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, or (ii) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised.

[(b) The cost of activities primarily designed for the purposes of providing compensation will not be considered organizational costs subject to this part, but will be governed by 15-205.6. These activities include:

(i) acquisition of stock for executive bonuses or employee savings plans and;

(ii) employee stock ownership plans.]

TAB B
Case 78-119
25 July 1979

[illegible]

Council of Defense and Space
Industry Associations (CODSIA)
2001 Eye Street, N.W.
Washington, D.C. 20006

Gentlemen:

This is in further reply to your letter of 28 July 1978 regarding your proposed revision to DAR 15-205.23, Organization Costs. By letter dated 8 September 1978 we informed you that we did not agree that Government contracts should be charged with organization costs but would give consideration to the examples you cited as to how such examples and their costs should be treated.

We remain convinced that organization expenses, including allocated administrative costs, should not be allowed on Government contracts and the final sentence in 15-205.23 should remain as written; however,

It was not intended that the provisions of 15-205.23 would limit or inhibit the methods or amounts paid as compensation.

Accordingly, we are considering a revision to specify that such costs, including bona fide Employee Stock Ownership Plans, Executive Compensation and Employee Savings Plans are allowable and are to be subject to the provisions of 15-205.6. [illegible] in the near future.

Sincerely,

Case 78-119

(Organizational Costs)

Responses to Letter to Industry, dated 5 September 1979:

ADPA	Concur
Canadian Embassy	No comments to offer
GAO	No objection
NASA	Agree and endorse

CODSIA & GSA -- Comments attached

19 Nov 79

DAR Case 78-119, Allowability of Costs Relating to Changes in Corporate Financial Structure, 15-705.23 Organizational Costs

DLA-AA

Mr. George Strouse, Chairman
Section XV, Part 2 Subcommittee

The DAR Council reviewed comments from Industry on subject case at its regular meeting of 16 November 1979. The Council referred the comments to your subcommittee for review and analysis. (As indicated on the enclosed summary sheet, only substantive comments are enclosed.) Your report date to the DAR Council is 7 January 1980.

S/ Lloyd
DAVID G. FREEMAN
DLA Policy Member
DAR Council

Encl

Case was closed and apprvd for print 27 June 80

INFO
27 NOV 1979

Case 78-119

H O 8/24
Info.

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

RESEARCH AND
ENGINEERING

20 August 1979

Council of Defense and Space
Industry Associations (CODSIA)
1909 K Street, N. W. - Suite 300
Washington, D. C. 20006

Gentlemen:

This is in further reply to your letter of 28 July 1978 regarding your proposed revision to DAR 15-205.23, Organization Costs. By letter dated 8 September 1978 we informed you that we did not agree that Government contracts should be charged with organization costs but would give consideration to the examples you cited as to how such examples and their costs should be treated.

We remain convinced that organization expenses, including allocated administrative costs, should not be allowed on Government contracts and the final sentence in 15-205.23 should remain as written; however, it was not intended that the provisions of 15-205.23 would limit or inhibit the methods or amounts paid as compensation.

Accordingly, we are considering a revision to specify that such costs, including bona fide Employee Stock Ownership Plans, Executive Compensation and Employee Savings Plans are allowable and are to be subject to the provisions of 15-205.6. The proposed change will be provided to you for review and comment in the near future.

Sincerely,

T G Cassidy

T. G. CASSIDY
Acting Director
Defense Acquisition
Regulatory Council

15 August 1979

PROPOSED CHANGES TO DAR 15-205.23

15-205.23 Organization Costs. (CWAS-NA)

[(a) Except as provided in (b) below,] expenditures in connection with (i) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, or (ii) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised.

[(b) The cost of activities primarily designed for the purposes of providing compensation will not be considered organizational costs subject to this part, but will be governed by 15-205.6. These activities include:

(i) acquisition of stock for executive bonuses or employee savings plans and

(ii) employee stock ownership plans.]

TAB A

78-119

RESEARCH AND
ENGINEERING

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

8 SEP 1978

MEMORANDUM FOR ACTING DIRECTOR, DEFENSE ACQUISITION REGULATORY COUNCIL

SUBJECT: Allowability of Costs Relating to Changes in Corporate Financial Structure, DAR 15-705.23 Organizational Costs

Attached is a copy of a letter which we recently received from the Council of Defense and Space Industry Associations (CODSIA) together with our reply. It appears that the change made to 15-205.23 in DPC 76-9 might be in conflict with the proposed coverage on Employer Stock Ownership Plans and could affect other areas where costs have been allowable in the past. Please review the existing and currently proposed cost principles to make certain that no conflict exists.

