MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N. W. WASHINGTON 6, D. C. REpublic 7-6512

Does this need an Ans.

November 14, 1958

Aren't these some good points

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

My dear Mr. McGuire:

In accordance with your suggestion of October 15, 1958, made during the joint industry-government conference, we are submitting herewith a further amplification of the views of the Machinery and Allied Products Institute in regard to the proposed adoption of a comprehensive set of contract cost principles. This statement is presented in behalf of the capital goods and allied equipment industries. Although, as you know, many of the companies in these industries are important government prime and subcontractors, the bulk of their production falls in the commercial area.

May we express once more our appreciation for the personal interest which you and Secretary McNeil have taken in this subject, as evidenced by the October 15 conference and by your willingness to receive supplementary written statements of industry views. Ideally, we might have hoped for additional time in which to file our supplemental statement, but we are most anxious to comply with the filing deadline of fifteen days from the date on which the transcript of the October 15 meeting was received by this organization.

In our opinion, the proposal for application of a set of comprehensive cost principles to all types of negotiated contracts becomes wholly meaningful only as we relate it to developments in the entire field of national defense. For this reason we should like to review briefly the history of this suggestion and--before proceeding to any detailed examination of the proposal itself--to set it against the backdrop of our total national defense program, considering it in this broader perspective.

The antecedents of the present proposal.--For some years the Department of Defense, acting partly upon its own motion and partly by reason of suggestions from Congressional committees and the General Accounting Office, has attempted to develop a set of cost principles which could be applied to negotiated, fixed-price contracts as well as cost-reimbursement contracts. This process, covering a period of some four or five years, is an outgrowth, of course, of developments dating back to the World War II use of T. D. 5000, the War and Navy Departments' "Green Book," the post-World War II Joint Termination Regulation and, finally, Section XV of ASPR which controls the reimbursement of contractors' expenses under cost-reimbursement type contracts.

This record of development, culminating in the present proposal, contains one interesting experience that is especially relevant to the document here under consideration. A Munitions Board memorandum of November 15, 1949, which limited the mandatory application of ASPR cost principles to cost-type contracts, nevertheless permitted their use "as a working guide" in fixed-price negotiations. In practice the working guide assumed the status of a rigid standard and, for this reason, permissive authority for the use of cost principles in connection with fixed-price contract negotiations was revoked by Department of Defense Instruction 4105.11, November 23, 1954.

So much for a brief history of the current proposal's antecedents. Let us now consider the history of that proposal against the broad background of the over-all national defense program.

Urgent need for reappraisal.--This recital of the present proposal's history is important, we think, because of some startling recent developments in military technology that have altered radically and permanently the total defense posture of the United States. The changed circumstances flowing from these developments are financial and managerial as well as technological and strategic. They are of such a fundamental nature as to require a most careful re-examination of all procurement policy and procedure. We believe that you should give primary consideration to the question of whether or not the proposal for a comprehensive set of cost principles drawn in the form of Section XV of ASPR--which has never been a completely sound proposal in our judgment--may not be altogether inappropriate at this time.

The Soviet Sputnik.--As we have noted, the case for application of ASPR cost principles to all types of negotiated contracts has developed during the post-World War II period which culminated in the launching of an earth satellite by the Soviet Union. This latter event, marking the dawn of the Space Age, has given rise to grave Congressional concern with the state of our national defense, highlighted by the hearings before the Preparedness Investigating (Johnson) Subcommittee of the Senate Armed Services Committee.

In addition to its numerous recommendations for enlargement and improvement of our national defense in terms of military programs and weaponry--with which this statement is not directly concerned--the Johnson Subcommittee

recommended in connection with stepping up the tempo of our defense effort a simplification of our military procurement procedures. With this latter recommendation our statement most emphatically is concerned.

The testimony of certain witnesses pointed up the shortcomings of our present procurement system, and such testimony is emphasized in the remarks of Senator Saltonstall in proposing certain amendments to the Armed Services Procurement Act (10 USC 2301 et seq.) on October 14, 1958. Senator Saltonstall said:

> "We have great confidence in the vitality and initiative of American industry. The free competitive system which has enabled our nation to achieve unheralded industrial advances should be able, as it has in the past, to achieve military weapons superiority second to none. But, as Professor Livingston of Harvard so aptly pointed out when he testified before the Preparedness Investigating Subcommittee hearings, our present system of defense contracting does not encourage those forces in our industrial establishment to work... Ironically, Livingston pointed out, even in the controlled economy and industrial establishment of the Soviet Union great rewards were provided for success in scientific and technological areas, and penalties for failure. The Russians know full well the virtue of the incentive system. If the future security of the United States depends upon its ability to develop in the shortest possible time modern weapons of destruction so as to deter our enemies from aggression, then we must make full use of the inherent characteristics of the American industrial system which give it vigor and strength."

It should be emphasized that the remarks of Senator Saltonstall and Dr. Livingston are typical of suggestions, both in and out of government, for increasing contractor incentives.

Contradictory trends in government procurement.--The spirit of the observations quoted above appears to have been reflected in a series of developments within government itself. First, it seems evident that the Military Services themselves are undertaking a fresh appraisal of the awesome technological problems thrust upon them by the Space Age. There is evidence, moreover, of a desire on the part of the Services to share increasingly with private industry the technological and financial burdens thus created.

General Quesada, newly appointed Administrator of The Federal Aviation Agency, bespoke this attitude in a recent speech in which he suggested that industry and government must "start work immediately on working out some new concepts embracing the ways in which we reward industry's efforts for scientific and technological development of advanced weapons." The report of the ad hoc Committee on Research and Development of the U. S. Air Force

Scientific Advisory Board--the Stever Report--emphasizes the same point in these words: "Contracting procedures should be changed to give contractors greater incentive to do research development work more effectively." In the legislative area the extension of the Renegotiation Act for a period of only six months--with the proviso that the process be subjected in the meantime to a searching Congressional study--would seem to offer further evidence of a new look by Congress at the whole question of providing incentives and removing disincentives to more efficient production of war materiel.

Within the framework of the Armed Services Procurement Regulation itself we find within recent months substantial improvement in regulations relating to pricing policies for negotiated contracts and in the acquisition of contractor's proprietary technical know-how. This whole complex of statements and action had encouraged us to believe that a new spirit was abroad in the whole area of government procurement. Unhappily, the dogged pursuit of this proposal for an across-the-board application of cost principles seems to us wholly inconsistent with the current emphasis on the new spirit described above and would, in our judgment, represent a serious backward step.

Let us turn now from the background of this proposal to a more detailed examination of specific questions which it involves.

Considerations of Public Policy

In the recent industry-Department of Defense conference on this subject, repeated reference was made by government spokesmen to considerations of public policy, particularly as they dictated the disallowance of certain items of expense regarded by industry as normal costs of doing business. Although raised for the most part in connection with the discussion of specific items of cost, we suggest that certain overriding considerations of public policy apply with even greater force to the question of the applicability of contract cost principles with which this supplemental statement is primarily concerned.

A reading of the Armed Services Procurement Act (10 USC 2301 et seq.) in conjunction with its principal administrative implementation, the Armed Services Procurement Regulation makes the advertised bid method of public contracting a preferred method as an unmistakable matter of both legislative and administrative policy. Although the statute deals with the point only by indirection, ASPR, we think, harmonizes completely and specifically with legislative intent in according the next order of priority in procurement preference to the firm, fixed-price contract. (Since the descending order of subsequent preference is well summarized in a quotation from Lt. Col. George Thompson, USAF, appearing at a later point in this statement, we shall not now dwell further on the matter.)

In addition to these express legislative and administrative preferences of procurement policy, ASPR itself contains one further significant statement of general procurement policy that deserves repetition in this connection: "It is the policy of the Department of Defense to procure supplies

and services from responsible sources at fair and reasonable prices, calculated to result in the lowest ultimate over-all cost to the government."

We regard these propositions as central and fundamental policies of Defense procurement to which all other considerations of public policy--from whatever source drawn or imagined--must be subordinated. Moreover, we cannot believe that policy demands a broadened application of proposed cost principles if, as a result, "ultimate over-all cost to the government" is increased. And this is precisely the result we predict in that eventuality.

At the risk of repetition we cannot fail to add that the widespread and continuing suggestions for the enhancement of private incentive in defense work--to some of which we have referred briefly above--are not only entirely consistent with these basic policies of military procurement but would lead almost certainly, in our judgment, to improved contract performance, an increased interest in defense production and a very considerable reduction in ultimate over-all cost to the government.

The real issue to be decided.--The realities of the situation as well as the evident concern of your staff with questions of public policy demand that the resolution of the question now before you be based upon the broadest possible considerations of public policy. This being so, the issue to be decided may be stated very simply: Would the present proposal for application of contract cost principles in their present form to all types of negotiated contracts serve the public interest?

We do not believe that it would.

The Present Proposal

In turning to the applicability of the proposal before you, we should point out once more that we do not regard ASPR cost principles--in either their present or proposed form--as desirable or proper standards even for cost-reimbursement type contracts.

The principal change in procurement practice to be effected by adoption of the current proposal would consist in applying a revision of the present ASPR cost principles to fixed-price as well as cost-reimbursement type contracts. Having in mind the effect of the proposal's adoption upon the broad public policy question posed above, we should like to consider it in terms of its essential nature, its effect on negotiated, fixed-price contracts, its use and effect in "cost-related areas," its effect upon normal business incentives, its effect on subcontracts, its effect on contract termination, and its effect upon the normal incidents of contract negotiation.

The nature of the proposal.--As a part of the colloquy on the subject of applicability at the recent Pentagon conference, the observation was made that industry spokesmen were confusing the applicability of proposed cost

principles with their content. We submit that one can no more consider the results of applying this proposal without considering all four corners of the document than one could judge the worth of a horse without examining the beast. What, exactly, is the nature of this proposal?

Although the document here involved purports to be a statement of cost principles, it consists in fact of a relatively brief statement of principles followed by an extended and detailed specification of costs which are allowable or unallowable in certain contract situations. Experience persuades us that in a practical contracting situation the statement of principles, such as it is, will be disregarded and the contract administrator will rely upon the specified list of allowable or unallowable costs. Moreover--and despite protestations to the contrary with which we shall deal later--the extent of allowability or unallowability of any item of contract expense identified in these "principles" would almost certainly be the same under either a cost-reimbursement or a fixed-price type contract.

We have reiterated these elementary propositions only because we regard them as fundamental to any consideration of the applicability of the proposed cost principles.

The proposal's effect on fixed-price contracts.--Having in mind the basic and unavoidable character of this proposal, we reiterate an argument which we have advanced repeatedly in the past that promulgation of a "comprehensive" set of cost principles applicable to both negotiated, fixed-price and cost-reimbursement type contracts will serve to convert fixed-price contracts--in one degree or another--into cost-reimbursement agreements. We regard this result as inevitable, both as a matter of logic and as a matter of experience.

In their present form the proposed cost principles represent an artful piece of draftsmanship and an evident effort to respond to prior industry criticisms relating to the inevitable effects of an across-the-board application of cost principles. Specifically, the proposal declares that cost principles are to be used (1) "for the determination of" reimbursable costs or cost-reimbursement type contracts, and (2) either (a) "as a basis for" the development and submission of cost data and price analyses--in support of negotiated pricing, repricing, etc., or (b) "as the basis for evaluation of cost data" in retrospective pricing and settlement or "as a guide in the evaluation of cost data" in forward pricing.

The excerpts from the regulation quoted above are, of course, those phrases which go to the very heart of applicability of the proposed set of comprehensive cost principles. The distinction which the draftsman of this regulation has attempted to make between applicability of cost principles in cost-reimbursement and fixed-price contract situations is an exceedingly nice one. We believe, nevertheless, that this distinction, however nicely drawn, will become a distinction without a difference in practice.

A chronology of the process by which the present phraseology of applicability came into being may be instructive. When this proposal was first publicly mooted in Mr. Lloyd Mulit's letter of May 28, 1956, the Institute called attention to what we regarded as a built-in weakness in the proposal--"...we urge that any generalization of contract cost principles be so framed and administered that it may not serve as a deterrent to greater emphasis on firm, fixed-price contracting." Doubtless, other industry associations had the same concern.

The September 10, 1957, draft of this proposal attempted--with somewhat less than complete success--to avoid this change by careful distinction as between the proposal's application to fixed-price contracts and cost-type contracts. Our comments of December 16, 1957, once again pointed to the impossibility of a distinction in practice.

Apparently unsatisfied with this attempt, as was industry, Pentagon draftsmen have tried once more with the greatest care and the utmost sincerity to overcome this problem in the language quoted above. We commend the effort. We cannot fail, however, to entertain grave doubts as to the manner in which this theory of differing applicability will be treated in actual procurement practice.

The almost inevitable obliteration of any distinction in actual practice is illustrated by a landmark decision of the Armed Services Board of Contract Appeals, the Swartzbaugh case. As you will recall, the question involved a dispute over the interpretation of a contract price revision article. The contracting officer sought to apply present cost principles. In its opinion the Board said "in contradistinction to a cost-reimbursement contract, Form IV of the Price Revision Article depends on negotiation and its sequel, compromise. Under contracts calling for the reimbursement of costs it is appropriate to audit in detail each expenditure and to test its allowability by the standards of the statement of cost principles (ASPR, Section XV). Such a detailed audit is neither required nor desirable in price revision...The statement of cost principles (ASPR, Section XV) upon which many of the disallowances were specifically based by contracting officers is not controlling in negotiations for revision of price."

The case in question involved a redeterminable fixed-price contract but the principle announced by the Board of Contract Appeals applies equally to the negotiation of price under any type of fixed-price contract. We believe the philosophy of the Swartzbaugh case is entirely correct, but we think this philosophy would be largely destroyed by adoption of the proposal here under discussion, and The Pentagon's own past experience with the Munitions Board memorandum referred to above further convinces us of this result.

The proposal's use in "cost-related areas".--The case for an across-the-board application of contract cost principles appears to rest finally upon the proposition that such a standard is required for examination of "cost-related areas" under both fixed-price and cost-type contracts. A corollary

proposition holds that a cost under a fixed-price contract is no different from a corresponding cost under a cost-type contract and that both should, therefore, be judged by reference to the same standard, i.e., a common or comprehensive set of cost principles.

We think no one would argue seriously that there is any essential difference between an item of expense under a fixed-price contract and a similar expense under a cost-type agreement, nor that the manufacturer incurring either cost must recover it in the selling price of his product. And to argue from this truism that both costs should, or must, be judged by reference to the same standard seems eminently proper as a matter of pure theory.

We are not, however, dealing with a theoretical exercise but a practical procurement situation. Let us consider the effects of the theory.

Assuming a 10 per cent fixed fee under a cost-type contract, this minor part of the whole price is the absolute limit of the contractor's risk and thus the limit of possible incentive. Conversely, a fixed-price contract, with no predetermined fee or profit, has a much wider area of risk for profit or loss and, logically, a much greater degree of incentive to the contractor. Moreover, it is precisely because the range of incentive in the latter case is so much greater than in the first that fixed-price contracting is preferred as a matter of policy.

This contrast goes to the very heart of our case against a comprehensive set of cost principles just as the propositions recited above constitute--as we understand it--the core of your staff's case for their adoption. With the issue thus squarely joined let us consider for a moment what this proposal would do to contractor incentive.

It seems to us inevitable that reference to the proposed cost principles in pricing or repricing fixed-price agreements will very greatly reduce the area of risk and the incentive possibilities of such contracts. Insofar as "cost-related areas" thereunder are subjected to the proposed cost principles such contracts will have been effectively converted into cost-type contracts--and price will be established by rote.

Finally, we should like once again to point out that fixed-price negotiations will degenerate into formula pricing at the very time that serious and responsible students of the procurement process are calling for immediate and drastic improvement in defense contract incentives.

The proposal's effect on normal business incentives.--As we have already suggested, both applicable law and regulations express a clear preference in defense contracting for firm, fixed-price agreements let either by formal advertisement or direct negotiation. An excellent capsule statement of this preference has been made by a leading contract pricing authority, as follows:

> "Our objective then is to negotiate a contract type and price that includes reasonable risk and provides the contractor with the greatest incentive for efficient and economical performance. In all cases it is basic to our pricing philosophy that a contractual arrangement lacks incentive until we reach a firm agreement on price. The firm fixed-price contract obviously supplies this incentive to the fullest degree, and it is the type preferred in the Department of Defense. We also prefer fixed-price types of cost-reimbursement types and firmed fixed pricing over retroactive pricing." (Underscoring supplied.)/1

We concur completely with this statement of policy. Moreover, its emphasis upon retention of maximum incentive to efficient performance is entirely consistent with the observations of General Quesada to which we referred very briefly above. In the course of his remarks on this subject, General Quesada further called attention to the fact that the process of cost reimbursement tends to penalize the efficient producer and to reward the inefficient producer. The point is by no means a new one--although few have made it as well as General Quesada--and we raise it again here simply to reinforce the statement of our conviction that the cost-reimbursement process has a built-in disincentive character which now, in our judgment, would be transferred to all fixed-price contracts by adoption of the present proposal.

The Institute firmly believes that the presently proposed set of comprehensive cost principles should have no application to any type of fixed-price contract. As contrasted with the cost-reimbursement situation, the contractor under a fixed-price contract must assume the risks associated with the price fixed prior to the incurrence of costs through contract performance. If the contract price has been fixed at too low a level the contractor may suffer a loss which is not recoverable from the government. Under cost-reimbursement contracting, on the other hand, the contractor faces no such problem. He will be reimbursed for contract costs incurred and, in most cases, will be paid a fixed-fee profit determined by formulas prescribed by ASPR. Under such a contractual arrangement the contractor has little or no incentive for the most efficient and expeditious contract performance. However, in the fixed-price area, when a contractor has no such profit guarantee, contract performance must of necessity be both efficient and expeditious or any originally hoped-for profit will be completely consumed by costs. Thus, under fixed-price contracting, the contractor's incentives and his concurrent risks are maximized.

1/ Lt. Col. George W. Thompson, "The Pricing Significance of Contract Types Used in Negotiated Military Procurement," XVIII Federal Bar Journal, No. 2, April-June, 1958, p. 136. Lt. Col. Thompson was recently awarded the Legion of Merit for his outstanding contributions to Air Force procurement.

The proposal's effect on subcontracts.--The manner and degree in which the proposed cost principles would apply to subcontracting are not entirely clear from the draft proposal. Nevertheless, its reference to "the use of cost principles and standards...in contracting and subcontracting" (Par. 15-101) clearly implies a fairly extensive application.

In the vast majority of cases no privity of contract exists between a defense subcontractor or vendor and the government--a point, incidentally, upon which the government has frequently relied to its advantage in proceedings before the Armed Services Board of Contract Appeals. This being true, a cost-reimbursement prime contractor, bound personally by Section XV and with his costs examined by reference thereto, may be placed in the situation of having to justify the costs of a subcontractor over which neither he nor the government exercises any control. He might as a result be required to absorb a subcontractor's disallowances as well as his own. It seems to us also that an already overpowering and very costly apparatus of contract administration will be further enlarged and normal commercial relationships between contractors will be seriously disturbed.

We urge, therefore, if the proposed contract cost principles in their present form are made a part of ASPR that they be amended specifically to exempt from their application all subcontracts which lack privity with the government.

The proposal's effect on terminations.--In its present form the proposed set of contract cost principles would apply to the allowance and disallowance of costs in termination settlements. It would replace the considerably more liberal set of special termination cost principles presently found in Section VIII of the Armed Services Procurement Regulation.