Robert E. Booton

ROBERT E. BOOTON
Acting Director, Contracts
and System Acquisition

Attachment
As stated

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

RESEARCH AND
ENGINEERING

8 SEP 1978

Council of Defense and Space
Industry Associations (CODSIA)
2001 Eye Street, N. W.
Washington, D. C. 20006

Gentlemen:

We have reviewed your recent letter requesting a change to Defense Acquisition Regulation (DAR) 15-205.23 as revised by Defense Acquisition Circular (DAC) 76-9. We cannot agree that Government contracts should be charged with organizational expenses. However, we are submitting your letter to the DAR Council for consideration of the examples you cited and how such costs should be treated.

Sincerely,

Signed

ROBERT E. BOOTON
Acting Director, Contracts
and System Acquisition

cc: Deputy Director, DARC

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

1909 K St., N.W.
WASHINGTON, D.C. 20006

(202) 862-3970

CODSIA Ref.
20-6 A(F)

November 9, 1979

Capt. Brady M. Cole, SC USN
Acting Director, Defense Acquisition
Regulatory Council
Office of the Under Secretary of
Defense (R&E)
Washington, D. C. 20301

Dear Capt. Cole:

The associations of the Council of Defense and Space Industry Associations (CODSIA) have authorized me to respond to your 5 September 1979 letter, concerning revision of DAR 15-205.23, Organization Costs.

We approve the proposed revisions which are to clarify that DAR 15-205.23 does not limit or inhibit the methods or amounts paid as compensation and that costs such as bonafide stock ownership plans, executive compensation, and employee savings plans are allowable, subject to the provisions of DAR 15-205.6, Compensation for Personal Services.

As we understand the proposal, these costs were considered allowable under DAR 15-205.6 and it was not intended that the costs be made unallowable when DAR 15-205.23 was revised by DPC 76-9.

The CODSIA letter of July 28, 1979, which you referred to in your letter, recommended that DoD eliminate the sentence which was added to 15-205.23 by DPC 76-8, and pointed out that this sentence seeks to make unallowable a whole category of activities inherent in and necessary to the normal activities of the business. The letter also provided examples of specific types of activities. The proposal to revise 15-205.23 addresses some of the examples. Although we concur with the proposed revision, we still believe that DoD should delete the specific sentence added by DPC 76-9.

Yours truly,

Philip J. Blattau

Philip J. Blattau
Project Officer

General
Services
Administration Washington, DC 20405

NOV 0 2 1979

Captain Brady M. Cole
Acting Director, Defense Acquisition
Regulatory Council
Office of the Under Secretary of
Defense Research and Engineering
Washington, D.C. 20301

Dear Captain Cole:

Your letter of September 5, 1979, requested our comments on a proposed revision to DAR 15-205.23, Organization Costs.

The proposal removes from coverage under DAR 15-205.23, the cost of activities designed primarily for purposes of providing compensation. While we do not object to the proposal, the structure of the proposed coverage seems to us to require revision in that the words "acquisition of stock" apply to both 15-205.23(b)(i) and (ii), but appear only in (i). We recommend that paragraph 15.205.23(b) read as follows:

> (b) The cost of activities designed primarily for the purposes of providing compensation will not be considered organization costs subject to subparagraph (a) above, but will be governed by 15.205.6. These activities include the acquisition of stock for:
>
> (i) executive bonuses,
> (ii) employee savings plans, and
> (iii) employee stock ownership plans.

Thank you for the opportunity to consider this matter.

Sincerely,

PHILIP G. READ
Director
Federal Procurement Regulations
Office of Acquisition Policy

78-119

GAO

United States General Accounting Office
Washington, DC 20548

Office of
General Counsel

In Reply
Refer to: B-196005

October 24, 1979

Captain Brady M. Cole
Acting Director, Defense
Acquisition Regulatory Council
Department of Defense
Washington, D. C. 20301

Dear Captain Cole:

You requested our comment on a proposed revision to DAR 15-205.23, Organization Costs.

You propose to revise the provisions of DAR 15-205.23 to make it clear that expenditures for the organization or reorganization of the corporate structure of a business are unallowable, while the costs of activities primarily designed for the purpose of providing compensation will not be considered organizational costs. The proposed revision specifies that costs, such as bona fide employee stock ownership plans, executive compensation and employee savings plans, are allowable subject to DAR 15-205.6, Compensation for Personal Services.

We have no objection to the revision as proposed.

Sincerely yours,

Milton J. Socolar

Milton J. Socolar
General Counsel

Canadian Embassy Ambassade du Canada

2450 Massachusetts Avenue, N.W.
Washington, D.C. 20008

11 October, 1979

DPW 5054-1

Captain Brady M. Cole
Acting Director
Defense Acquisition Regulatory Council
OUSDRE
Room 3D1080, The Pentagon
Washington, D.C. 20301

Dear Captain Cole:

Reference is made to your letter of 5 September, 1979 enclosing DAR draft revision 15-205.23.