It seems to us that this further evidence of insistence on rigid application of the proposed cost principles in all "cost affected" areas emphasizes once again the spurious logic of applying them to all types of contract price negotiations in the first instance. As we have already suggested in our discussion of the essential difference between fixed-price and cost-price contracting situations, we think the logic of a general and unrestricted application of the proposed cost principles is wholly illusory.

Rather obviously, a contractor is in no way to blame for a decision to terminate its contract for the convenience of the government. The equities of the situation seem to us to demand a more liberal treatment of accrued costs than would be permitted under this proposal, and the fact that cost principles now appearing in Section VIII of ASPR are, in fact, considerably more liberal, would seem to indicate that this point has been recognized in the past. Moreover, no justification has been offered for a failure to continue to recognize this.

The proposal's effect on the process of contract negotiations.--We have already voiced our concern over the virtual certainty that adoption of the proposed set of comprehensive cost principles would convert many, if not most, fixed-price contracts into simple cost-reimbursement agreements. We think this view is supported when one applies to the present proposal the acid test of a practical contracting situation.

The contracting officer is directed by Section III, Part 8, of ASPR to prepare some form of price analysis in every negotiated procurement. In the absence of competitively established prices available to the contracting officer, his fulfillment of this regulatory requirement customarily takes the form of a demand on the contractor or prospective contractor for a cost analysis of the proposed contract price. (This is borne out by the experience of capital goods manufacturers who report an increasing volume of demands for cost data with respect to negotiated fixed-price procurement together with a concomitant increase in pre-contract audits of contractors' books and records.)

It is understandable that, in many situations, the government will request pre-contract cost analyses. This is done on the basis that the contractor's costs are a factor to be considered together with many other factors (ASPR 3-101) in determining a reasonable negotiated price.

Two important questions, however, are raised immediately--questions which are made more critical by the proposal now before us. First, are costs as submitted by a fixed-price contractor in a pre-contract price analysis to be judged by the ordinary standards of business or by an arbitrary manual of cost allowance and disallowance? Second, assuming a pre-contract audit, what form will that audit take and to what use would it be put?

The first of these questions answers itself when one examines the present proposal. The second, relating to the form of a military audit report, has been described by one of the members of the Navy panel of the Armed Services Board of Contract Appeals as follows:

> "In other than cost-reimbursement contracts, the government audit report is merely advisory and generally the form of the report clearly segregates, in separate columns, those costs which are accepted, those which are questioned, and those which are disallowed--so as to permit proper examination at the contracting officer and Board levels in accordance with the cost principles applicable to the particular type of contract involved." (Underscoring supplied.)/2

2/ John Green, "Costing and Pricing in Contract Appeals Procedures," XVIII Federal Bar Journal, No. 2, April-June, 1958, p. 189.

This statement makes clear that advisory audit reports on contractor-furnished data presently include an itemization of "unallowable" estimated costs. To what extent such "unallowability" is presently based on ASPR Section XV is not at all clear; if Section XV is now made directly applicable to fixed-price contracts there can be no question as to the source of such "unallowability." Indeed, such advisory audit reports would probably serve, under a broadly applicable set of cost principles, as the basis for unilateral disallowance of expense items now proscribed by the proposed draft of comprehensive cost principles.

Faced with an "advisory" audit report based directly on a revised Section XV of ASPR--as here proposed--and which "advises" him that many of the contractor's costs are "unallowable," can we expect our hypothetical contracting officer to engage in the "exercise of sound judgment" which another section of ASPR (Part 8, Section III) demands of him. As a practical matter, we think his judgment will have been stultified by this development.

Thus, it seems to us that the fictional character of the distinction now sought to be drawn between the application of cost principles to fixed-price contracts and to cost-type contracts (see page 6, supra) is amply illustrated.

The proposal's effect on the "All Costs" concept.--Just as we believe the adoption of this proposal would so circumscribe a contracting officer's area of discretion as substantially to deprive him of the exercise of any real judgment in contract negotiations, so do we think it would inevitably tend to make unallowable under fixed-price contracts certain unquestioned costs of doing business which are presently disallowed under cost-type contracts.

Consider once again the "advisory" audit report to our hypothetical contracting officer who is directed by the regulation "to employ Section XV of ASPR as the basis for the evaluation of cost information....Whenever such information becomes a factor in pricing, repricing, etc.,...." This means, of course, that some thirty-odd specific elements of normal business cost are to be regarded as unacceptable and are to be disregarded in arriving at a contract price.

The Institute has long objected to the arbitrary and categorical disallowance under cost-type contracts of such items as advertising, selling expenses, etc. We have thought such rejection economically unsound and, in the long run, unwise from the standpoint of both government and industry. To adopt the proposal for a comprehensive set of cost principles will compound the direct subsidy to the government--and the corresponding disadvantage to other customers of a government contractor--which such disallowance necessarily requires.

We repeat our suggestions of the past--which are set out in the attachment to this letter--that, with minor exceptions dictated by law and

public policy, those portions of all legitimate and reasonable costs of doing business properly allocable to government work should be reimbursed as proper contract costs. We cannot but view with dismay a situation in which this principle is to be all but obliterated in government contract work.

Specific Recommendations as to Applicability of the Present Proposal Summarized

1. That the draft of comprehensive contract cost principles not be published in its proposed form.

2. That if the Department of Defense desires to pursue the goal of a broadly applicable set of cost principles, that it confine the publication of regulations in the area to principles alone, as suggested on pages 11 and 12 of our letter of December 16, 1957, copy attached.

3. That if a set of cost principles in the approximate form of this proposal is to be published that certain specific exemptions be made to its applicability, as summarized below:

   (a) That contract cost principles be made specifically inapplicable to (1) advertised contracts, (2) all firm, fixed-price contracts, (3) all subcontracts except those clearly involving privity with the government, and (4) contract terminations. (As a corollary we recommend that cost principles now appearing in Section VIII of ASPR be retained for application to contract termination.)

   (b) That as to all other types of fixed-price contracts, general principles only (enumerated in Paragraphs 15-100 through 15-203 of the proposed draft) as distinguished from that portion of the draft which is a catalog of allowances and disallowances (15-204 "Application of Principles and Standards") be made applicable to such contracts.

Application of Principles and Standards

The Institute has commented repeatedly in the past on the proposed comprehensive cost principles' treatment of specific items of cost. We think it unnecessary to reiterate at length the arguments already advanced in prior statements and, with that in mind, we are attaching an extra copy of our statement of December 16, 1957.

We do want to acknowledge significant improvements which have been made by your staff in the September 10, 1957, revision of the proposed cost principles, particularly in such areas as executive compensation, research

and development, and the allowance of overtime costs. Important as those improvements are, we continue to believe that if the Department of Defense deems it essential to publish a set of cost principles in substantially the form here proposed, then its treatment of specific items of cost should be further liberalized in accordance with prior recommendations in the attached statement.

We should like once again to thank you, your staff, and your associates for your courtesy, your patience, your understanding, and your obvious personal concern with the resolution of this most important question. May I assure you again of the Institute's desire to cooperate in any way possible.

Respectfully yours,

Charles Stewart
President

CWS:c
Enclosures

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

NATIONAL HEADQUARTERS: *1707 19th Street, N.W. • Washington 6, D.C. / REpublic 7-7474*

N. B. McLEAN
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Chairman, Executive Committee

R. N. McFARLANE
Executive Director

29 April 1958

The Honorable E. Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon - Room 3 E 810
Washington 25, D. C.

Dear Mr. Secretary:

In the general comments of the National Security Industrial Association on the Department of Defense Proposed Revision of Section XV of the Armed Services Procurement Regulation submitted with our letter of December 16, 1957, we indicated that our Contract Finance Committee has been devoting extensive effort for more than a year to the development of an Industry proposal for a Comprehensive Set of Cost Principles. We are now pleased to submit this to you.

We trust that this proposal will receive your serious consideration since it might provide the basis for resolution of many of the problem areas on which we commented with respect to the Department of Defense draft.

You will note that our submission is a complete presentation of basic principles except for cost interpretations on specific items of costs of an indirect nature. We plan to submit a proposal on these cost interpretations once the basic principles are resolved.

We again wish to reiterate that many of the differences of opinion are susceptible to resolution if fully explored across the conference table by representatives of Government and Industry. Agreement should be reached on the basic principles to be employed before the drafting of the cost principles is completed.

It would be greatly appreciated if you would extend an opportunity for a small group of qualified individuals to meet with you and members of your Staff to discuss this proposal. We believe that the result of such a discussion might well be the realization of developing a mutually acceptable solution of this long outstanding problem area. I will be glad to discuss, at your convenience, arrangements for such a meeting.

Sincerely,

Jas. D. Boyle
Director of Committees

JDB/rm
Enclosure

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. • Washington 6, D.C. / REpublic 7-7474*

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Chairman, Executive Committee

R. N. McFARLANE
Executive Director

2 May 1958

TRANSMITTAL MEMORANDUM

To: All Official Representatives, NSIA
All Members, Procurement Advisory Committee
Contract Finance Task Committee and Panel
Contract Negotiations Task Committee
Contract Terminations Task Committee

Subject: NSIA Proposal for a Comprehensive Set of Cost Principles

The efforts extended by your Contract Finance Task Committee for over a period of a year have culminated in the attached proposal of a Comprehensive Set of Cost Principles, which was submitted to The Honorable Perkins McGuire, Assistant Secretary of Defense (Supply and Logistics), under date of 29 April 1958.

It is hoped that our request for a meeting with Mr. McGuire and his Staff will be favorably considered and that such a conference can be held at an early date.

Sincerely,

William F. Romig

William F. Romig
Committees Executive

WFR/jtm

Attachment:
Transmittal letter to OSD:
NSIA Draft of Proposed Comprehensive
Set of Cost Principles.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

Draft of Proposed Comprehensive Set of Cost Principles

Index of Contents

February 10, 1958
Revised

Part I - Introduction

Part 2 - General Principles and Standards

Part 3 - Application of Cost Principles to Cost Reimbursement Type Contracts

Part 4 - Application of Cost Principles to Negotiated Fixed Price Type Contracts

(Over)

Part 5 - Cost Interpretations

500 Scope of Part
501 Purpose
502 Direct Costs
503 Indirect Costs
504 Methods of Allocation of Indirect Costs
505 Application of Cost Principles and Standards to Typical Items of Costs

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

Draft of Proposed Comprehensive Set of Cost Principles

February 10, 1958

Part 1 - Introduction

100 Scope of Statement

This statement sets forth in general terms contract cost principles and standards to be used as a general policy guide in the negotiation, administration and termination of contracts.

The Statement consists of five Parts as follows:

Part 1 - Introduction
Part 2 - General Principles and Standards
Part 3 - Application of Cost Principles to Cost Reimbursement Type Contracts
Part 4 - Application of Cost Principles to Negotiated Fixed Price Type Contracts
Part 5 - Cost Interpretations

101 Purpose

(a) This Statement of cost principles has the following main objectives:

(1) To identify those categories of costs recorded in a contractor's accounting records which represent normal and true costs of doing business, and

(2) To set forth acceptable methods for allocating costs and expenses to the contractor's business and, where required, to contracts or other detailed segregation.

(b) This Statement will be useful in the preparation, review, and evaluation of cost data, in connection with contract pricing, pricing revisions, payments, termination settlements and other phases of contract administration by:

(1) Government audit personnel in establishing the scope of their examination of contractors' accounts and in evaluating the propriety of costs allocated to contracts as shown by contractors' accounting records.

(2) Government procurement personnel in reviewing, analyzing, and evaluating accounting data prepared by contractors or auditors relative to contracts, and in negotiating prices, price revisions, payments and settlements on contracts.

(3) Contractors in preparing estimates for negotiation with procurement personnel where applicable, and in preparing cost analyses where required.

102 Use of Cost Data in Contract Pricing - General

The general cost principles and standards set forth in this Statement are not intended to be rigid rules for cost determination but rather to act as a broad framework to be applied with discrimination and judgment. In each individual case, the nature of the industry and the policies and practices of the contractor

102 Use of Cost Data in Contract Pricing - General (Continued)

must be recognized and evaluated.

With respect to the use of cost data in connection with contract pricing, the following basic principles shall be considered:

(a) The primary objective of the Government is to procure supplies and services from responsible sources at fair and reasonable prices to both the Government and the contractor calculated to result in the lowest ultimate overall cost to the Government giving due consideration to such factors as capability or quality of performance, ability to meet specifications, delivery in accordance with required schedules, and advancement of the art, or improvement in the product.

(b) The scope of work involved in each procurement shall be evaluated to determine the most desirable type of contract for the Government and the contractor.

(c) In the negotiation and administration of fixed price type contracts (including price redeterminable and incentive types) the objective shall be to negotiate a fair and reasonable price in which due weight is given to all relevant factors. In establishing prices under negotiated contracts, educated judgment and not mechanical rules or mathematical formulae based on costs shall be used. It follows that pricing decisions shall not be made on a basis of a determination of cost plus a percentage of cost. Specific agreements need not be negotiated with contractors as to the individual elements of cost except when it may be desirable to do so to cover special or unusual items.

(d) Costs shall not be considered an important factor for determining prices under fixed price contracts when other valid and adequate criteria are available. Examples of pricing criteria, other than cost estimates, which may be valid and adequate in particular cases for negotiating prices include (but are not necessarily limited to) the following:

(1) Competitive price proposals,
(2) Published market prices,
(3) Catalogue prices or prices otherwise established, and
(4) Previous procurement price experience on the same or similar items, with appropriate allowances for changes in qualtities or specifications or changes in labor, materials, and other cost indices.

(e) Prices established by competitive bidding eliminate the need for cost estimate audits and are performed whenever circumstances permit. In the case of contract terminations, cost audits may be required.

(f) Profits are considered reasonable and just when based on performance measured by such factors as improvement in the knowledge of the art, efficiency, risk and relative cost. None of these factors are such that they can be measured with precision and therefore excessive attention shall not be devoted to limitations of profit margins based on rule-of-thumb standards or uniform profits rates for companies in the same industry.

103 Applicability

(a) In order for the principles outlined in this Statement to be binding upon the Government and upon a contractor, the applicable principles shall be incorporated by reference in a contract as follows:

(1) Part 2, defining general principles and standards, shall apply to the following situations where costs are a factor in determining price:

(i) All cost reimbursement type contracts where costs relating to the contract are reimbursable under the provisions of the contract;

(ii) Fixed price type contracts (including those with price redetermination clauses and those of the incentive type) wherever cost data are an important factor to be considered in the negotiation of price, either initially or in subsequent price revisions, if any, and

(iii) Termination settlements of the above types of contracts.

(2) Part 3 shall also apply to all cost reimbursement type contracts where costs relating to the contract are reimbursable under the provisions of the contract.

When requests for proposals are issued for contracts in which cost data are an important factor in the negotiation of price, the request shall state that the provisions of Part 2 shall be followed.

(b) The provisions of Part 4 with respect to negotiated fixed price type contracts are set forth for the guidance of Government and contractor personnel in the negotiation of prices of such contracts, either initially or in subsequent price revisions, if any, or in termination settlements thereof.

(c) Part 5 sets forth cost interpretations which are intended to be used as a guide by Government and contractor personnel in the promotion of fairness in price negotiations and cost determinations.

(d) In certain instances, it may be desirable to spell out in cost reimbursement type contracts those items of cost which are to be charged directly and those contemplated for recovery through indirect costing procedure (i.e. overhead), provided these provisions are in harmony with the principles and standards set forth in this Statement. Under such conditions, the contractual provisions shall govern the treatment of such costs. Otherwise the contractor's accounting system shall prevail in accordance with generally accepted accounting principles as set forth in Part 2 of this Statement.

(e) The term cost-reimbursement type contracts, as used throughout this Statement, includes cost or cost-sharing contracts, cost-plus-a-fixed-fee contracts, and the cost-reimbursement portion of time-and-materials contracts.

(f) This Statement shall not apply where cost data are not a factor in establishing firm fixed prices, as for example:

103 Applicability (Continued)

(1) Contracts awarded on the basis of formal advertised competitive bids,

(2) Commercial Articles for which competitive prices have been established in the open market and/or which are established in a contractor's price lists, forms, discount sheets, catalogs, or other media, and

(3) Contracts awarded by negotiation on a firm fixed price basis where the reasonableness of the price is established by previous procurement price experience on the same or similar items with adjustments for price changes, where appropriate, or by any other valid criteria referred to in Paragraph 102 (d).

104 Effective Date of Statement

The principles and standards contained in this Statement shall be effective for contracts or amendments thereto executed on or after _____, or such earlier date as may be mutually agreed upon by the Government and the contractor.

Part 2 - General Principles and Standards

200 Scope of Part

This Part sets forth general principles and standards which shall apply to all contracts as provided in Paragraph 103. This Part does not prevent special treatment of any item of cost by contractual provision.

201 General Standards for Use of Cost Principles

The following are general standards for the use of these cost principles in arriving at sound pricing on Government contracts:

(a) Sound pricing depends primarily upon the exercise of sound judgment by all personnel concerned with the procurement and therefore cannot be measured exactly. Various methods may be equally appropriate for arriving at fair compensation, and reasonable variations of method and of sound judgment may be accepted as a basis for fair compensation. The application of sound business judgment as distinct from strict accounting principles is an essential element of sound negotiation. 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.

(b) Cost and other accounting data may provide guides for ascertaining fair compensation but are not rigid measures of it. Other types of data, criteria, or standards may also furnish reliable guides to fair compensation. In appropriate cases, costs may be estimated, differences compromised, or doubtful questions settled by agreement in an expeditious manner.

(c) The amount of record keeping, reporting, and accounting required shall be reduced to the minimum compatible with reasonable protection of the public interest.

202 General Bases for Cost Determination

In considering cost data as a guide for negotiation or for cost reimbursement under a contract, the general principles set forth below shall be used in arriving at fair compensation. These principles are intended to include consideration of direct costs incident to the performance of the contract, and the allocation of indirect costs. In applying these principles, the following factors shall govern:

(a) Costs must be reasonable; judgment shall be exercised in determining reasonableness.

(b) Conformance to generally accepted accounting principles and practices shall govern.

(c) Indirect costs must be properly allocable to the contract in accordance with the contractor's established accounting system.

(d) The costs of a contract are subject to the limitations or special provisions as to types or amounts as set forth in the contract.

203 Reasonableness of Costs

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

(b) The primary factors to be taken into account in evaluating reasonableness of costs include the following:

(1) Established policies and accounting practices of contractor,

(2) Prior experience of contractor, and

(3) Prevailing level of comparative types of cost or expense in similar concerns or in industry in general.

(c) In appropriate circumstances the following additional factors may have a bearing:

(1) Application of business and public policies,

(2) Size and complexities of business, and

(3) Prevailing general economic conditions.

(d) In the negotiation of fixed price type contracts, the presumption of reasonableness shall be accepted if the overall price is reasonable when measured against competitive sources of supply, giving due consideration to such factors as capability or quality of performance, ability to meet specifications and delivery in accordance with required schedules.