Those officials of the Government of Canada who, under the USA/Canada Defense Development and Production Sharing Arrangements, are required to co-ordinate U.S. and Canadian procurement regulations, have reviewed the proposed revision of DAR 15-203.23 and

a) have no comments to offer

b) find the proposed revision compatible with relevant Canadian procurement regulations.

Sincerely,

J. C. Bond
Counsellor
(Defence Production)

AMERICAN DEFENSE PREPAREDNESS ASSOCIATION
DEDICATED TO PEACE WITH SECURITY THROUGH DEFENSE PREPAREDNESS

UNION TRUST BUILDING, 15TH AND H STREETS, N. W., WASHINGTON, D. C. 20005
202-347-7250

Founded 1919

17 September 1979

Captain Brady M. Cole, (SC, USN)
Acting Director, Defense Acquisition
Regulatory Council,
Office Under Secretary of Defense
(Research and Engineering)
Washington, DC 20301

Dear Captain Cole:

In accordance with your letter of September 5, 1979, we have examined the proposed revison to 15-205.23, dealing with "organization costs".

We regard the revision as a welcome improvement. The acquisition by a company of its own stock for purposes connected with compensation paid to its officers and employees is not an organization expense and the clarification will be helpful.

The opportunity to comment on this change is appreciated.

Sincerely,

Frank A. Hinrichs
Major General, U.S. Army (Ret.)
Vice President and Director
Technology and Management
Advisory Service

FAH/jwb

NASA

National Aeronautics and
Space Administration

Washington, D.C.
20546

SEP 12 1979

Reply to Attn of HC-1

Captain Brady M. Cole, USN
Acting Director, DAR Council
Office of the Under Secretary
of Defense (R&E)
The Pentagon
Washington, DC 20301

Dear Captain Cole:

Your letter dated September 5, 1979 requesting our comments regarding a proposed revision to DAR 15-205.23, Organization Costs. The proposed change would provide clarification that costs which pertain to compensation, e.g., employee stock ownership plans, executive compensation and employee savings plans, are subject to the provisions of 15-205.6, Compensation for Personal Services, rather than 15-205.23.

We agree with the intent of the change and endorse its inclusion in the DAR.

Thank you for inviting our comments in this matter.

Sincerely,

S. J. Evans
Director of Procurement

78-119
HO 9/5

RESEARCH AND
ENGINEERING

OFFICE OF THE UNDER SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

5 September 1979

The DAR Council is considering a revision to DAR 15-205.23, Organization Costs. This proposed revision was developed in response to a recommendation by the Council of Defense and Space Industry Associations (CODSIA).

We propose to clarify the provisions of DAR 15-205.23 to not limit or inhibit methods or amounts paid as compensation. The proposed revision specifies that costs, such as bona fide Employee Stock Ownership Plans, Executive Compensation and Employee Savings Plans, are allowable subject to the provisions of DAR 15-205.6, Compensation for Personal Services.

Your comments (25 copies) on the attached proposed coverage are requested within 60 days from the date of this letter.

Sincerely,

B Cole

BRADY M. COLE
Captain, SC, USN
Acting Director
Defense Acquisition
Regulatory Council

Attachment
Tab A

COUNCIL OF DEFENSE AND SPACE INDUSTRY ASSOCIATIONS (CODSIA)

2001 Eye Street, N.W.
Washington, D.C. 20006

(202) 457-4985

CODSIA Ref.
20-6 A(F)

July 28, 1978

Mr. Dale W. Church
Deputy Under Secretary (Acquisition Policy)
Office of the Under Secretary of
Defense (Research & Engineering)
Washington, D. C. 20301

Dear Mr. Church:

The purpose of this letter is to urge a change to paragraph 15-205.23 "Organization Costs", of the Cost Principles Section of the Defense Acquisition Regulation (DAR). The most recent revision to this paragraph was made by DPC 76-9 dated August 30, 1977, purportedly to clarify the intent of Armed Services Board of Appeals (ASBCA) Boeing Company Case No. 14370 as it relates to the costs of any change in corporate financial structure. The present provision has the potential for creating problems and is certainly inconsistent with the current emphasis on reducing the burden and complexity of acquisition regulations.

The current coverage is as follows, and we are specifically recommending that the last sentence be deleted:

> 15-205.23 Organization Costs. (CWAS-NA) Expenditures in connection with (i) planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, or (ii) raising capital (net worth plus long-term liabilities), are unallowable. Such expenditures include but are not limited to incorporation fees and costs of attorneys, accountants, brokers, promoters and organizers, management consultants and investment counsellors, whether or not employees of the contractor. Unallowable "reorganization" costs include the cost of any change in the contractor's financial structure, excluding administrative costs of short-term borrowings for working capital, resulting in alterations in the rights and interests of security holders whether or not additional capital is raised.