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

204 Application of Generally Accepted Accounting Principles and Practices

Generally accepted accounting principles and practices are derived from many sources. They may, for example, be described in professional accounting literature, accredited accounting textbooks and in official pronouncements of recognized associations of accountants, or they may become generally accepted through usage by industry and the accounting profession. The publication of research bulletins, and other work of the professional accounting associations, has done much to establish reliable standards of accounting practice. Such standards permit the use of alternative practices or conventions, particularly in varying types of business activities. For example, there are several acceptable methods of depreciation accounting, expense allocation and inventory pricing. At the

204 Application of Generally Accepted Accounting Principles and Practices (Continued)

same time there are generally accepted rules regarding accounting practices, the violation of which is not condoned by the accounting profession. Because of the alternative practices which may be followed in adhering to generally acceptable accounting principles, the accounting principles and practices of a particular contractor shall be measured in the light of the aggregate body of generally acceptable principles and not on the basis of rigid formulae. Consideration shall be given to whether or not the principles or practices followed in the contractor's accounting system are:

(a) Recognized and endorsed by the accounting profession,

(b) Commonly used by the business community,

(c) Consistently applied,

(d) Such that will provide reasonable assurance of equitable results to both the contractor and the Government, and

(e) Approved by the contractor's public accounting firm.

205 Acceptable Accounting System

The accounting system of a contractor shall be regarded as acceptable if adequate accounting records, documents and other evidence are maintained to the extent and in such detail as will properly reflect all costs, direct and indirect, for which reimbursement is claimed under the provisions of a contract, or which may be used as a basis for price negotiations or price revisions. In the case of cost reimbursement type contracts such records are the basis of reimbursement by the Government. An acceptable accounting system shall include the following requirements:

(a) The system shall be based on generally accepted and sound accounting practices consistently applied.

(b) The system shall be suitable for the contractor's type of operations.

(c) The methods employed shall be productive of reasonably accurate costs by contract. This does not mean "actual" costs to the exclusion of acceptable standard cost systems, nor does it imply job order costs to the restriction of process, parts and assembly costs accumulated on a production program basis.

(d) It is desirable that the cost system be controlled by the general books of account. However, a statistical type cost system giving actual costs, which is tied into primary records, but not controlled by the general ledger, will also generally be acceptable.

(e) The cost system shall readily lend itself to selective auditing procedures.

A standard cost accounting system, that is, a cost system making use of standard or normal rates for manufacturing costs as a means of management control, is

205 Acceptable Accounting System (Continued)

acceptable for cost determination under Government contracts, if the variations from actual costs are restored properly so that in the end the costs chargeable to a contract will stand upon the basis of the actual costs as described in paragraph (c) above.

The devising and establishment of a contractor's accounting system is a management responsibility. Although there may be as many different cost accounting systems as there are contractors, the majority are based on either the job-order or process methods, either of which may be with or without standards. Individual accounting systems will vary as to the elements of costs covered, whether such costs are treated as direct or indirect, and the method of allocation employed. In some cases, the method may be such that the cost of performance of a contract as a whole is determined, rather than the cost of indivudual completed units of production. In establishing a cost accounting system, management is guided by the needs of the business, the extent of accuracy and exactness required and economy of operations.

In determining the acceptability of a contractor's accounting system the Government may review it. Where such review establishes that the system of accounts and the method of cost accounting employed is compatible with the principles and standards set forth in this Statement and the costs properly allocable to a contract are reasonably ascertainable therefrom, the cognizant audit agency shall approve the accounting system and thereafter the results of consistent application of that system shall be accepted by all military agencies. However, this shall not preclude the contractor from making changes in its system, provided such changes conform to generally accepted accounting principles and practices, and notice of the change is given to the cognizant audit agency.

206 General Policy for Direct and Indirect Costs

An acceptable method of cost accounting shall provide for proper identification of direct and indirect costs applicable to a contract, in accordance with generally accepted accounting principles and practices.

Direct cost elements, usually but not limited to items of material and labor, are any items of cost (or the aggregate thereof) which may be identified specifically with a product, service, program, function, or project on a consistent and logical basis.

Indirect costs, in contrast, are any other items of cost (or the aggregate thereof) which cannot be economically associated specifically with a particular contract or order, or which are not obviously traceable to a unit of output or a segment of business operations, such as a product, service, program, function, or project, and therefore are allocated or apportioned to a product or other objective on a fair method of distribution.

A cost may be direct with respect to some specific service or function which in itself is indirect with respect to the end product, service, program, function, or project. The distinction between direct and indirect costs is sometimes arbitrary or is based upon convenience and cost accounting simplicity. In the interest of economical accounting the contractor shall not be required to extend the practice of direct costing to items treated as indirect cost if the method used does

206 General Policy for Direct and Indirect Costs (Continued)

not sacrifice reasonable accuracy in overall cost charged either on a direct or indirect basis. Consistency of treatment of similar cost elements as between direct and indirect is of fundamental importance in actual practice.

207 Composition of Overhead Pools

(a) Indirect costs (or overhead expenses) as used in this Statement, generally fall within but are not limited to, the following general groups of indirect expenses:

(1) Manufacturing and production expenses which are incurred in fabricating the article or service rendered and which are not considered as direct charges,

(2) Selling and distribution expenses incurred in marketing and distributing the contractor's products,

(3) Engineering expenses, to the extent not included in (1) and (2) above,

(4) General and administrative expenses incurred in the overall management, supervision, and conduct of the business, and

(5) Other categories of indirect costs which may be accumulated by burden centers, cost centers or departmental centers either within the above general groups or in newly established categories, where appropriate, such as material overhead, research and development overhead, etc.

(b) In determining the acceptability of overhead pools employed, consideration shall be given to the following:

(1) Natural grouping of machines, methods, processes, or operations;

(2) Identification with management responsibility for the control unit;

(3) Common characteristics of individual cost elements;

(4) Degree of accuracy required;

(5) Simplicity of cost accounting; and

(6) Economy of operation.

208 Methods of Allocation of Indirect Costs

A method of allocation of indirect costs or expenses chosen by the contractor shall be acceptable if it is in accord with generally accepted accounting principles and practices, provides uniformity of treatment for like cost elements, and is consistently applied. Once the accounting system of the contractor has been reviewed and approved as provided in paragraph 205, the results of consistent application of that system, with respect to individual cost elements or groups of indirect costs, shall be accepted if the costs are reasonably determined under the provisions of

208 Methods of Allocation of Indirect Costs (Continued)

paragraph 203 and their allocation is in accordance with the system accepted or approved.

The base period for allocation of overhead is the period during which such costs are incurred and accumulated for distribution to work performed in that period. Any period that is consistent with the contractor's established practice and furnishes an equitable basis for the determination of an overhead rate may be used.

209 Application of Cost Principles to Methods of Determining Costs in Contract Pricing

The Cost Principles set forth in Part 2 shall apply to any method of determining costs for pricing and repricing activities, unless otherwise qualified by this Statement or by specific contractual provision. Such methods include the use of historical (or actual) costs, standard costs, and cost estimates or combinations thereof, whichever is appropriate for the specific type of procurement action. (See Paragraphs 210 and 211.)

210 Use of Historical Costs in Contract Pricing

Historical (or actual) costs incurred in the base period are sometimes required to be used as a guide, when appropriate, in redetermining prices, establishing escalation and incentive targets, and in termination settlements.

Where standard costs are in use, they are acceptable for the determination of historical costs, provided appropriate adjustment is made in costs for variances between standard and actual costs.

211 Acceptability of Cost Estimates in Contrace Pricing

In general, cost estimates may be used as a guide, in the absence of other valid and adequate pricing criteria in establishing prices, targets, ceilings, hourly rates for labor, and overhead expenses, in precontract negotiations, in forward price negotiations and price revisions during the course of contract performance, and in the negotiation of contract changes.

When cost estimates are used, exactness is not attainable and specific methods which could be applied by a given contractor in all circumstances cannot be delineated. The methods of cost estimating used by a contractor will, of necessity, be related to or influenced by (i) the contractor's method of cost accounting, (ii) the complexity and magnitude of the product or service under consideration, (iii) the economic aspects of the particular industry involved such as the diversity of the product from the types of products usually produced, (iv) the frequency of cost and price quotations, or (v) other special features not normally encountered. Accordingly, cost estimating methods which may be acceptable to one contractor may be inadequate or inaccurate for another. Therefore, skill and judgment are required in evaluating the methods of cost estimating.

Where standard costs are available they may be used in cost estimates for contract pricing. Wherever standard costs are used in estimating, appropriate adjustment

Part 3 - Application of Cost Principles to Cost Reimbursement Type Contracts

300 Scope of Part

This Part sets forth applications of the general cost principles and standards established in Part 2 of this Statement in connection with the determination of costs under cost reimbursement type contracts. It is impractical and unnecessary to cover every element of cost or every possible situation that might arise in a particular case. In areas where this Part does not furnish specific guidance, the philosophy expressed or implied in the principles and standards comprising Part 2 of this Statement and the treatment of similar or related items in this Part, shall be followed.

301 Use of Historical Costs in Contract Pricing - Cost Reimbursement Type Contracts

Historical or actual costs shall be used in the following situations under cost reimbursement type contracts:

(a) Determination of costs incurred subject to reimbursement,

(b) Negotiation of final overhead rates,

(c) Determination of costs incurred subject to reimbursement under cost type portion of time and materials contracts, and

(d) Under contract termination settlements.

302 Use of Cost Estimates in Contract Pricing - Cost Reimbursement Type Contracts

Cost estimates may be used, where other valid and adequate pricing criteria are not available, in the following situations under cost reimbursement type contracts:

(a) Initial estimates as a basis for negotiation of fixed fees,

(b) Establishment of provisional overhead rates to be used as tentative rates established for interim billing purposes pending negotiation of final overhead rates,

(c) Negotiation of maximum cost limitations, and

(d) Negotiation of contract changes affecting contract consideration.

303 Costs Allowable

All direct costs, as defined in paragraph 502, are allowable. All other normal and true costs of doing business shall be allowable, irrespective of whether the particular costs are treated as direct or indirect, subject to the normal tests of (i) reasonableness as to amount and (ii) allocability as defined in Part 2 of this Statement. Such costs include those paid or accrued in the overall operation of the business as well as those specifically attributable to the performance of the contract.

211 Acceptability of Cost Estimates in Contract Pricing (Continued)

will be included for anticipated variances.

Historical cost data, when used for estimating costs, shall be reviewed for changed or changing conditions that would result in a difference between past costs and future costs.

303 Costs Allowable (Continued)

Examples of allowable cost items are listed below:

(a) Advertising
(b) Bidding expenses
(c) Civil Defense costs
(d) Compensation for personal services
(e) Contributions and donations
(f) Corporate business expenses - i.e. stockholders' meetings, financial reports, directors' fees and expenses, etc.
(g) Depreciation and amortization
(h) Employee morale, health and welfare costs
(i) Entertainment costs
(j) Excess facilities costs
(k) Food and dormitory service costs
(l) Fringe benefits
(m) Insurance and indemnification
(n) Interest on borrowings, except bond discounts
(o) Labor relations
(p) Maintenance and repairs
(q) Overtime premium
(r) Patent costs
(s) Plant protection costs
(t) Plant restoration and reconversion costs
(u) Precontract costs
(v) Professional services costs - legal, accounting, engineering and other
(w) Recruiting expenses
(x) Rental of plant and equipment
(y) Research and development expenses
(z) Royalties and other costs for use of patents, copyrights and proprietary information
(aa) Service and warranty costs
(bb) Severance pay
(cc) Shift differentials
(dd) Special tooling costs
(ee) Taxes
(ff) Trade, business, technical and professional activity costs
(gg) Training and educational costs
(hh) Transportation costs
(ii) Travel costs.

The omission of any item in the above listing is not indicative that such item shall be unallowable. In such instances, the principles and standards set forth elsewhere in this Statement shall govern.

304 Costs Unallowable

The necessity for incurring a specific cost is a question of management judgment. An item of cost shall not be unallowable per se except for the items listed below which constitute a distribution of profits, are considered to be contrary to public policy, or may not be properly allocable to Government contracts. Elements of cost shall not be unallowable because they are incurred by some contractors

304 Costs Unallowable (Continued)

and not by others.

Unallowable costs, unless the contract specifically provides otherwise, are:

(a) Commissions or contingent fees (under whatever name) in connection with obtaining or negotiating for a Government contract, excepting commissions necessary to maintain representatives in the field to expedite and service Government contracts, or bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business.

(b) Fines and penalties, resulting from violations of, or failure of contractor to comply with Federal, State, and local laws and regulations, except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing of the contracting official,

(c) Bad debts and reserves for such debts of a purely commercial nature,

(d) Federal taxes on income and excess profits,

(e) Dividend payments,

(f) Bond discounts,

(g) Losses and gains from sales or exchanges of capital assets including investments, and

(h) Premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneficiary directly or indirectly.

Part 4 - Application of Cost Principles to Negotiated Fixed Price Type Contracts

400 Scope of Part

This Part sets forth applications of the general cost principles and standards established in Part 2 of this Statement, for the guidance of Government and contractor personnel, in connection with the preparation, review, analysis, and evaluation of cost data relative to the negotiation and administration of fixed price type contracts. This Part is not applicable to contracts where cost data are not a factor in establishing firm fixed prices as set forth in paragraph 103 of this Statement.

401 Use of Historical Costs in Contract Pricing - Fixed Price Type Contracts

Historical (or actual) costs incurred in the base period set forth in the contract may be used as a guide in price negotiations under fixed price type contracts in the following situations:

(a) Under fixed price contracts with retroactive price redetermination provisions:

(1) Negotiation of fixed prices.

(2) In combination with cost estimates, in the negotiation of prospective prices.

(b) Under incentive type contracts:

(1) In combination with cost estimates, to negotiate firm target costs and target prices, including those cases where the targets are set or revised during the course of the contract, and

(2) Determination of final prices.

(c) Under fixed price contracts with escalation provisions, to the extent necessary.

(d) Under contract termination settlements.

402 Use of Cost Estimates in Contract Pricing - Fixed Price Type Contracts

Cost estimates may be used in the following situations under fixed price type contracts:

(a) Negotiation of fixed prices. (See paragraph 103)

(b) Under fixed price contracts with redetermination provisions:

(1) Negotiation of tentative initial prices,

(2) Negotiation of firm revised prices on a forward-basis during contract performance, and

402 Use of Cost Estimates in Contract Pricing - Fixed Price Type Contracts (Continued)

(b)

(3) In combination with historical costs incurred in the base period in arriving at firm revised prices during contract performance for both retroactive and prospective application.

(c) Under incentive type contracts:

(1) Establishment of billing prices for use until target prices are negotiated, and

(2) Negotiation of target costs and target prices, sometimes in combination with historical costs.

(d) Under time and materials contracts:

(1) Negotiation of hourly labor rates for labor, overhead expenses, and profit.

(e) Under all the above types of contracts for negotiation of:

(1) Contract price ceilings, and

(2) Contract changes affecting the contract consideration.

403 Use of Costs in Pricing Negotiations

When costs are used as a factor in the negotiation of prices under fixed price type contracts, the following listed items shall not ordinarily be considered since they constitute a distribution of profits, are considered to be contrary to public policy, or may not be properly allocable to Government contracts.

(a) Commissions or contingent fees (under whatever name) in connection with obtaining or negotiating for a Government contract, excepting commissions necessary to maintain representatives in the field to expedite and service Government contracts, or bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business.

(b) Fines and penalties, resulting from violations of, or failure of contractor to comply with Federal, State, and local laws and regulations, except when incurred as a result of compliance with specific provisions of the contract, or instructions in writing of the contracting official,

(c) Bad debts and reserves for such bad debts of a purely commercial nature,

(d) Federal taxes on income and excess profits,

(e) Dividend payments,

(f) Bond discounts

(g) Losses and gains from sales or exchanges of capital assets including investments, and

403 Use of Costs in Pricing Negotiations (Continued)

(h) Premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneficiary directly or indirectly.

Part 5 - Cost Interpretations

500 Scope of Part

This Part deals with the application of the basic cost principles and standards set forth in Parts 1 to 4, inclusive, to specific accounting methods and individual items of cost.

501 Purpose

The cost interpretations contained in this Part are intended to provide detailed information and uniform guidance to Government and contractor personnel responsible for the exercise of judgment in the evaluation of the contractor's accounting system, cost estimates and prices or determination of costs, as the case may be, in the light of the applicable cost principles and standards set forth in Parts 1 to 4 inclusive. They are also intended to assist in the promotion of fairness in price negotiations and price determinations.

These interpretations are not intended to provide factual methods of measurement for either the precise or formula determination of costs applicable to a contract, nor are they intended to preclude consideration by Government representatives and contractors of the specific facts or circumstances in a particular contract or negotiation.

In no case shall these cost interpretations be so applied as to result in a deviation from the basic principles and standards set forth in Part 2 of this Statement.

502 Direct Costs

Under the provisions of Paragraph 206, direct costs would include the following:

(a) Material - The cost of direct material is the cost of all items purchased, supplied, manufactured or fabricated, for the performance of the contract and may include collateral items of expense such as inbound transportation, intransit insurance, etc. In computing material cost, consideration shall be given to reasonable losses normally encountered including overruns, spoilage, and defective work. Withdrawals from a contractor's stock shall be charged in accordance with the cost system used by the contractor, provided such system is in accordance with generally accepted accounting principles and practices and is consistently followed. Reasonable charges or credits arising from differences disclosed by periodic physical inventories or by obsolescence shall be taken into consideration in arriving at the cost of performance of the contract, whether treated as a direct or indirect cost. The cost of materials shall be suitably adjusted for applicable portions of such allowances as trade discounts, refunds, and rebates; and credits taken by the contractor, such as (1) credit for any materials returned to stock or to vendors, and (2) credit for the value of scrap and salvage. Such allowances and credits may be applied directly to the charges for material involved or may be allocated as credits to indirect costs.

Where a contractor has an established method for pricing sales or transfers of materials, services and supplies between plants, divisions, or organizations, under a common control, or the item is regularly manufactured and

502 Direct Costs (Continued)

(a) Material (Continued)

sold commercially in the regular course of its business, the item may be stated at a price which does not exceed the lower of (i) the transferor's price customarily charged to its most favored customer for the same item or service in like quantity or (ii) the price charged by other suppliers for items or services of like quantity and quality. All other sales or transfers between such plants, divisions or organizations shall be stated on the basis of total cost to the transferor.

(b) Labor - The cost of direct labor includes salaries and wages properly chargable directly to the performance of the contract. It may also include other associated costs such as payroll taxes, workmen's compensation insurance, and other fringe benefits such as bonuses, shift differentials and premium payments, where it is the established practice of the contractor to treat these items as a part of direct labor costs. Generally, the salaries and wages shall be charged at the actual rates paid by the contractor. If it is the contractor's established accounting practice to make such charges on the basis of average or standard rates, this practice will be acceptable unless it is demonstrated that it will produce unreasonable results.

(c) Other Direct Costs - In some instances, items ordinarily charged as indirect costs may be treated as direct costs, either because of contract provisions or because of the normal operations of the contractor's accounting system, provided the cost of such items applicable to other work of the contractor shall be eliminated from indirect costs allocated to the contract. Examples are traveling and relocating expenses, engineering and design expenses, outward freight and transportation, manufacturing royalties and license fees, special costs of rearranging plant facilities and preparation costs.

The same types and classes of costs shall be treated as direct charges or as overhead uniformly throughout the entire performance of the contract. Exceptions may be made in cases in which changes in operational conditions require or justify changed treatment of certain costs, or improved and refined methods of cost determination have been adopted which make possible the treatment of certain types of cost as direct charges which were formerly included in overhead.

503 Indirect Costs

Indirect costs are defined in Part 2 of this Statement. (See paragraphs 206 and 207). Typical application of the principles outlined therein are contained in the following:

(a) Indirect Manufacturing and Production Expenses - Indirect manufacturing and production expenses consist of items of cost which are incurred in the productive process and are not readily subject to treatment as direct costs.