The last sentence was added by DPC 76-9 and is the cause of our concern. This revision is an expansion of the ASPR to add many normal administrative duties relating to the maintenance of the corporate structure to the constantly increasing list of unallowable costs.

As brought out in the Boeing Company ASBCA case, the financial definition of a reorganization is quite clear. The Board agreed with the description of W. A. Patton in the Accountants Handbook, Third Edition, at P.1014, "In Law and Finance"a reorganization generally implies a serious overhauling through legal procedure...". The Board concluded that although the Boeing transaction might loosely be described as "reorganizations:, they should more properly be described as "rearrangements".

Administrative rearrangements and adjustments to maintain a viable capital structure are not new. Such activities existed to some degree or other at the time ASPR 15-205.23 was originially developed. We believe this is another in the series of cases where DoD having been ruled against by the Board on the basis of equity has changed the rules. DoD evidently considered the distinction between corporate "adjustments" and "reorganization" drawn by the ASBCA as unrealistic and decided that the allowability of the costs of "adjustments" was contrary to the "apparent" intent of 15-205.23.

In so doing, DoD is seeking to make unallowable a whole category of activities that are inherent and necessary in the normal activities of a business and which are not related to the original purposes for which 15-205.23 was devised. Following are examples of specific types of activities that relate to debt and equity securities that are for purposes other than raising capital and that which can be expected to occur in any business and which now may be subject to disallowance.

Redemption of Debt Securities

Debt securities may be retired at maturity, or at some earlier time, for cash or other tangible (or intangible) property. Such transactions do not affect the corporate capital, although they do affect the securityholders' interests. If a company has two or more classes of debt outstanding and retires the senior issue, the holders of the junior issue or issues obtain rights not previously enjoyed. Therefore, there has been an alteration in the rights and interests of the securityholders but the corporation's capital is not affected.

Employee Stock Ownership Plans

Corporations may purchase their own stock and provide employees the opportunity to purchase these shares at certain given prices. Although the securityholders' interests may change, the corporation's capital is not affected.

Executive Compensation

Corporations may also acquire stock for executives' bonuses and other forms of compensation affecting the shareholder's individual interests without raising any new capital.

Forgiveness of Indebtedness

Under certain circumstances, such as in parent and subsidiary relationships, the foregiveness of indebtedness does not affect the combined debt and capital of a corporation. The transaction on the subsidiary's books would be recorded as a decrease in debt and an increase in capital surplus.

Quasi-Reorganization

With the approval of its board of directors, a corporation may eliminate its deficit in retained earnings by zeroing it out and recording the offset in capital surplys. This is called a quasi-reorganization and does not affect total capital.

Employees Savings and Investment Plans

Various expenses are incurred in the organization and administration of an employee savings and investment plan without affecting a corporation's total capital.

Conversion of Convertible Securities

When convertible securities are converted (either as a result of a call provision or at the securityholders' option) new securities are subsequently issued. Although no new capital is raised by such transactions, the securityholder's interests are affected.

Adjustment of Purchase/Conversion Prices of Convertible Securities and Warrants

Antidilution provisions of warrant and convertible security agreements require price adjustments in order to prevent the dilution of the related securityholders' interests. No new capital is raised as a result of these adjustments, although securityholders' interests are affected.

Exchange of Securities

Both debt and equity securities may be exchanged for other like securities, which would affect the securityholder's interests without raising new capital.

The Government should not ignore the necessity of, and should encourage, corporate economic growth and financial stability, whether for expansion, efficiencies, or market penetration. Such costs are clearly General and Administrative costs -- indirect costs allocable to all work of the contractor. The provision on Organization Cost should not address unallowability of administrative costs that are not necessary to the overall operation of the business as a whole (ASPR 15-205.4 (iii)). The examples we have provided are of costs that are ordinary and necessary for the operation of a going conc-rn. Reasonableness and equity should be fundamental and applied rather than for the ASPR to be adding provisions in violation of these precepts.

In summary, we sincerely urge that DoD take specific action to eliminate the last sentence of the current ASPR 15-205.23. We stand ready with knowledgeable industry representatives to discuss this matter with you at your convenience.

Yours truly,

Karl G. Harr, Jr.
President
Aerospace Industries Association

Jean K. Lambert Vice Pres.
for Wallace H. Robinson, Jr.
President
National Security Industrial Assn.

Charles A. Elliott, for
J. A. Caffiaux
Staff Vice President
Electronic Industries Association

Richard T. Kaplar
Motor Vehicles Manufacturers Association

Edwin M. Hood
President
Shipbuilders Council of America

John W. Gilpin
American Electronics Association
(formerly WEMA)