(b) Indirect Engineering Expenses - Indirect engineering expenses include such items of cost as engineering salaries and wages, including supervision, and

503 Indirect Costs (Continued)

(b) Indirect Engineering Expenses (Continued)

administration, drafting supplies, and other similar items relating to the engineering function which are not readily subject to treatment as direct costs. Engineering activities from which indirect engineering expenses may arise may include such items as product design, tool design, experimental development, manufacturing and production development, layout of production line, determination of machine methods, and related blue printing and drafting. To the extent that engineering costs can be readily identified with a particular activity, such as production, facilities, and research and development, they may be charged to that activity.

(c) Indirect Selling and Distribution Expenses - The expenses in this group consist of items which represent the cost of marketing and distributing the contractor's products and may include such items as contract or order administration, negotiation, liaison between Government representatives and the contractor's personnel, advertising, distribution costs, and other like services. They also include salesmen's or agents' compensation, fees, commissions, percentages, or brokerage fees, which are contingent upon the award of contracts when they are paid to bona fide employees or bona fide established selling agencies maintained by the contractor for the purpose of securing business.

(d) Indirect General and Administrative Expenses - General and administrative expenses consist of items of cost incurred in the overall management, supervision, and conduct of the business.

(e) Other Categories of Indirect Costs - These include such categories as material overhead, research and development overhead, etc.

504 Methods of Allocation of Indirect Costs

The method of allocation of indirect costs must be based on the particular circumstances involved. The objective shall be the selection of a method or methods which will distribute the indirect costs in a fair and equitable manner. The method used shall, in order to be acceptable, conform with generally accepted accounting principles and practices, and be applied consistently.

No definite rules can be stated regarding the allocation of indirect costs because the nature of the particular operations and the actual conditions in each instance may influence the determination of a suitable method or methods to be employed. In the selection of the particular method or methods of allocation, special consideration shall be given by the contractor to any unusual factors which may require special treatment. All pertinent factors shall be reviewed from time to time especially if and when there is a change in the method of operation or in the nature or volume of production, to determine whether the existing system of allocating indirect costs should be continued. As stated in paragraph 205 of this Statement, if the Government has approved or accepted the contractor's accounting system, the results of consistent application of that system shall be accepted unless changes in circumstances warrant reconsideration.

504 Methods of Allocation of Indirect Costs (Continued)

The basis selected for pro-rating overhead in a particular department, burden center, or plant shall be used for all contracts (including fixed price and other work) performed within such department, burden center, or plant. The basis selected shall not be modified or changed after it has been accepted for previous fiscal perios unless it is found to be inadequate because of major changes in operating conditions or unless improved methods of cost determination have been developed.

(a) Allocation of Indirect Manufacturing and Production Expenses - Among the acceptable bases, in appropriate circumstances, for allocating indirect manufacturing expenses are direct labor costs, direct labor hours, machine hours, units processed, and direct material costs, any one or a combination of which may be applied to an entire plant or to its departments or other subdivisions for a representative period. In more complex manufacturing plants, it may be appropriate to departmentalize the plant for purposes of accounting for manufacturing expenses when any given type of production is concentrated in departments having a much higher or lower expense rate than the average. Expense departmentalization may also be desirable in larger and more complex plants for purposes of expense budgeting and control by the responsible foremen, regardless of the need for a more refined method of expense allocation to contracts or products. When manufacturing expenses are departmentalized, it may be permissable to charge expenses of service departments (such as industrial relations, legal, accounting, building maintenance, etc.) to the productive departments on appropriate bases before allocating the respective productive department expenses to products (or parts thereof) or to contracts or job orders for products. Appropriate bases include floor space, number of employees, dollar value of output, number of direct labor employees, etc., depending upon the item being allocated.

(b) Allocation of Indirect Engineering Expenses - Among the acceptable bases, in appropriate circumstances, for allocating indirect engineering expenses to the benefited activities, i.e. contract and other work of the contractor, are direct engineering man-hours expended, direct engineering labor dollars, or some other equitable basis. In appropriate cases, it may be desirable to departmentalize engineering activities (such as production, facilities, and research and development) and segregate the engineering expenses accordingly. Any remaining amount which cannot be charged directly to these departments should be allocated to the benefited activities as indicated above.

(c) Allocation of Selling and Distribution Expenses - Selling and distribution expenses are allocable to the contractor's Government business, to the extent that they are reasonable, using any generally acceptable method of allocation. Generally, such methods may include any of those used for distributing general and administrative expenses indicated below, provided equitable results are thereby obtained.

(d) Allocation of Indirect General and Administrative Expenses - Among the acceptable bases, depending upon the circumstances, of allocating general and administrative expenses are processing costs (direct labor, factory overhead, and other factory production costs exclusive of direct material), factory put-in costs (processing costs plus direct material), costs of goods completed, cost of sales, sales, or any other basis which produces equitable results.

505 Application of Cost Principles and Standards to Typical Items of Costs

(Reserved)

Interest

We, in the Government, have traditionally indicated that interest costs are unallowable, except that they have been allowed in the past in termination settlements. We have had this policy on the theory that a contractor's profit is for the utilization of his assets and talents toward our production. If the contractor chooses to supply all of those assets out of his own ownership and capital, then it seems to me appropriate that the contractor retains all of the profit to himself. If, on the other hand, the contractor chooses to share the supply of assets by only having a partial investment, with others contributing to the investment in the form of a loan of capital, then it seems only fair to me that such a contractor should recognize that the price he has received for the use of the assets must be shared by him with his other partners in the performance; namely, the people who have loaned him the money.

General. The old Sec. XV listed costs which were allowable and those which were unallowable on two pages. The new Sex. XV devotes more than 20 pages to the same subject. Forty-six separate cost items, from advertising to travel, are discussed. Generally each is defined, different circumstances are discussed, and its allowability or unallowability is stated. In some instances, the same item of cost is allowable under some circumstances and unallowable in others. Generally, where this happens it is because the cost is allocable where allowed, and not allocable where unallowable.

Unallowable Costs. The old Sec. XV listed 18 items of cost which were unallowable. However, some of these were not costs at all; e.g., dividends and contingency reserves. The new Sec. XV lists 14 unallowable costs and nine items where the cost may or may not be allowable depending on the circumstances. This difference is more apparent than real. It is occasioned by a different labeling of some items, rather than any change in concept. With one major exception, costs which were unallowable under the old Sec. XV are still unallowable under the new set.

Research and Development Costs. The major change in allowability brought about by the new principles is to allow research and development costs. General research costs were formerly unallowable. Costs of pure research, not including product development, are now allowable if not sponsored by a contract or grant. Product development costs, if related to product lines for which the contractor has defense contracts, are also allowable.

Reasons for Unallowability of Costs. An analysis of the unallowable costs reveals certain reasons for so classifying the items. While not every reader will agree with the discussion which follows, the author presents it in order to place this subject in reasonable perspective:

1. "Cost" items which are not costs. Of the 14 unallowable items, four are not considered to be costs; i.e., costs in the sense of expense incurred. These are provisions for contingency reserves, interest on borrowings, organization expenses, and federal income taxes.

Organization expenses are assets which continue to have value so long as the business exists and are not consumed in use. Additions to contingency reserves are not expenses but rather are segregations of retained income. Interest on borrowings and federal income tax payments represent distributions of operating net income rather than expenses of performance.

2. Costs considered to be contrary to public policy. Four unallowable costs may be categorized as contrary to public policy; Contributions and donations, entertainment, fines and penalties and costs of stock option plans. The author believes that the first and last of these should be allowable as normal business costs; that allowance of entertainment is theoretically justified but is subject to so much possible adverse criticism so as to create more problems than it would solve; and that fines and penalties are correctly unallowable.

3. Costs considered to be unallocable. The Department of Defense considers five items to be unallocable: advertising, bad debts, excess facility, losses on

other contracts, and reconversion costs.

4. Cost disallowed for administrative convenience. Profits and losses on disposition of plant, equipment or other capital assets are not considered because of the difficulties of relating such profits or losses to the period of contract performance. There are several reasons why such profits or losses emerge, not all of which are related to a contract.

Costs Unallowable Under Certain Circumstances. There are nine cost items which are unallowable under specified conditions. Most of these are allowable as specifically covered in the contract, e.g., overtime and shift premiums. Others are unallowable because they relate to another cost which is unallowable; e.g., professional services incurred in organizing the business.

CONCLUSIONS

Unfortunately, the new cost principles are not much of an improvement over the old from a contractor's point of view. The only cost item previously unallowable which the new principles allow is general research. Certainly other normal business costs, yet unallowable, should be allowable. Also, there is a failure to recognize that some cost items (e.g., bad debts) should be allowable to subcontractors if not to prime contractors.

The new principles are improved by the recognition of allocability and the appropriateness of a particular accounting principle or practice to the specific circumstances. However, virtually all this improvement is negated by the provisions concerning individual cost elements. By defining certain legitimate cost elements to be unallowable the principles deny to the contractor the benefits of allocability.

It is possible that the new principles will create more problems than they solve. It appears to the writer that there is a conflict between the factors affecting the allowability of costs in general and the specific provisions of the paragraphs devoted to individual cost items. The application of the principles to fixed-price contracts by military department personnel where none officially existed before will result in the Government negotiating from one set of criteria while the contractor should properly use another. It is reasonable to expect that the Board of Contract Appeals will be a lot busier.

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CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
Subcommittee on Manpower Utilization
of the
Committee on Post Office and Civil Service

January 20, 1960

Honorable Thomas S. Gates, Jr.
Secretary of Defense
U. S. Department of Defense
Washington 25, D. C.

Dear Mr. Secretary:

In December 1956, as Chairman of the Manpower Utilization Subcommittee, I wrote to your predecessor, the Honorable Charles E. Wilson, concerning the need for immediate action to curb the excessive use of tax money for advertising and other costs incidental to the recruiting of engineers and scientists by Defense contractors. For your information I have attached a copy of that letter.

At that time I requested a report on the actions the Defense Department was taking in this area. Included in the information that your Department submitted to the Subcommittee is an analysis by the Military Services of recruiting costs of a sample of Defense contractors. The data from the Department of Navy was printed, which showed some rather excessive recruiting costs. A copy of this report is enclosed. /Personnel Procurement Costs of Selected Navy Department Contractors for Recruitment of Engineering and Technical Personnel, Committee on Post Office and Civil Service, House of Representatives, Eighty-Fifth Congress, First Session/

Your Assistant Secretary for Supply and Logistics, the Honorable Perkins McGuire, has also provided the Subcommittee with a Department of Defense Instruction No. 4105.49, dated April 8, 1958, and Armed Services Procurement Regulation No. 50, dated November 2, 1959, both of which relate to some degree to recruiting costs.

In both of the above documents the Subcommittee has noted the absence of quantitative standards to govern the allowability of recruiting costs by Defense contractors. Instead, we have noted the use of the term, "reasonableness" in allowing or disallowing such costs.

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The Subcommittee feels it both necessary and timely to have a more recent report on the effectiveness of your policies and the administration of the criteria in adjudging recruitment expenditures by Defense contractors. It is therefore requested by the Manpower Utilization Subcommittee that the Department of Defense provide the Subcommittee with a report on recruiting costs of scientists and engineers for the fiscal year 1959 of a sample of Defense contractors. The report should be in accord with the attached set of instructions and format and submitted in duplicate on or before May 31, 1960.

With best wishes, I am

Sincerely yours,

(SIGNED)

James C. Davis, Chairman

Enclosures

C O P Y December 14, 1956 C O P Y

Honorable Charles E. Wilson
The Secretary of Defense
Washington 25, D. C.

My dear Mr. Secretary:

The recent hearings of our Subcommittee have reemphasized the need for immediate action to curb the excessive use of tax money for advertising and other costs incidental to recruiting of engineers and scientists by private industry. I am speaking of the need for precise quantitative standards governing allowable costs under contracts for research and development and production for defense. The present rather loose terminology of "reasonable costs" places too great a burden upon each of the military services and the individual contract officers.

The amount and types of advertising being used, as well as other costs of recruiting and, in many cases, the salaries being offered for engineers and scientists, appear to have far transcended normal and reasonable practices. These have grown largely from the use of government funds made available by defense contracts.

The result has been the creation of what may be, to a certain extent an inflated demand for engineers and scientists. Regardless of that, it has placed undue pressure upon both the civil and military services to provide money for higher pay, greater fringe benefits, and increased recruiting costs in order to maintain an adequate work force. This kind of competitive cycle is both abnormal and costly to the taxpayer.

As Chairman of the Subcommittee on Manpower Utilization and Departmental Personnel Management, I am requesting your cooperation and asking that you take action to see that quantitative standards are set for cost allowances for engineering and scientific salaries and all expenses incident to recruiting, with particular emphasis upon advertising which is, or tends to be, institutional in character. At the same time, I wish to restate the desirability of encouraging industries with defense contracts to initiate active manpower utilization programs. We would appreciate a report on the action you take.

Sincerely yours,

James C. Davis, Chairman

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January 1960

MANPOWER UTILIZATION SUBCOMMITTEE
OF
HOUSE POST OFFICE AND CIVIL SERVICE COMMITTEE

Instruction for Preparing Report on Personnel Procurement Costs of Selected Defense Contractors

I. The Office of Secretary of Defense is requested to submit to the Manpower Utilization Subcommittee of the House Post Office and Civil Service Committee a one-time report showing the personnel recruiting costs of a sample of Defense contractors. The report should be in three parts -- prime contractors under Army, prime contractors under Navy, and prime contractors under Air Force. The same contractor should not be listed by more than one military service.

II. The Personnel Covered in the report relate to professionally qualified engineers and scientists. The report is restricted to employees occupying positions that require engineering or scientific degrees or the experience which is the equivalent of a degree.

III. Personnel Recruiting Costs include:

(a) Help-wanted advertising.

(b) Other advertising -- This includes so-called institutional advertising and costs of participation in exhibits.

(c) Recruiting expenses -- This includes the salaries and expenses of company recruitors.

(d) Travel expenses of new applicants.

(e) Moving expenses of new employees.

(f) Other recruiting costs -- Includes such items as:

1. Fees paid employment agencies.
2. Bonuses paid for referral of new employees.
3. Any other expenses not otherwise reportable.

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IV. The Sample of Defense Contractors should meet the following criteria:

(a) For each Service a minimum of 25 different companies.

(b) The contractor's volume of Government business represents at least 20 per cent of the total company sales for the year.

(c) The sample from each Service should include a minimum of 10 companies whose volume of sales to the Federal Government represent 51 per cent or greater of total yearly sales.

(d) Where possible the sample should reflect contractors in research, development, production of hardware, and in different geographic areas.

V. The Format of the report shall be as attached.

VI. The Report is to be in duplicate.

VII. The Due Date of the report is on or before May 31, 1960.

PERSONNEL PROCUREMENT COSTS OF SELECTED DEFENSE CONTRACTORS
FOR
FISCAL YEAR 1959

Contractor	Total Sales Volume	Per cent U.S.Gov't. Business	Engineers-Scientists			Procurement Costs				Costs per New Hire
			Total Employment	New Hires	Separations	Total	Help Wanted Ads	Other Adv.	All Other Recruiting Expenses	
I	II	III	IV	V	VI	VII	VIII	IX	X	XI
	$	%				$	$	$	$	$

Explanation: Column I - Identifies the contractor.
" II - Fiscal Year 1958-59 total volume of business.
" III - Per cent of the contractor's volume that is known to be for U. S. Government.
" IV - Total employment of <u>all</u> engineers and scientists employed by the contractor as of June 30, 1959.
" V - All new hires of engineers and scientists by the contractor for Fiscal Year 1959.
" VI - All separations of engineers and scientists from the company during the fiscal year.
<u>Note</u> - Columns IV, V, and VI represent all the engineers and scientists with the contractor regardless of Government or Non-Government business.
" VII - Total procurement costs reflect six different categories of procurement costs as shown in Item III of the attached instructions. These costs represent all the money spent by the contractor for engineers and scientists regardless of whether the new employee worked on Government or Non-Government business.
" VIII - Help-wanted advertisements for engineers and scientists.
" IX - All other institutional advertising, including exhibits to attract engineers and scientists.
" X - This column represents expenses of recruitors, travel of applicants, moving expenses, fees to employment agencies, etc.
" XI - Represents the relationship of new hires (Col. V) to total procurement cost (Col. VII).

CONTRACT COST PRINCIPLES

This Committee is well aware of our intensive efforts over the past few years to complete the major project of promulgating a set of comprehensive contract cost principles. I am happy to report the completion of this task. On 2 November 1959, the Department of Defense issued Revision 50 of the Armed Services Procurement Regulation which contained the first major revision of our cost principles since they were originally issued in 1948.

The new regulation provides a single comprehensive set of cost principles which will give more detailed and precise policy guidance in treating cost elements. They apply to all types of contracting or contract settlement situations.

The revised principles will serve as the contractual basis for the payment of costs under cost-reimbursement type contracts. In all other contracting or contract settlement situations, they will serve as a guide in the negotiation of prices or settlements, to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices. Provision is made for specific agreement on the handling of costs in advance of the signing of contracts when particular areas present difficult problems of administration.

The new feature of the regulation is its use in connection with negotiated fixed price type contracts. While cost information has always been considered when appropriate in the pricing of these contracts, no uniform ground rules have been in use throughout the Department of Defense. The new rules will provide common guidelines for both Government and Industry

and will facilitate the selection of the proper type of contract for specific situations since costs will be treated similarly for all types of contracts. Further, the new rules will assist Government auditors in preparing advisory audit reports.

The promulgation of cost principles applicable to all types of negotiated contracts is designed to foster an atmosphere of mutual understanding among contractors and contracting officers. It should ultimately lead to more efficient negotiation and administration of Government contracts.

The Department of Defense has always prescribed and used cost principles in connection with the negotiation of termination settlements when contracts are terminated for the convenience of the Government. In the past, a separate set of cost principles has been used for this purpose. These termination cost principles have been different in some respects from those used in connection with the award of contracts. The new regulation eliminates these separate cost principles and requires the use of one set of rules to cover all situations in which the consideration of costs is appropriate.

The new regulation prescribes that when costs are considered in pricing defense contracts, they shall be subjected to the test 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. Numerous individual elements of cost have traditionally not been allowed in prior cost principles. These include such things as most advertising costs, bad debts, entertainment,

contributions and donations, interest on borrowings, and certain selling costs. These individual items will continue to be treated as unallowable costs. Other individual cost elements, such as cost of material, salaries and wages, depreciation, insurance, maintenance, production engineering, and independent research and development are allowable. In this connection, certain administrative controls and limitations are provided for to insure that costs charged to the Government are reasonable in amount.

These new cost principles are now in use on a permissive basis. They will be used mandatorily after 1 July 1960. This long familiarization period is necessary due to the far-reaching nature of this new regulation.

I must tell you in all candor that the development of these cost principles was a most difficult undertaking. Resolution of the strongly held and divergent views of the many parties having a legitimate interest in this project necessarily took a great deal of time. We do not claim that our finished product is perfect in every respect. Neither do we look upon these cost principles as the panacea for all of our contracting problems. We do feel, however, that we have made a substantial contribution in the field of contracting policy that will materially assist us in our efforts to buy the most for every tax dollar. We will watch these new cost principles closely in actual operation and we will be ready to make any changes which seem appropriate as we go along.

RAYTHEON COMPANY

WALTHAM 54, MASSACHUSETTS • TWINBROOK 9-8400

January 22, 1960

AAF:ENJ:0205:3669

Commander John M. Malloy
Staff Director ASPR Division
Office of the Secretary of Defense
Pentagon, Washington 25, D. C.

Dear Commander Malloy:

In view of the relatively short period of time now remaining before the use of the newly revised Section XV of the Armed Services Procurement Regulation, revision No. 50, becomes mandatory, on 1 July 1960, it is our opinion that Raytheon should now begin negotiation of advance agreements with the Government on certain categories of costs, in conformance with the provisions of ASPR 15-107.

Raytheon has for many years negotiated on an annual basis final overhead rates in lieu of audit determination as provided for in Part 7, Section III of ASPR and the large number of contracts held with the various military agencies contain a provision to this effect. These negotiations have been under the cognizance of the Coordinated Negotiation Branch, Office of Naval Material. This method we believe has proven to be beneficial to both the Government and Raytheon. We further believe that the intent of Part 7, Section III of ASPR will not be accomplished unless effective procedures for the timely negotiation of advance agreements on a tri-departmental basis are established for the various contracting offices holding contracts with Raytheon.

The thought we have just expressed stems from the fact that, with but one or two exceptions, the types of costs which most typically are appropriate in advance agreements are items which are in the area of indirect costs. If, on the one hand, numerous individual negotiations of an extremely large number of contracts ultimately result in one hundred per cent (100%) uniformity of advance agreements, it would appear very obvious that the Department of Defense and the contractor would have achieved a substantial saving of both time and expense if the same result had been obtained in one single tri-departmental negotiation. If, on the other hand,

the individual negotiations of the various contracts result in a lack of uniformity in the advance agreements which are reached, the result would be that this lack of uniformity would make it necessary for the Department of Defense and the contractor to negotiate numerous sets of overhead rates in order to match the various different advance agreements reached for the individual contracts held by the three military departments. There can be no escape from this conclusion as concerns those contracts in which advance agreements differing among themselves, are in fact incorporated as part of the contract provisions. In this connection, it is noted that ASPR 15-107 states that such agreements should be incorporated in cost-reimbursement type contracts.

In view of the above, we earnestly urge that most serious consideration be given to the conclusion which we reached, namely, that the three military departments should establish procedures for tri-departmental negotiation of advance agreements, unless the Department of Defense prefers to amend Part 7 of Section III of ASPR so as to provide expressly and unmistakably that contracts which provide for annual final overhead rates negotiation can validly be interpreted as being legally receptive to the application of the negotiated overhead rates irrespective of individual indirect cost provisions of individual contracts. In our opinion such a provision is already present in our existing contracts, but during the past year we have not been able to obtain full recognition of this fact by the military departments, and it therefore appears that express clarification to the above effect would be necessary.

It is our hope that this letter will serve to explain why Raytheon would appreciate being advised at the earliest possible time as to the procedures which are to be followed in undertaking negotiation of advance agreements in preparation for use of the new Section XV of ASPR.

Sincerely yours,

RAYTHEON COMPANY

A. A. Farrar, Director
Government Contracts

cc: Harry B. Christenat
Office of Naval Material
Department of the Navy
Washington 25, D. C.

CR

11 March 1960

Dear Mr. Farrar:

I have your letter of 22 January 1960, in which you requested advice as to the procedures which are to be followed in undertaking negotiation of advance agreements in preparation for use of the new Section XV of ASPR.

I have delayed replying to your letter in the hope that I might be able to furnish you with more specific information as to our current planning with regard to advance understandings, particularly in connection with the research and development cost principle. As to the research principle, our plans are well underway, and envision the assignment of individual companies to a particular Military Department for negotiation purposes in much the same manner as companies have heretofore been assigned for the negotiation of final overhead rates. We are in the process of establishing a scientific committee to be made up of representatives of the three Military Departments which would provide the technical review and evaluation which will be necessary in most instances in connection with establishing advance understandings.

We do not intend to set up for the immediate future, at least, a formal procedure for the centralized negotiation of advance understandings. As you are well aware, the areas suggested as appropriate for advance understandings present differing problems by their very nature. We do not perceive that there is any easy solution to these problems. At the present time, we do not feel that a formal, centralized negotiation structure for advance understandings would present any great advantage. In an organization as large as the Department of Defense, such a program would create many internal problems of an administrative and management nature. We are, however, watching this phase of the new cost principles very carefully and we will be prepared to take whatever steps seem appropriate to make the system work. In this connection, you may care to glance over some remarks I made on this subject in Philadelphia recently.

It is my understanding that the Navy has negotiated final overhead rates with Raytheon for the past several years. It is my further understanding that the personnel in the Navy who have conducted these negotiations will be happy to discuss such advance understandings as are necessary with Raytheon in connection with cost-reimbursement type contracts. The outcome of any such negotiations can well be used by you as a precedent in other areas of contracting.

I hope that this information will be helpful to you.

Sincerely yours,

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

Attachment

Mr. A. A. Farrar
Director, Government Contracts
Raytheon Company
Waltham 54, Massachusetts

cc Harry B. Christenat
Office of Naval Material
Department of the Navy
Washington 25, D.C.

CONTRACT COST PRINCIPLES

BY

COMMANDER J. M. MALLOY, SC, USN

OFFICE OF THE ASSISTANT SECRETARY OF DEFENSE (SUPPLY AND LOGISTICS)

GOVERNMENT CONTRACTS BRIEFING SESSION
OF THE FEDERAL BAR ASSOCIATION

Philadelphia, Pa.

February 19, 1960

I am quite pleased at this indication of your continued interest in the Department of Defense contract cost principles. I had hoped that the problems associated with this project would somehow steal quietly away from my desk after publication of our "magnum opus" on 2 November 1959, but such is not the case.

I have the feeling that most people are happy to see the end of the great arguments over the individual cost principles and particularly, the manner in which the principles will be used in connection with fixed-price type contracts. I don't think it would be helpful to continue to debate these matters today in an academic way. Rather, I intend to discuss some of our current planning in connection with the implementation phase of this exercise.

A good many of you are probably aware that the Department of Defense procurement program for fiscal year 1959 was a 25 billion dollar effort. You may not know that about 41% --- over nine billion dollars --- was spent under cost-reimbursement type contracts. I mention this figure to indicate the direct affect of the new cost principles. Another segment of our program -- fixed-price incentive contracts -- accounted for 15% and 3 1/2 billion dollars. Fixed-price redeterminable type contracts account for almost five percent and over one billion dollars.

All together, these three types of contracts alone account for 61% of our total program -- a rather sizeable sum -- fourteen billion dollars. Cost principles will be used rather extensively on these contracts. As you know, the cost principles are intended to be used as a guide in connection with fixed-price type contracts whenever costs are a factor in pricing. From time to time, we need to consider costs in connection with firm fixed-price contracts. These accounted for 39% of our program -- amounting to nine billion dollars. My guestimate is that about 10% of this total will feel the effect of cost principles. All together, then, these new regulations will affect two thirds of our total procurement program or a total of about 15 billion dollars. Their application to terminated contracts will, of course, add to the total effect. We have about 5,000 prime contract terminations a year having a face value as to the terminated portion of about 2 billion dollars, although actual termination claims paid run about 10% of this figure. In addition, there are many thousands of subcontracts under these 5,000 primes that will be directly affected by the new cost principles.

We have many cases that go to the Armed Services Board of Contract Appeals which involve the factor of costs. The Board will have use for these new principles, particularly in the area of fixed-price type contracts. For the past several years, the Board has had no guidelines whatsoever in this area and, hence, it created its own rules and precedents. I believe that many of these precedents will be upset in the future.

We are anxious to get on with the task of putting the new rules to the acid test. You will recall that Revision 50 of the Armed Services Procurement Regulation (ASPR) was published on 2 November 1959 and that the mandatory effective date for the cost principles was set as 1 July 1960, although it was stipulated that they could be used permissively upon publication. Many contracts have already been signed incorporating the new principles. Oddly enough, the first actual use of the new principles that came to my personal attention involved a half million dollar development contract issued by the Post Office Department. The contract actually stipulated that reimbursement would be in accordance with Section XV, Part 2 of ASPR.

Shortly after publication of the new cost principles, it became apparent that additional policy guidelines were necessary to allow for the more orderly application of the principles. We studied ways to avoid the situation in which a particular contractor would be operating under two different sets of cost principles at the same time. We explored the feasibility of making a general policy finding to the effect that, on the whole, it made no substantial difference if the new principles were substituted for the old principles in existing cost-reimbursement contracts. Many contended that the extra administrative cost to the Government and to our contractors of operating under two different sets of cost principles would offset any possible cost differential that could be attributable to the new principles. We wanted to obviate the need for a contract-by-contract analysis in favor of a plan to cut over each contractor across-the-board with respect to existing contracts and new contracts, at some convenient point in time, such as the beginning of the contractor's fiscal year.

You lawyers can appreciate the problems we had to overcome. If we could prove that the Government was getting an even break, we could proceed. But how could we prove this without a contract-by-contract analysis? And how do we measure the impact of the new principles down the subcontract chain? The situation in which a particular concern is acting as a prime contractor and also as a subcontractor to another prime contractor -- who probably has a different fiscal year -- presented an almost insurmountable problem. We concluded that the conversion of contractors to a single set of cost principles would, for the most part, be impracticable.

We have just issued new guidelines to our people in this area. Much to the relief of our lawyers, we concluded that existing cost-reimbursement type contracts should, in most instances, be costed out in accordance with the cost principles incorporated therein. We felt that, although it is probable that the differences in result between the old and new cost principles 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. We don't actually forbid the amendment of existing cost-reimbursement type contracts. The door is open just a crack to take care of clear cut situations not involving great administrative problems, where the amendment would not be to the disadvantage of the Government. Obviously, no such amendment could be made without the contractor's agreement.

As to new cost-reimbursement type contracts, we want to starting using the new principles as soon as possible. However, where all of a contractor's contracts are now being costed under the old cost principles, any new contracts will provide for the use of the revised cost principles, but may carry a proviso for the use of the old principles for the period between the date of the contract and the end of the contractor's fiscal year. Our aim here, of course, is to minimize the administrative problems involved in the changeover period. The provision that I just outlined will carry the old cost principles past our previously stipulated mandatory date of 1 July 1960 in some cases.

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

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

I have gone into these new guidelines in some detail because of their currency and their obvious bearing on the impact of the new cost principles. In fact, the Department of Defense may issue a press release to let industry know of our plans in this area.

I would like to turn now to one of the unique features of the new cost principles. ASPR paragraph 15-107 describes a technique called "advance understandings." The basic theory of advance understandings is to provide a framework for agreement by the contracting parties prior to the expenditure of funds. Its purpose is to avoid second guessing. The new feature of this portion of the regulation is merely that decisions with respect to reasonableness and allocability are made at a different point in time than heretofore. This approach is particularly useful in dealing with certain potentially troublesome areas, such as compensation for personal services, precontract costs, unusual travel costs, research and development costs, royalties, use charge for fully depreciated assets, and so forth. I want to discuss research and development as a separate problem, as it has complications and implications which are much more critical than the other areas I have mentioned.

Although the theory of advance understandings is sound, it is apparent that we may have many problems in putting this technique into effect. For example, many contractors are using the system of negotiated final overhead rates for cost-reimbursement type contracts described in ASPR Section III, Part 7. These rates are negotiated after the completion of a contractor's fiscal year. It is an over-all negotiation based on actual costs incurred, and is done centrally for all three military departments. Most of the areas that we suggest as possibly appropriate for advance understandings are reimbursed through overhead. With the exception of independent research and development costs, we do not intend to set up, for the immediate future, at least, a formal procedure for the centralized negotiation of advance understandings.

In some instances, advance understandings can be worked out centrally with the same group that handles the negotiation of final overhead rates. In other cases, they must necessarily be handled by each purchasing activity. If the same understandings cannot be reached with respect to all contracts, this will, of course, raise complications for some contractors and will engender certain administrative problems for the Government, since each centrally determined overhead rate may require several adjustments to take into account the advance understanding provisions of individual contracts.

These problems do not appear to be insurmountable, however. While the use of advance understandings is encouraged where appropriate, I am satisfied that, where problem areas are foreseen and the costs involved are significant, we will have to put up with the consequences in terms of extra administrative effort.

One further point on this question of advance understandings. You should take particular notice of the ASPR provision that the absence of an advance understanding on any element of cost will not, in itself, serve to make that element either allowable or unallowable. It is obviously better, however, for smooth contractual relations, to agree in advance of the incurrence of special or unusual costs, where reasonableness or allocability are difficult to determine, in order to avoid possible subsequent disallowances or dispute based on unreasonableness or on non-allocability.

I would like to turn now to a more specific consideration of the problems which are involved in implementing our research and development cost principle. This was perhaps the most difficult of all of the individual cost principles for us to resolve. It is obviously an area in which the use of advance understandings is particularly pertinent and useful.

Our cost principle on research and development provides that a contractor's independent research program (covering both basic and applied research) will be an allowable cost under our contracts, without regard to the type of contract which is involved. Additionally, a contractor's independent development expense will also be allowable to the extent that such development is related to the product lines for which the Government has contracts. We have provided definitions for the terms "basic" and "applied" research as well as for "development" which I will not elaborate on at this time. In essence, then, we have adopted a rather clear policy with respect to a contractor's independent research and development program. The basic problem that we had to wrestle with was that this policy might be potentially far too costly to the Department of Defense and might well provide a framework for an unrestrained race for technical supremacy on the part of a great many of our major contractors, particularly those whose business is predominantly with the Department of Defense. In establishing the basic policy, then, we recognized that some type of control was essential in this area. We considered many different approaches, such as a mandatory flat percentage share arrangement. Under this concept, we would build in an automatic restraint on the enthusiasm of some of our contractors by providing for a matching contribution by the contractor out of his own funds, in return for a similar contribution by the Department of Defense. Although this approach would cure some problems, it would obviously introduce many others and might well be inequitable for a considerable number of our contractors if it was prescribed as the only solution. We finally concluded that the type of restraint or control that we must necessarily exercise in this area could not be applied in any across-the-board arrangement applicable alike to all contractors.

Rather, our approach needed to be much more selective. That is, it must be oriented towards the situation found in particular companies, and possibly in particular industries. That is the reason, then, why we provided for advance understandings in this area on a contractor-by-contractor basis, and left the method of control quite flexible. The cost principle, for example, contains these words "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."

At the time we adopted our research cost principle, including the control feature I have just enumerated, we agreed that this particular cost item was potentially so large and so critical that it could not be left to an individual negotiation with each of several hundred contracting officers throughout the Department of Defense. Rather, we felt that some mechanism was necessary within the Department whereby our major contractors could, on a periodic basis, presumably an annual basis, present to a central group, plans for independent research and development.

After examination of the contractor's program and whatever discussions were necessary, the Department of Defense would agree to either accept the full allocable portion of the total expense programmed or, possibly, some reduced amount, along the lines that I have previously indicated.

We are now in the process of establishing the mechanics to carry out this program. We are developing a plan whereby our major contractors will be assigned to either the Army or the Navy or the Air Force, for the purpose of reaching advance understandings in this area, in much the same way that some contractors have heretofore been assigned for negotiated final overhead rate purposes. This negotiating group would be assisted by a committee made up of scientists from the Army, Navy and Air Force. Upon receipt of a contractor's program and his funding forecast, an initial review will be made by the scientific committee to insure that a proper segregation has been made as between independent research programs and independent development programs. Our experience indicates that contractors often use different criteria to segregate these two expense areas. Obviously, it is to a contractor's advantage to classify his work as independent research rather than independent development, because of the broader spread which he can obtain. Thereafter, if the total expense involved appears to be reasonable under the circumstances, we might well agree to reimburse our allocable portion of the total expense. In other situations, based on recommendations from our scientists, we will agree to reimburse a contractor for less than an allocable portion of the total independent research and development expense. The results of these negotiations will be promulgated to our contracting officers, who will be expected to follow these over-all decisions.

It must be ovious to all of you that this program, in its initial stages, regardless of how good it sounds on paper, will bring some rather major administrative problems. We intend to do everything possible to face up to these problems in a realistic manner. Obviously, the type of cooperation contractors extend in this area will be a major factor in the success of the program.

I want to mention here that this idea of reviewing a contractor's research program and funding it in less than the full allocable amount is not a new concept. Many of you know that this approach has been used for many years in some areas. The new feature here is that it will be extended on a much broader scale and will be done in advance of cost incurrence, rather than after the company has incurred the expense.

The words which have been spoken and written on this subject of contract cost principles over the past few years are quite voluminous. This is true even with respect to the few facets which I have dealt with today. I hope that I have been successful in providing you with some of our current plans and ideas which we hope will make the change-over to the new cost principles as painless as possible.

Not for publication until
released by the House
Appropriations Committee.

3/7/66

STATEMENT OF THE
ASSISTANT SECRETARY OF DEFENSE (SUPPLY & LOGISTICS)
BEFORE THE
SUBCOMMITTEE ON DEPARTMENT OF DEFENSE APPROPRIATIONS
OF THE
COMMITTEE ON APPROPRIATIONS, HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I appreciate this Committee's continued interest in the supply and service programswhich are under the policy guidance of the Office of the Assistant Secretary of Defense (Supply and Logistics).

We who are associated with Defense logistics believe that significant advances have been made in Defense policies and management techniques.

This Committee has provided appreciable assistance to us through encouraging prompt implementation of plans and programs which we have presented from time to time -- parenthetically, I might add that some of our progress has also resulted from pointed and constructive criticism.

Appearing with me today is the Deputy Assistant Secretary of the Army (Logistics), Assistant Secretary of the Navy (Material), and Assistant Secretary of the Air Force (Materiel). They are also prepared to present a statement regarding the activities of their respective organizations.

CONTRACT COST PRINCIPLES

This Committee is well aware of our intensive efforts over the past few years to complete the major project of promulgating a comprehensive set of contract cost principles. I am pleased to report the completion of this task. On 2 November 1959, the Department of Defense issued Revision 50 of the Armed Services Procurement Regulation which contained the first major revision of our cost principles since they were originally issued in 1948.

The new regulation provides a single comprehensive set of cost principles which will give more detailed and precise policy guidance in treating cost elements. It applies to all types of contracting or contract settlement situations.

The revised principles will serve as the contractual basis for the payment of costs under cost-reimbursement type contracts. In all other contracting or contract settlement situations, they will serve as a guide in the negotiation of prices or settlements, to the extent that the evaluation of costs is necessary for the setting of fair and reasonable prices. Provision is made for specific agreement on the handling of costs in advance of the signing of contracts when particular areas present difficult problems of administration.

A new feature of the regulation is its use in connection with negotiated fixed price type contracts. While cost information has always been considered when appropriate in the pricing of these contracts, no uniform ground rules have been in use throughout the Department of Defense. The new rules will

provide common guidelines for both Government and Industry and will facilitate the selection of the proper type of contract for specific situations since costs will be treated similarly for all types of contracts. Further, the new rules will assist Government auditors in preparing advisory audit reports.

The promulgation of cost principles applicable to all types of negotiated contracts is designed to foster an atmosphere of mutual understanding between contractors and contracting officers. It should ultimately lead to more efficient negotiation and administration of Government contracts.

The new regulation prescribes that when costs are considered in pricing defense contracts, they shall be subjected to the test 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. Numerous individual elements of cost have traditionally not been allowed in prior cost principles. These include such things as most advertising costs, bad debts, entertainment, contributions and donations, interest on borrowings, and certain selling costs. These individual items will continue to be treated as unallowable costs.

Other individual cost elements, such as cost of material, salaries and wages, depreciation, insurance, maintenance, production engineering, and independent research and development are allowable. In this connection, certain administrative controls and limitations are provided to insure that costs charged to the Government are reasonable in amount.

These new cost principles are now in use on a permissive basis. They will be used mandatorily after 1 July 1960. This long familiarization period is necessary due to the far-reaching nature of this new regulation and, insofar as possible to accommodate contractors' fiscal year closings.

I must tell you in all candor that the development of these cost principles was a most difficult undertaking. Resolution of the strongly held and divergent views of the many parties having a legitimate interest in this project necessarily took a great deal of time.

We do not claim that our finished product is perfect in every respect. However, we do believe that a substantial contribution in the field of contracting policy has been made that will materially assist in our efforts to buy the most for every tax dollar. These new cost principles will be watched closely in actual operation and we will be ready to make any changes which seem appropriate as we go along.

PRICING POLICIES

Also, during the year, re-evaluation of the Department of Defense pricing procedures and practices was undertaken with a view to improvement of pricing of prime and subcontracts. The results of this re-evaluation were published as a revision to the Armed Services Procurement Regulation on 1 October 1959.

One of the more significant changes is to require that contracting officers, prime contractors, and subcontractors obtain and utilize the most current, accurate and complete cost data which is available. As evidence that this has been done,

COPY

UNITED STATES NAVY AREA AUDIT OFFICE
8 RATHBONE PLACE
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March 11 1960

From: Officer in Charge, U.S. Navy Area Audit Office, London
To: Officer in Charge, U.S. Navy Purchasing Office, London

Subj: Use of Section XV Cost Principles, in contracts and subcontracts in Europe

Ref: (a) NPO office memo dtd 24 Feb 60

Encl: (1) Statement of Method of Determining Profit for Use under Profit Limitation Shipbuilding Contracts and Subcontracts thereunder

1. Reference requests our comments upon the subject cost principles for use in your discussions with the ASPR Committee when it visits Europe during the month of April.

2. At the outset we wish to point out that we have only very limited experience with the application of Section XV ASPR to contracts in Europe. The very few cost type contracts which incorporate Section XV ASPR have not given us a large and firm enough basis to warrant drawing any definite conclusions. On the other hand in the audit of the European shipbuilding contracts we make use of cost principles which were developed on the basis of the Maritime Administrations's regulations in prescribing method of determining profit under its shipbuilding program in the U.S. There were several deviations from the usual cost principles in this regulation as will be seen from enclosure (1). For example particular attention is invited to the paragraphs therein on Amortization of Asset Appreciation, Interest, Pension and Retirement Payments, Taxes and Unproductive Time of Employees. In addition to the shipbuilding program there is the base construction program in Spain which makes use of part 4, Section XV ASPR. However, no outstanding exceptions were taken in the audit of this contract which is with an American contractor.

3. Under the cost type contracts, which we audit in Europe, we have encountered only a very few problem areas of minor incidence and which have not had much impact upon the contractors involved. Our policy has been that as long as Section XV ASPR is incorporated by reference in a contract we administer it, audit wise, accordingly. Thus if a contractor claims a cost which is considered unallowable under Section XV ASPR we have no alternative

but to disallow it in accordance with our established procedures. In connection with overhead rate analyses where we submit advisory reports for negotiation purposes, our report is advisory to the contracting office. In such cases we recommend for acceptance or non-acceptance costs claimed by the contractor, using Section XV ASPR as the basis for our findings. The determination of the overhead rate is the responsibility of the contracting officer. Likewise, in the reporting of direct labor hourly rates under time and material contracts, an advisory report is prepared for the use of the contracting officer.

4. In general all that we can say at this time is, that as far as we have used Section XV ASPR in cost type contracts we have found it workable. While no contractor, whether American or European, is particularly fascinated with any kind of contract cost principles, it has been our experience that upon explanation and discussion with a contractor of specific points brought up no unusual difficulties have been encountered.

5. Perhaps, if we had many cost type contracts, particularly for large amounts, with a large selection of contractors throughout Europe and for different types of supplies and services we might run into some unusual difficulties, but our experience to date has been otherwise.

(Signed) W.G. LEARY

S T A T E M E N T

OF

METHOD OF DETERMINING PROFIT

FOR USE UNDER PROFIT LIMITATION SHIPBUILDING CONTRACTS

AND SUBCONTRACTS THEREUNDER

CONTENTS

STATEMENT OF METHOD OF DETERMINING PROFIT FOR USE UNDER PROFIT LIMITATION SHIPBUILDING CONTRACTS AND SUBCONTRACTS THEREUNDER

SECTION 1. GENERAL

1.1 This "Statement of Method of Determining Profit for use under Profit Limitation Shipbuilding Contracts and Subcontracts Thereunder" is issued to provide guidance to contractors and subcontractors in the application of profit limitation provisions on U.S. Navy prime contracts and subcontracts thereunder, and will also be used by the U.S. Navy Area Audit Office in the audit of costs and the preparation of advisory accounting reports thereon for the Contracting Officer, Bureau of Ships, United States Navy.

1.2 All accounts, books, documents, memoranda, minutes and records of every kind of a contractor or subcontractor involving the cost of performing a contract or subcontract containing a profit limitation provision are subject to inspection and audit. Contractors shall also make available all subcontracts and purchase orders and shall furnish copies of such instruments when requested.

1.3 In the event a contractor or a subcontractor fails to obtain agreement of a proposed subcontractor to the profit limitation provisions as required by a contract or subcontract, the contractor should notify the Contracting Officer in writing of such failure and give the reasons therefor.

1.4 Contractors and subcontractors subject to the provisions of this Statement should keep their books and records in a consistent manner conforming to generally accepted accounting practice. In cases where a diversified line of operations, commodities, products or services is carried on or dealt in, the books and records should clearly distinguish between such several lines. Should it be found that improper or inadequate accounting methods have been or are being followed, the contractor or subcontractor may be required to restate its accounts or otherwise satisfactorily account for the profit under its contract or subcontract so as to accord with generally accepted accounting practice and the principles herein prescribed.

1.5 If a contractor or subcontractor shall be found to have kept its books and records in such a manner that a proper determination of profit in accordance with generally accepted accounting practice and this Statement cannot be made therefrom or shall have failed to retain any books or records essential to compliance with the principles herein prescribed, the U.S. Navy Area Audit Office will recommend for acceptance only such charges as are shown by the contractor or subcontractor on evidence satisfactory to the U.S. Navy Area Audit Office to have been properly incurred in the performance of such contract or subcontract.

STATEMENT OF METHOD OF DETERMINING PROFIT

FOR USE UNDER PROFIT LIMITATION

SHIPBUILDING CONTRACTS
AND SUBCONTRACTS THEREUNDER

SECTION 2. - DETERMINATION OF PROFIT

2.1 Profit or Loss Defined.

2.11 Profit under a particular contract or subcontract is the excess of the adjusted contract price over the total allowed cost of performance.

2.12 Loss under a particular contract or subcontract is the excess of the total allowed cost of performance over the adjusted contract price.

2.2 Cost of Performing a Contract or Subcontract shall consist, for the purpose of this statement, of four general classifications as follows:

(a) Direct material.
(b) Direct Labor.
(c) Other direct charges.
(d) Overhead.

2.21 Direct Material shall include the cost of all items purchased, supplied, manufactured or fabricated, which enter directly into the end product or which are used or consumed directly in connection with the manufacturing, fabricating, processing, furnishing or converting of such product.

The prices at which materials are charged shall be fair, just, and not in excess of reasonable market price. Prices paid to any supplier associated or affiliated with the contractor or subcontractor will be scrutinized in this connection. All materials, including fittings, parts, auxiliaries, etc., must be taken into account at prices not in excess of the net cost thereof, but materials purchased for and drawn from general stores may be priced by any recognized method of pricing stores withdrawals conforming to generally accepted accounting practice and consistently followed. In certain countries where currency inflation has been of such magnitude that pricing of stores on a level with original purchase figures would result in hardship to the contractor by reason of the necessity to replace those stores at permanently inflated prices, this provision may be modified to allow basis of pricing on current valuation or by relating the generally accepted inflation index to the original cost. However, in cases where the contractor or subcontractor is using materials which are surplus or overstock items, the original cost basis is considered the most equitable.

The net effect of any adjustments related to inventory accounts shall be taken into account to the extent that the propriety of such adjustments is established. In determining any question as to the propriety of prices at which materials purchased specifically for the performance of a contract or subcontract are charged as related to a reasonable market price, the market price prevailing at the time of commitment for purchase shall govern. In any cases where the contractor's or subcontractor's accounts do not cause transportation charges to follow cost of materials, the method of allocating such charges, whether through overhead or otherwise, must be equitable and consistently followed.

2.22 Direct labor generally covers the wages and other compensation of employees whose time can be definitely and accurately measured as a direct charge to contracts or subcontracts.

It is preferable that direct labor be taken into account upon the basis of the individual rates actually paid. Where a contractor or subcontractor follows consistently a method of accounting for direct labor on a productive hour basis at average rates or emplpys other approximations to reduce clerical work, such method may be allowed provided it shall be shown that substantial accuracy is attained thereby. Compensation paid to leading men, quartermen and foremen whose time can be accurately allocated to specific work may, and preferably should be accounted for as direct labor, but an arbitrary allocation of supervisory pay roll or of any part thereof to "direct labor" will be allowed only if and to the extent that it is shown to be conducive to an accurate determination of cost. Overtime, production bonuses, premiums, incentive payments and other indemnities to employees whose time is accounted for as direct labor are preferably to be included as direct labor but if charged in whole or in part to overhead the method of taking such charges into account must be such that no part of such charges incurred by reason of other work is inequitably borne by the contracts or subcontracts.

2.23 Direct Charges - Other may include costs of builder's risk insurance, performance and payment bonds, royalties, outside professional services, inspection, drafting and engineering, mold loft patterns, wood staging and shoring, repair and maintenance of metal staging, launching, docking, trials and other similar items.

Costs of builder's risk insurance, performance and payment bonds, royalties, outside professional services, inspection, etc., which are incurred on account of a contract or subcontract may be charged directly thereto provided that such method is consistently followed and that no similar charges on account of other work are made through overhead in such manner as to prorate any part thereof inequitably to a contract or subcontract.

[illegible]

The following principles apply to the distribution of overhead in determining profit:

All charges which are not directly allocable to particular contracts or subcontracts, and constituting what is broadly regarded and herein referred to as "overhead," shall be distributed over all operations in such manner as will approximate as closely as practicable an accurate determination of cost. To that end the method of distributing overhead must conform to generally accepted accounting practice, and where more than one class of work is being performed must be such that no class of work is caused to bear appreciably any part of the indirect expense which should properly be borne by some other class of work.

The distribution of the various classes of overhead equally over all or substantially all varieties of production work will not ordinarily be accepted as in accordance with generally accepted accounting practice unless it shall be shown that such method results, under the prevailing conditions, in a substantially accurate determination of cost.

The practice of determining separate departmental rates for overhead distribution applicable to the corresponding direct labor charges is acceptable but only the actual productive direct labor may form the basis of the computation and must not include any unproductive time and wages of the type referred to in subsection 3-344.

Distribution of various classes of factory overhead otherwise than upon the basis of direct labor may be accepted if it be shown that a substantially equitable distribution is effected.

The use of machine-hour rates or of standard or specification manufacturing costs properly determined is acceptable.

A differential distribution of overhead to various classes of work, as for example, the use of a variety of fixed percentages suitably determined by periodic cost-engineering survey or by other acceptable means, so that each class of work bears its appropriate overhead rate, may be accepted if it be shown that a substantially equitable distribution is thereby effected.

In cases where, by the use of predetermined rates (departmental, machine-hour, differential, etc.) or otherwise, the actual total of all indirect charges incurred in or allocable to a particular month or other relatively brief accounting period is not exactly absorbed, the under- or overabsorption must be completely distributed currently either ratably

...or by such other means as will effect an accurate and equitable allocation. The equalizing of seasonal expenses, such as heating, is permissible if a consistent policy is maintained in such connection.

In passing upon the general acceptability of a contractor's or subcontractor's principles and methods of accounting, particular enquiry will be made into the method of overhead distribution and no change should be made therein during the progress of work without prior notice to the Officer in Charge, U.S. Navy Area Audit Office.

2.25 Representative Items of Cost are summarized below under three general categories consisting of those ordinarily allowable, those subject to qualification or disallowance, and those unallowable in the determination of cost of a contract or subcontract. Further clarification is contained in the explanatory text in the subsections under section 2.3. All conceivable items cannot be mentioned specifically, and the explanation furnished is indicative and not inclusive; that is to say, omission of mention is to be in no way restrictive in determining the costs of a contract or subcontract. If an item of cost is not specifically mentioned under admissible costs it is not to be thereby automatically excluded, and conversely, if an item of cost is not listed under inadmissible cost or described as one subject to qualification or disallowance, it does not therefore follow that such item is acknowledged to be admissible. In such cases any questions are subject to interpretation and decision according to the nature of the item. Moreover, any of the explanations given below are subject to the application of any special provisions expressly included in the contract or subcontract.

2.251 Items Ordinarily Allowable	See Subsection
Bidding Expenses	2.304
Bonuses	2.305
Castings	2.307
Direct Charges - Other	2.23
Direct Labor	2.22
Direct Material	2.21
Directors' Fees	2.310
Dredging	2.313
Drydocks	2.314
Excess Material (Credits)	2.317
Insurance	2.324
Material Operations - Departmental	2.331
Overhead	2.24
Pension and Retirement Payments	2.334
Scrap (Credits)	2.338
Towing	2.341
Travel Expense	2.342
Welfare Expense - Employee	2.346

		See Subsection
2.252	Items Subject to Application of Principles	
	Advertising Expenses	2.301
	Amortization or Write-off of Special Tooling	2.302
	Central Office Expenses	2.308
	Depreciation of Plant Facilities	2.309
	Discounts	2.311
	Donations	2.312
	Dues and Memberships	2.315
	Fees, Legal, Accounting, and Other Professional	2.320
	Fees of Transfer Agents and Registrars	2.321
	Interest	2.325
	Intracompany and Intercompany Charges	2.326
	Launching Expense - Ceremonial	2.327
	Maintenance and Repair Costs	2.330
	Reserves	2.335
	Royalties	2.336
	Salaries	2.337
	Selling Expenses	2.339
	Taxes	2.340
	Unclaimed Wages	2.343

		See Subsection
2.253	Unallowable Items	
	Bad Debts	2.303
	Capital Gains and Losses	2.306
	Entertainment Expenses	2.316
	Excess Profits	2.318
	Expense and Income - Nonoperating	2.319
	Fines and Penalties	2.322
	Income from Investments	2.323
	Liquidated Damages	2.328
	Losses under other Contracts and Subcontracts	2.329
	Organization and Reorganization Expenses	2.332
	Penalties	2.333
	Unproductive time of Employees (Standby Labor)	2.344
	Unreasonable Charges	2.345

2.3 Alphabetical List of Representative Items of Cost. - In connection with specific items, there are offered the following descriptive explanatory comments:

2.301 Advertising Expenses. - The general policy in regard to advertising for the purpose of effecting sales, as distinguished from institutional advertising in trade or technical journals, is described as follows:

As a general rule a contractor's cost of advertising is not allowable on the reasoning that advertising is not required in order to undertake contracts with the Government of any country. However, certain kinds of advertising of an industrial or institutional character, placed in trade or technical journals, not primarily with the object of selling particular products but essentially for the purpose of offering

[illegible] for the dissemination of technical information [illegible] industry, are not [illegible] to effect [illegible] operating expense incurred in a matter of policy for the benefit [illegible] business and the industry. Thus the reasonable cost of such advertising placed in trade publications as relates to the particular business may be allowed.

The reasonable cost of advertising consistent with the normal and usual practice of a subcontractor may be allowed in determining the cost of performing a subcontract.

The cost of advertising to obtain employees ordinarily is allowable as a part of personnel expense distributable to contracts and subcontracts unless determined to be excessive.

Reasonable expenses of non-elaborate publications issued for the purpose of morale, production, protection, or welfare of a contractor's or subcontractor's employees, which are within the scope of a plant publication are allowable costs.

3.302 Amortization of Asset Appreciation shall not be taken into account in determining the cost of performing contracts or subcontracts. It is, however, recognized that in certain European countries inflation has been of considerable magnitude in the years after World War II and that in such circumstances depreciation on fixed assets may be computed on adjusted (upward) values which take into account the deflation in the value of local currency. It is considered therefore that in the computation of depreciation it would not be unacceptable to take into account the appreciation in value of such assets, because of depreciation in the value of currency since the acquisition of relevant asset. Such increase in value should be in conformity with any applicable laws and regulations of the Government of the country involved, and must not exceed the decrease in value of the currency since the date of acquisition. The practice of the contractor in relation to its general policy of charging depreciation may influence the allowability of this item.

3.303 Bad Debts may be defined as uncollectible or worthless notes or accounts receivable arising from sales of products or other transactions entered into for the purpose of profit. Such items or expenses related thereto are not allowable in contract or subcontract performance costs.

Advances in reasonable amounts made to employees in connection with allowances for traveling expenses which have not been recovered are not regarded as bad debts, but as ordinary business losses allowable in cost directly, if practicable, or through distributable overhead.

3.304 Bidding Expenses. - Reasonable preliminary expenses incident to preparation of bids inclusive of other necessary costs such as legal, accounting, and other professional fees and traveling expenses, are allowable costs through

direct suitable overhead, [illegible] as a direct charge to the contract or subcontract [illegible] and only when approved by the Contracting Officer.

2.305 Bonuses. Payments to employees in pursuance of a regularly established and properly administered incentive bonus system may, subject to the limitations in subsections 2.337 and 2.345 hereof, be allowed as costs provided the aggregate compensation paid to each individual is reasonable and proportionate to services actually rendered in the regular course of business.

2.306 Capital Gains and Losses resulting from financial transactions not directly related to the contract or subcontract shall not be taken into account in determining recapturable profit.

2.307 Castings. - Castings made in the contractor's or subcontractor's own foundry may be charged upon fixed price per pound or other arbitrary basis provided that the scale of prices takes account, when appropriate, of differences in size and kind of castings, and that proper adjustments on such charges are made for the actual cost of castings as determined by reasonably frequent inventories of foundry materials or by other adequate foundry cost methods. The method of pricing foundry raw materials, particularly such higher cost materials as copper, spelter, aluminum, etc., must be consistent with the principles prescribed herein for the pricing of materials generally.

2.308 Central Office Expenses. - Whenever a contractor or subcontractor operates through a central or home office, expense of administration thereof shall be acceptable as contract costs only in direct proportion to the contribution to work under the contract or subcontract.

2.309 Depreciation of Plant Facilities. - Depreciation of buildings, machinery, equipment, and other plant facilities will be allowed as a cost in the determination of profit in general upon the basis of the schedule of rates of depreciation in current use by the contractor or subcontractor and taking into consideration the rates used by the Inland Revenue or Treasury Department of the Government of the country of the contractor or subcontractor and any other particular rates statutorily allowed in abnormal circumstances by that Government, subject, however, to the approval of the Contracting Officer. In certain circumstances, see subsection 6.302 (Amortization of Asset Appreciation) the above principles will be related to inflated valuations of assets.

In the case of buildings, machinery, equipment and other plant facilities subject to depreciation which are used in and are necessary for performance of a contract or subcontract and which during the performance or upon the completion of the contract or subcontract are demolished, dismantled, sold as machinery or equipment or as scrap or, in the absence of a market therefor, are abandoned, in such manner and under such circumstances as shall establish the fact that such demolition, dismantlement, sale or abandonment is in good

[illegible] and residual values [illegible] the proportion of such depreciation as to redetermine [illegible] contracts or subcontracts with respect to which a final determination of profit shall not theretofore have been made shall be allowed in determining the profit thereunder.

2.310 Directors' Fees. - Fees and traveling expenses in connection with authorized meetings of Boards of Directors are allowable as distributable overhead, provided that such fees and expenses are reasonable, and are in accordance with contractors' or subcontractors' usual procedure, subject to the limitation provided in subsection 2.337.

2.311 Discounts. - Earned discounts of all kinds, including trade discounts, cash discounts, special allowances, etc., must be taken into account in such manner that, in the determination of profit, effect is given to the net prices actually paid. Discounts taken on material bills may be deducted from the purchase price in charging to inventory or to the contract or subcontract, or the discounts may be accounted for by distributing discounts earned as a credit item in the overhead, or by a separate computation of net material cost or by such other means as may accord with the contractor's or subcontractor's accounting practice and this requirement of accounting for discounts. If a contractor fails to take advantage of discounts or dis-allowances amounting to one percent (1%) or more, only the net amounts of invoices after deduction of such discounts shall be admissible as the cost of performance, unless adequate justification exists for failure to take discounts.

2.312 Donations may not be taken into account except to the extent that necessary service is rendered to the contractor or subcontractor by the recipient, for example, donations to a local hospital serving the contractor or subcontractor or those which, by local general custom, constitute necessary and proper business expenses.

2.313 Dredging. - Where it is the established practice of the contractor or subcontractor to accrue a reserve for dredging and to charge to such reserve the cost of particular dredging operations necessary for launching or for the maintenance of depth of water at and for access to the shipyard, such accruals may be taken into account as part of the overhead to the extent that it shall be shown that such accruals represent a reasonable average of such expenses actually incurred over an appropriate period. Direct charges for dredging are allowable only when no such reserve is included in the contractor's or subcontractor's established practice, and then only to such extent as may be reasonably allocated.

In waters open to public navigation, in the absence of reserves for dredging, the costs of dredging may be charged to contract or subcontract performance costs provided such costs are equitably allocated to the

contracts or subcontracts affected by such dredging.

The initial cost of dredging of privately owned "slips" should be capitalized; amortization or depreciation of such costs is not allowable, but costs of redredging to establish depths of such slips, in the absence of reserves, are allowable when properly allocated to contracts or subcontracts affected

2.314 Docking. - Where the contractor or subcontractor uses its own drydock in the performance of the contract or subcontract, it is allowable to base the charge to the contract or subcontract for the use of such drydock upon the average cost of operation of the drydock, inclusive of maintenance, depreciation and taxes, as determined over a suitable accounting period not in excess of one year provided that the total such charge shall not exceed an amount determined by use of the prevailing commercial rate for similar services in the vicinity or where the nearest comparable services are available.

2.315 Dues and Memberships in regular trade associations and technical societies are in general allowable, but other dues and memberships may not be allowed.

2.316 Entertainment Expenses are not allowable costs of performing a contract or subcontract. Reasonable luncheon costs necessarily incurred in the normal conduct of a contractor's or subcontractor's business may be allowed.

2.317 Excess Material refers to material, in usable condition, which is left over after a contract or subcontract is completed and resulting mainly from overpurchases, overproduction, overdrawn stores, or as a result of changes and extras. Excess material should not be confused with scrap which is such material as is produced during the course of construction or manufacture and which has only scrap value. (See "Scrap" - subsection 2.338).

Material which has been charged to the cost of performing a contract or subcontract and is found in excess of actual requirements and has not been incorporated in the work shall be credited, at the reasonable value thereof, to the cost of performing the contract or subcontract to which it was originally charged.

If such materials credited to cost are reissued for use in performing a contract or subcontract the materials should be charged into costs at amounts not in excess of the value agreed upon as the reasonable credit.

2.318 Excess Profits paid or repayable to the United States or any Government under any contract whether under any statutory requirement or otherwise, shall not be treated as a deduction or used in any way as a factor in the determination of profit under any other contract.

.319 Expense and Income - Nonoperating (including such items as Income from Investments, Interest, and Royalties, individually commented upon under their respective captions) ordinarily may not be taken into account in determining recapturable profit. Their inclusion in exceptional cases will be subject to the specific approval of the Contracting Officer.

.320 Fees, Legal, Accounting, and Other Professional, for services required in the performance of a contract or subcontract are allowable to the extent deemed reasonable.

Generally speaking, legal and accounting fees in connection with the prosecution of claims against the United States Government or any other Government including income tax matters, are not allowable costs. In cases, however, where such fees are incurred and result in successful adjudication or negotiation of the validity of a claim by a contractor or subcontractor, reasonable expenditure may be taken into account in connection with such contracts or related subcontracts with the United States Navy.

.321 Fees of Transfer Agents and Registrars of stock or other securities and of trustees under mortgage or similar indentures, regularly employed in and necessary to the normal operation of the business, may be allowed as overhead costs, if reasonable in amount.

Fees for the same purposes, covering the organization or reorganization of a corporation, shall not be allowed.

.322 Fines and Penalties incurred for violation of laws are not allowable in costs of performing a contract or subcontract. Similarly, payments and costs under an Arbitration award are not allowable.

.323 Income from Investments shall not be taken into account in determining recapturable profit.

.324 Insurance.

.3241 Monies paid into Government funds for compensation insurance, and net premiums paid or accrued for payment to insurance companies for insurance of risks not found to be unusual or excessive coverage or inconsistent with reasonable and prudent business practice are allowable items of cost.

.3242 If the contractor or subcontractor assumes its own insurable risks (a) for compensation payable to employees for injuries received in the performance of their duties, or (b) for unemployment risks in States or Countries where insurance is required or (c) for other risks not found to be excessive or unusual coverage or inconsistent with reasonable and prudent business practice, there may be allowed in costs the charges set up for such self-insurance

under a system of accounting, regularly and consistently employed by the contractor or subcontractor, at rates not exceeding the lawful or approved rates of insurance companies for such insurance reduced by amounts representing the "acquisition cost" (i.e., commissions, fixed expenses and excess losses) in such companies and after giving effect to any credits for safety provisions, experience, etc., to which the contractor or subcontractor would be entitled in determining such rates, but losses actually sustained must be charged only to the reserves created by such self-insurance charges.

2.3243 If the contractor or subcontractor assumes its own insurable risks and does not record current charges to operations in the manner contemplated by subsection 2.3242, above, losses sustained from such risks during the performance of the contract or subcontract shall be allowable only by such means and to such extent as is equitable under the circumstances attendant upon a specific case.

2.3244 If the contractor or subcontractor assumes its own insurable risks and its practice with respect to charges therefor is not covered by the principles set forth in the foregoing subsections 2.3242-3243, the contractor or subcontractor shall submit the matter to the Contracting Officer for determination at the earliest practicable date after execution of the contract or subcontract, and such charges shall be taken into account in such manner as the Contracting Officer shall determine.

2.3245 Premiums covering insurance on the lives of corporate officers, partners, proprietors, or other executives or employees, where the contractor or the subcontractor is the beneficiary directly or indirectly, shall not be allowed in determining recapturable profit.

2.3246 Reasonable premiums and other reasonable costs of group insurance plans consistently administered and in existence on the date the contract or subcontract was awarded, are allowable. No costs under group insurance plans established after such date will be allowed unless the plan is specifically approved by the Contracting Officer.

2.325 Interest received, paid, or accrued for receipt or payment will not be taken into account in determining profit except that reasonable amounts of interest on bank loans of a contractor for construction, reconditioning or reconstruction of a ship obtained for the purpose of discounting bills or for current working funds, may be allowed to the extent attributable to the contract; provided, that interest on such loans shall not be allowed unless the contractor shall show the necessity for such loans.

Similarly, interest on bank loans of other types of contractors and subcontractors (for example, suppliers of direct materials), when deemed to be reasonable and for the purpose enumerated in the preceding paragraph,

shall be allowed to the extent attributable to performance under the contract or subcontract; provided also that such loans mature not later than six months after the date of timely delivery of the last material or timely performance of the last service, excluding provisions of the guarantee clause.

It is recognized that in certain countries there is a more extensive use of loan financing, rather than capital stock and also that interest rates tend to be high, and the principles set forth in this subsection will be strictly adhered to, since, as a general rule interest is considered as a charge for the use of capital and as such should be taken care of as part of the profit factor. Among other factors to be considered is that if progress payments under a contract are frequently made by the United States Navy, it should not be necessary to incur any substantial amount of interest under that contract. It is also felt that allowances should not be made for interest on any Government funds which might be loaned to the contractor or subcontractor either directly or indirectly through other than normal banking or financing channels, and furthermore, that the Government involved should endeavor to assist as much as possible in making funds available.

To the extent interest is determined to be allowable, the higher European rates may be recognized on an individual case basis provided such rates do not exceed the local rates of interest pertaining in the area of the contractor or subcontractor.

.326 Intracompany and Intercompany Charges. - Intracompany transfers between plants or divisions must be made at cost, excluding any internal or intermediate profit.

Transactions with subsidiary, affiliated or controlled companies covering material purchases or transfers, services, expense allocations or any other type of charge must be disclosed fully. The not allowable cost of intercompany transactions may not exceed the cost of comparable goods or services from alternative outside sources.

.327 Launching Expense - Ceremonial. - The following is prescribed as a general guide to the nature of expenses incidental to launching ceremonies which will be regarded as not excessive and, consequently, chargeable to performance costs.

In particular instances where a budget or a program for launching ceremonies has been approved by the Contracting Officer or where special instructions with respect thereto have been issued by the Contracting Officer, such budget, program, or instructions will govern.

In other cases, expenses not deemed to be excessive would include such items as the erection of launching platform and decorations, erection and use of public address system, christening champagne and preparation of bottle, but would not include expenses of reception, banquets, transportation and entertainment of guests, sponsor's gift and other incidental expenses.

In general, traveling and hotel expenses of the sponsor and agent, and cost of invitations are unallowable unless otherwise designated by the Contracting Officer in specific instances.

.328 Liquidated Damages paid by a contractor or subcontractor for failure to meet contract or subcontract requirements are not allowable costs of performance.

.329 Losses under other Contracts and Subcontracts. - Losses incurred under other contracts or subcontracts or in respect of other work are not allowable as costs of the contract or subcontract in question.

.330 Maintenance and Repair Costs which are of such a nature and extent as under generally accepted accounting practice are chargeable to depreciation reserve or capitalized may not be taken into account except through proper charges for depreciation.

.331 Material Operations - Departmental. - In cases where a contractor or subcontractor manufactures for stores or for direct charge to a contract or subcontract items such as rivets, paint, acetylene, etc., such items may be charged upon a fixed price basis, provided that proper adjustments are made to such charges at reasonably frequent accounting intervals so as to reflect their actual cost.

.332 Organization and Reorganization Expenses. - Costs incident to the formation or refinancing of corporations, partnerships, or proprietorships such as the issuance of capital stock, bonds or other securities, taxes on the issue or transfer of securities, discounts on securities sold, bankers' commissions, or other like financial costs, legal and accounting fees involved in developing organizations or reorganizations, shall not be allowed in determining recapturable profit.

.333 Penalties payable by a contractor to the United States Government whether such payment be effected directly or by deduction from sums otherwise payable by the said Government to the contractor, shall not be allowed.

.334 Pension and Retirement Payments to employees and payments made into trust funds for pension and retirement purposes provided that such trust funds are alienated from the contractor's ownership, may be allowed in the determination of recapturable profit. In every case the payments must be reasonable in amount and consistently and equitably distributed.

In certain cases such costs are accrued on the books of the contractors but are not paid into a trust fund, nor are otherwise funded. Ultimate payment is, therefore, dependent upon financial solvency of the particular company at the time the payment is due; however, in some countries, in case of a company's bankruptcy, the retiring employees take precedence over all other creditors, including national taxes. As those payments are required by law, it is felt that they must be treated as allowable costs, but in basing the computations, the estimates must be realistic and conservative.

.335 Reserves. - Charges resulting in the creation or increase of reserves for general contingencies or other reserves which are not properly chargeable to current operations shall not be allowed.

.336 Royalties. - Income from royalties shall not be taken into account in determining recapturable profit under contracts or subcontracts.

In most cases royalty expense in connection with material or equipment furnished under a contract or subcontract is not properly chargeable inasmuch as the United States Government or the Government of the contractor or subcontractor may have a royalty free license for such material or equipment. If reimbursement for royalty payments is to be claimed, all royalty agreements must be referred to the Contracting Officer for review and approval.

.337 Salaries. - Salary is construed in its broadest sense to include a bonus, director's fee, and all other forms of compensation. Charges or accruals for salaries, year-end bonuses, vacation pay, or other compensation, not actually paid at the date of completion of a contract or subcontract, must be approved by the Contracting Officer as to allowability.

To be allowable as an element of cost of Navy contracts, the total compensation paid to any one individual must be reasonable in relation to his responsibilities, his own efficiency, and that of his organization, and the general level of compensation for like services to other employers of similar size or kind of business in the same country or region.

.338 Scrap is such material as is produced during the course of construction or manufacture and having only scrap value and should not be confused with excess material (see subsection 7.317). Scrap must be credited at the price obtained when sold, or at the current market price if used by the contractor or subcontractor or held for sale beyond the period of the contract or subcontract. If practicable, the credit should be given to the job from which the scrap was derived, otherwise credit should be given through distributable overhead at reasonably frequent intervals.

.339 Selling Expenses. - Generally, expenses incurred for the distribution of the products of a contractor through usual trade and business channels and methods are not regarded as allowable costs under contracts for the reason that such expenses are not incident to or necessary in doing business with the United States Government.

Ordinary selling expenses should not be confused with technical, consulting and other services of the application and adaptation of product to the uses and requirements of the customer. Manufacturers' employees attached to sales departments, who are primarily technicians and product service engineers, render services that are as important and essential when products are sold to the United States Government as when they are sold to other customers. Expenditures representing payments to any person or selling agency employed or retained to solicit or secure contracts with the

[illegible] performance of a contract or subcontract.

Selling expenses which represent the cost of marketing an article, as distinguished from the cost of producing an article, are not to be considered a part of the cost of performing a contract.

2.340 Taxes. - Income and excess profit taxes and surtaxes, Federal, State and other, are not allowed as contract or subcontract performance costs; such taxes merely represent a payment of a part of the net profits to the Government.

Franchise taxes, property taxes (except taxes on property held in reserve or for investment, or for other extraneous purposes), social security taxes and the like (not including payments deducted from or chargeable to employees, including corporate officials) are allowable cost items. Various European countries have differing kinds of taxes which have been listed in a manual issued by the United States European Command on 3 August 1949, reference No. 70-1, and this manual indicates the taxes of those countries which under the Mutual Security Act of 1951 are exempted taxes, and are not allowed as costs in United States Foreign defense expenditure contracts.

Taxes for which exemptions are available are not allowable costs.

2.341 Towing. - Where the contractor or subcontractor uses its own tugs or other floating equipment in the performance of a contract or subcontract, reasonable charges therefor are allowable.

2.342 Travel Expense. - The actual costs of authorized business trips such as transportation, maintenance, communication and other necessary business costs of the traveler during his period of travel may be allowed to the extent such costs are shown to be reasonable and equitably charged to a contract or subcontract.

A reasonable allowance determined prior to the traveler's departure may be accepted in lieu of actual expenses if deemed to be warranted by the circumstances and conditions involved.

2.343 Unclaimed Wages charged to contracts and subcontracts shall be adjusted by an allowance for future claims against unclaimed monies and the remainder shall be ratably credited to the cost of performing the contracts and subcontracts. The allowance and the credit are subject to audit for the purpose of determining the reasonableness thereof.

2.344 Unproductive Time of Employees. - Reasonable amounts of normal stand-by labor costs occasioned by machine breakdowns, non-availability of materials at working site, etc., will be considered in determining contract cost. In contrast, where by law or other agreement contractors are required to

maintain on their payrolls a given number of employees (or a given total 'hours') regardless of the existence of work to be done, standby costs, when the payment of such standby labor will not be included in overhead but either as a direct charge or as part of the overhead application. Charges within this classification may take the form of full wages paid to employees reporting to the work site for "made" work or undirected assignments made to employees listed on the payroll who are ordered there reporting to the work site. Expenditures of this nature should be segregated in a separate account which will not be distributed to the contract or to overhead. In this connection see also Section 2.311

2.345 Unreasonable Charges. - Excessive or unreasonable payments, whether made under bonus or profit-sharing plans, expenditures for the personal benefit of the contractor or subcontractor, payments in excess of reasonable salaries or other compensation of any kind including payments to affiliates and payments to individuals who are connected with the contractor or subcontractor, whether by blood or employment, whether in cash, stock, or other property, will not be allowed as costs in determining recognizable profit.

2.346 Welfare Expense - Employee is allowable as a part of overhead, subject to proper distribution, provided the contractor or subcontractor shall, if required, show the reasonableness thereof.

STANDARD FORM NO. 64

Office Memorandum • UNITED STATES GOVERNMENT

TO : Mr. Bannerman

DATE: 23 March 1960

FROM : Commander Malloy

SUBJECT: Contract Cost Principles - Recreational Activities, Allowability of ASPR 15-205.10

I have looked over the attached memorandum which recommends a change in the Contract Cost Principles with respect to the allowability of certain fringe benefits, particularly those offered in connection with the recruitment of personnel. To the best of my knowledge, the type of cost here in question has not been shown to be in any way significant in amount. I am opposed to making these minor elements of cost unallowable just because it may be difficult to determine reasonableness in a given case. For my own part, I see nothing wrong with fringe benefits, such as a membership in a country club, provided the over-all compensation is reasonable, taking into account the country club membership.

I understand that this point was raised by one member of the Committee. Hence, it is difficult to understand how "the Subcommittee seriously questioned" our practice. As a minimum, we should await the subcommittee report to see if this point is even mentioned. Further, the general statement that we made for the record is pretty indefinite and requires no change per se in the cost principles. If we set a precedent with this type of knit-pick, I don't know where we will stop.

At one time, the Secretaries agreed that individual cost elements would not be made unallowable unless there was some compelling reason for this action, such as the public policy aspects of entertainment expense. In other words, it was agreed that we would not solve problems of "reasonableness" by administrative fiat on our part. I realize that our current principles have departed in some instances from the above principle. However, I hope we can now hold the line. The item here under consideration would be a flagrant violation of an excellent concept.

As to Al's solution, it could well raise problems of race discrimination in the South (by the words "for the benefit of <u>all</u> of its employees"). Also, it would require that certain facilities, now restricted to executives, be made available to all. This type of expense is so minor that it would probably only be dealt with by auditors on the spot. In the event this type of fringe benefit became a cost problem and the question of reasonableness became difficult to determine, I would think that some coverage in an audit manual might be in order.

If you still desire this item to be processed to the ASPR Committee for consideration, please return to me.

J. M. Malloy

Attachment
Draft Memo
dated 16 Mar 60

COST PRINCIPLES

Questions for Cdr. Malloy
Federal Bar Association Meeting
19 February 1960

1. Contractor owns a parcel of land. He sells the land to a builder for the purpose of having a plant built to contractor's specifications. The contractor leases the plant from the builder. Is the rent paid by contractor reimbursable, or will this transaction be considered a lease-back restricting contractor to depreciation?

2. Under the conditions where a contractor furnishes services to both civilian customers and the US Government, how are incidental sales of services to civilians (not connected with the primary business of the contractor) normally treated?

3. The Government contract is a cost type contract and the incidental sales do not generate any extra expense. The possibilities would seem to be:

(1) As civilian sales which should share the burden of general overhead
(2) As incidental sales to which no general overhead need be allocated

or

(3) Should the revenue from these sales be used to reduce the aggregate general overhead before its allocation to civilian and Government work?

4. Regarding the reimbursement of general research costs under cost-plus-a-fixed-fee contracts, should general research costs incurred by a contractor performing both commercial and government work be included in the corporate general and administrative expense or in the computation of the burden rates of the division performing the work under Government contracts?

5. Should the same treatment be accorded to expenses incurred in the preparation of bids on Government contracts?

6. Can you expand upon the meaning of the words "a concurrent sale and lease-back of production facilities" as used in the "rentals" subsection of ASPR Sec. XV. Does the word concurrent mean the same day, the same month, the same year?

Example -- Contractor buys unimproved land -- sells it to a financing institution and leases the unimproved land back on a temporary basis with an option to buy -- Contractor constructs a factory on the land -- After completion contractor is paid cost of building by financing institution and enters into a long-term lease. Is this a rental or a sale and lease-back?

7. Does ASPR Part 6 (new) apply to a retrospective negotiation of the costs exceeding target costs in an FPI contract?

Should such overrun costs be the subject of negotiation and tested against the "allowability" guide of ASPR XV?

8. New contracts (CPFF) issued between November 1959 and July 1, 1960, incorporate Part 2, Sec. XV of ASPR without indicating whether this refers to the new or old Part 2, Sec. XV. Since the new Part 2, Sec. XV, does not become mandatory until July 1, 1960, which Part 2, Sec. XV, applies?

9. Where contractor and DOD cannot agree on an advance understanding for independent research and development costs

1. Will DOD make a unilateral determination at that time? or
2. Will the matter be left open for negotiation after the fact?

10. With respect to the plan for advance agreements for independent research and development costs to be allowed on a percentage basis, how will this overcome the objection of the General Accounting Office, as it was applied to predetermined overhead rate negotiation, that this constitutes a violation of the ban on cost-plus-a-percentage of-cost contracting?

11. Since the Armed Services Board of Contract Appeals, a quasi-judicial body, cannot negotiate, i.e. dicker or bargain, how can the Board apply the Principles as a "Guide"? Are they more likely to be applied as a RULE by the Board?

12. Assume in a redeterminable-type, or incentive, contract that the contractor's initial proposal demonstrates a need for financing and shows proposed interest charges of $50,000. The contracting officer negotiates a round figure with no agreement or understanding as to interest.

On final redetermination, as to appeal on basis that the interest disallowance was improper, assuming that price would be reasonable with inclusion of interest:

(1) What could Board do?
(2) What could courts do?

13. If, after delivery of the end-items under a CPFF (research and development) contract a retroactive adjustment of the overhead rate, made in accordance with the 'Negotiated Overhead Rates' clause, results in a substantial upward revision of the overhead rate and this in turn pushes the total costs over the maximum cost limitation set forth in the contract, is this excess allowable? If so, is it within the contracting officer's authority to amend the contract to allow this additional cost? To paraphrase the question--which clause of the contract controls the clause which provides the overhead rate will be adjusted to actual or the clause which sets a maximum cost limitation? Why do not the ASPR or the applicable implementations clarify this?

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

CR
SUPPLY AND LOGISTICS

25 March 1960

MEMORANDUM FOR THE DIRECTOR FOR PROCUREMENT POLICY

SUBJECT: Contract Cost Principles - Allowability of Cost of Recreational Activities

Pursuant to our recent conversation, I have looked into the question of the allowability of certain fringe benefits, such as recreational activities, under our cost principles. I understand that this type of cost was discussed during recent hearings before the House Appropriations Committee. Certain Committee members apparently were referring to some recruit advertisements which emphasized to prospective employees the availability of company paid recreational activities, such as a country club, as an inducement to join certain companies.

Our new cost principles treat with the subject of cost of recreational activities in ASPR 15-205.10 which states that "reasonable costs of health and welfare activities, such as . . . . recreational activities . . . . in accordance with the contractor's established practice or custom in the industry or area, for the improvement of working conditions, employer-employee relationship, employee morale, and employee performance, are allowable." Although the new cost principles are somewhat more comprehensive in this area, this type of cost has been recognized for many years under our old cost principles.

You have indicated that several members of the Subcommittee raised questions concerning this type of expense. I can only presume that the Subcommittee members would raise a question about this type of expense if it were unreasonable in amount or scope, or not in accordance with the contractor's established practice. In this situation, we would share the Committee's concern. This is the type of decision as to reasonableness which the auditors constantly face in their day-to-day work of certifying costs under cost reimbursement type contracts. For the most part, expenses in this category are quite small and very few abuses have ever come to our attention. The usual situation can be illustrated by the practice of the United Shoe Machinery Corporation, located in Beverly, Mass. The Company has long underwritten a substantial portion of the expense of a country club, having golf, tennis, swimming, etc. facilities. This club is available to most of the employees of the

Corporation. Although dues are paid by the employees, the charges are heavily subsidized by the Company.

With respect to the mention of the availability of fringe benefits, such as a country club membership, in recruit advertising, I can see nothing wrong with either this practice or the subsequent payment of such a fringe benefit. This presumes, of course, that the overall compensation of the individual is reasonable, taking into account the country club fringe benefit. I would be very opposed to any suggestion that we declare, by fiat in the cost principles, that this type of fringe benefit be unallowable. In my view, it would be a grave mistake to solve isolated problems of "reasonableness" by an across-the-board disallowance. This type of narrow approach would endanger our ability to make good use of the new cost principles as a comprehensive document; ie, in fixed price contracts.

I have discussed this matter with Mr. Kilgore who has agreed to alert the audit organizations to be watchful for abuses in this area. Beyond this, I do not feel that any other action is either necessary or appropriate.

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

NATIONAL SECURITY INDUSTRIAL ASSOCIATION
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J. K. RICHARDS
Executive Director

February 7, 1956

The Honorable Reuben B. Robertson, Jr.
Deputy Secretary of Defense
The Pentagon
Washington 25, D. C.

Dear Mr. Robertson:

The National Security Industrial Association, on June 20, 1955, submitted to the Department of Defense its comments on a proposed revision of Part 2 of Section XV of the Armed Services Procurement Regulation dated March 23, 1955 in which objection was expressed to the current and proposed policy of disallowing interest and other financial costs for military contract pricing purposes as proper costs of doing business. That the disallowance of interest is inconsistent with generally accepted accounting principles and practices was fully discussed in an earlier report on this subject which was presented to the Honorable Charles E. Wilson in a letter dated September 3, 1954, a copy of which was attached to our comments on the revision of Section XV of ASPR.

We now wish to supplement these statements with the following additional comments on interest which we believe merit your further consideration in connection with any review of this problem.

In order to ascertain the probable position of the General Accounting Office relative to the allowability of interest on borrowings, a meeting was held in August 1955 between representatives of the National Security Industrial Association and representatives of the Comptroller General's Office, including the Honorable Joseph E. Campbell, Comptroller General of the United States. The representatives of GAO indicated that no ruling had been released by the Comptroller General's Office requiring the disallowance of interest on borrowings except in instances which have held invalid any contract provision, not specifically authorized by statute, which had provided for interest on delayed payments by the Government. 2 Comp. Gen. 181 (1922); 5 Comp. Gen. 649 (1926); 22 Comp. Gen. 772 (1926). Cf. 27 Comp. Gen. 690 (1948). Interest referred to in these cases is completely distinct from interest on borrowings here involved.

The GAO representatives indicated that, in the published rulings of the Comptroller General, interest on borrowings as a cost had never been questioned; that the GAO, in carrying out its responsibilities in determining whether government contracts were properly negotiated and administered, was guided by contractual provisions and controlling regulations emanating from the Department of Defense; and that they would not oppose a regulation which permitted reasonable types of interest to be allowed as a cost in certain situations. It was also stated that the experience of the past ten years has indicated a real necessity for borrowings to finance government contracts and that there appears to be a proper place for the allowance of interest on borrowings in reasonable circumstances (Permission was granted by Mr. Campbell to refer to this conversation.)

A brief summary of legal references, which seem to support interest allowability is also submitted for consideration.

(a) The disallowance of interest on borrowings as a cost is inconsistent with the requirements of federal statutes applicable to contractors. For instance, interest is accepted as an allowable cost for tax purposes under Section 163 of the Internal Revenue Code of 1954. It is also recognized as a cost in Renegotiation under Section 103(f) of the Renegotiation Act of 1951. It should be noted that "reasonable interest, not in excess of 4%" is allowable as a cost under the Vinson-Trammell Act when paid on indebtedness, the proceeds of which are used to acquire additional equipment and facilities for defense production or working capital to operate such equipment and facilities. See I.T. 3400, 1940-2 C.B. 415.

(b) Interest on borrowings is also recognized as a cost under ASPR 8-402(b)(14) in settling terminations of fixed price contracts and ASPR 8-512 authorizes its inclusion in settling the termination of a cost-type contract when not inconsistent with the reimbursement provisions of the particular contract.

(c) Allowance of interest as a cost has been expressly authorized by statute. The Judicial Code (28 U. S. Code Sec. 2516) provides that "interest on a claim against the United States shall be allowed in a judgment of the Court of Claims . . . under a contract expressly providing for payment thereof." Under prior legislation which is essentially identical (as codified in the 1948 Judicial Code), the Supreme Court has construed such legislation as authorizing the payment of interest on sums due and owing by the United States under a contract expressly providing for such allowance. See also United States v. Thayer-West Point Hotel Company, 329 U. S. 585, 590 (1947); United States v. Tillamooks, 341 U. S. 48, 49 (1951); Ramsy v. United States, 101 F. Supp. 353, 356 (Ct. Cls. 1951), cert. den. 343 U. S. 977 (1952).

(d) The First War Powers Act permits the allowance of interest on borrowings as a cost without regard to the provisions of any other law even if any other law which might be existent caused doubts. See 40 Ops. Atty. Gen. 225 (1942).

(e) Interest as a cost has been allowed by the Armed Services Board of Contract Appeals. In Hughes Aircraft Company (ASBCA No. 1933) (1954) the Board allowed interest as a cost under a cost-type contract where ASPR Section XV was not incorporated by reference and therefore did not control. In Hayward Wollen Co. (ASBCA No. 1580(1955), the Board allowed interest in an RFC loan as provided by contractual agreement. Where there was nothing specific with respect to the disallowance of interest as a cost in repricing a fixed price contract, the Board has considered ASPR Section XV to be inapplicable to deny such interest and interest was disallowed only because there was nothing in the record "which would serve as a proper basis for the allowance of interest." See Edo Corp., 5 CCF par. 61, 243 (ASBCA No. 670) (1951).

Where specific departmental regulations, other than ASPR Section XV, applicable to contracts have disallowed interest in repricing a fixed price contract, the Board has followed such provisions. See Rainier Incorporated, 5 CCF par. 69, 519 (Army BCA No. 1733) (1948); Swartzbaugh Mfg. Co. 6 CCF par. 61, 479 (ASBCA No. 792) (1952), motion for reconsideration denied, 1953). However, in a very recent decision of the Wichita Engineering Company (ASBCA 2522) (December 1955), the Board in setting forth the current policy of the Army (as set forth in Army Procurement Procedure paragraph 7-152, and in Department of Defense Instruction No. 4105.11 dated 23 November 1954, which applies to the administration of all "Price Redetermination" articles) stated "We find no prohibition against the inclusion of interest as a cost for the purpose of pricing fixed-price contracts, including fixed-price contracts containing 'Price Redetermination' articles, in current regulations (Armed Services Procurement Regulation and Army Procurement Proceeding) and the Government has cited us to none. Thus to the extent that the decision in Rainier was based upon policy as set forth in procurement regulations, it can no longer be relied upon to automatically exclude the allowance of interest." At another point in the decision the Board stated "We see nothing in the above statement of policy that requires that interest be 'disallowed,' or permits it to be 'disallowed' merely because it is interest."

In view of the above supplementary comments and our previous statement to Secretary Wilson, it is respectfully requested that consideration be given to redefining the position of the Department of Defense in this regard to a basis consistent with that recognized for tax purposes, for renegotiation of military contracts, for terminations of government contracts, and with generally understood and accepted accounting principles and practices.

It is recognized that the allocation of interest to particular contracts will pose certain accounting problems. This association will be pleased to send several members of the Accounting and Auditing Committee to any meeting you or your staff care to hold in this regard.

Cordially,

J. K. Richards

J. K. Richards
Executive Director

JKR:phw
cc: The Honorable W. J. McNeil
The Honorable Thomas P. Pike

Enclosure: NSIA Accounting and Auditing Committee membership list.

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June 4, 1956

Mr. Loyd H. Mulit
Director of Requirements, Production and Distribution
Office of the Assistant Secretary of Defense (Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Mulit:

The National Security Industrial Association greatly appreciates the opportunity granted to review the revised draft of the proposed revision of Part 2 of Section XV - Contract Cost Principles - of the Armed Services Procurement Regulation, dated April 20, 1956, applicable to certain cost-reimbursement type contracts. It also appreciated the invitation which was extended to send selected industry representatives to the joint meeting which was held with the Department of Defense in the Pentagon on May 21, 1956 for the purpose of reviewing this draft.

At your invitation, we are submitting below comments made at the meeting supplemented by the detailed presentation in the attachment on major problem areas of cost and recommendations for their correction. Because of time limitations in making this presentation, attention has been directed to major issues only, although there are other areas existent where the problems encountered have a less broad industry application. Comments were submitted on these in the statement filed with Rear Admiral L. H. Thomas on June 20, 1955 on the draft of March 23, 1955 and are applicable to the current draft.

Our industry association is very much aware of problems existent in the Department of Defense in terms of

(a) The development of a satisfactory set of cost principles which will be acceptable both to the Department of Defense as well as to Congress,

(b) The provision for proper and adequate reimbursement of costs in connection with cost-reimbursement type contracting,

(c) The development of uniformity of treatment by working level personnel in the application of cost principles, and

(d) The prevention of abuses or their minimization to the greatest extent practicable.

In attaining these objectives NSIA is desirous to be helpful and constructive. We have been appreciative of opportunities afforded us in the past to discuss various major issues on other Sections of ASPR and believe that a joint government-industry approach on the Cost Principles could result in a revision which would be mutually satisfactory.

In comparing the current draft of the cost principles with that submitted to industry for comment, dated March 23, 1955, we believe that the new draft constitutes an improvement in the following respects:

(a) There has been eliminated the requirement for hindsight judgment of military audit personnel and contracting officers in reviewing the "exercise of good business judgment in incurrence of cost" by management. (See paragraph 15-201.2) Obviously such a provision should never be made a part of a document used for cost determination.

(b) There has been eliminated the 25% Government business factor on the allowability of Research and Development Costs and Compensation for Personal Services which would have arbitrarily discriminated against contractors with more than 25% Government business.

(c) There have been general language improvements throughout the draft the obvious intent of which has been to clarify ambiguities existing in the previous draft as well as to reduce the necessity for implementation.

Even on these points, however, we do not consider them a significant enough improvement over the existing Part 2 of Section XV to warrant publication of the proposed revision in the very near future, since the existing cost principles provide greater clarity and afford a basis for a more uniform treatment than is reflected in the new draft. The release of this proposal will multiply current contracting problems being experienced by the Government and industry by causing delays in contract negotiations which would be cumbersome and administratively burdensome as well as disputes on the reimbursability of various items of cost many of which will only result in appeals to review boards.

Principle shortcomings of the new draft, most of which have been carried over without alteration from the draft of March 23, 1955 are:

(a) It fails to allow or it allows only in part some 29 items of cost which are true costs of doing business and which cannot be avoided by contractors merely because performance is under a cost-reimbursement type contract. (See Schedule A attached) In this respect, the draft actually amounts to a major expansion of the list of unallowable costs as stated in the present Section XV. Many of these provisions are not only inconsistent with current cost allowances which are being experienced in the field by contractors but they are also inconsistent with "generally accepted accounting principles and practices". This represents an unjustifiable disinclination on the part of the Government to share in normal costs of doing business through which the Government derives clear and demonstrable benefits. Most of the expenses in the unallowable categories are normal regular costs of doing business and contribute to the productive ability of any business enterprise.

In order to attain properly the objectives stated above, the following recommendations are presented:

(a) Any set of cost principles should recognize the true costs of performance under a cost-reimbursement type contract.

(b) The allowability of true costs should not be subject to shadings, gradations or special circumstances; nor should allowability be conditioned on the ability of the contractor to negotiate special cost allowances into individual contracts.

(c) The principle of cost-reimbursement type contracting is that the contractor will be reimbursed for all elements of cost. Because the contractor is presumably guaranteed such cost-reimbursement, he is regarded to have assumed a limited risk and accordingly he receives a limited fee. In actual practice, however, fees of contractors in cost-reimbursement type contracting are being diluted to an unwarranted extent because of the failure of the Government to recognize true costs. Contractors are therefore assuming risks of performance which are much greater than those ever intended under this type of contracting. The low profit rates experienced are far from being commensurate with the skill and engineering "know-how" which industry has been contributing to the overall Government program.

(d) Uniformity of treatment is best achieved by having a simple and clear cut statement of costs which are allowable and those which are unallowable. Gradations for special curcumstances and the requirements for negotiation of special contract provisions tend to defeat the uniformity of treatment afforded by a clear cut statement of cost principles.

(e) Abuses can best be prevented by the application of the normal tests of reasonableness and allocability, and the disallowance of unreasonable or improperly allocated costs.

We are grateful for the opportunity of presenting these comments to you. However, we believe that there is a fundamental problem of Government relations involved which results from the lack of general understanding and agreement between the parties involved which will never be dissolved by an exchange of correspondence. Although it is recognized that to some degree this problem will always exist, we feel strongly that a great deal can be done to narrow down its area and magnitude.

The basic ideas back of some of the cost principles are good. However, the current draft has failed to accomplish the stated objectives because of the failure to understand adequately the problems of both the Government and industry. It must be pointed out that many of the items being treated in Part 2 of Section XV are items which fall within the category of those which normally should be negotiated between the contractor and the contracting officer on specific contracts. However, we recognize, because of the magnitude of the problems and because of the desirability of handling these items in a uniform manner where practical, such negotiations cannot be accomplished

(b) The new draft would also require the negotiation of specific contractual coverage or authorization as to some 19 items of cost which should automatically be allowed to the extent that they are reasonable in amount and allocable to the contract. (See Schedule B attached) This requirement would be cumbersome, administratively burdensome and in fact would not achieve the objective of uniformity as actual practice would soon show some contracting officers willing and others unwilling to negotiate these special provisions. Large companies in a strong negotiating position would undoubtedly achieve some manner of success in negotiating such allowances while smaller companies and those in a weaker negotiating position would not. Our small business membership has expressed particular concern over this requirement.

(c) There are 20 provisions of the new draft which either dictate the accounting system to be used by the contractor or spell out such detail as to constitute an audit manual approach. (See Schedule C attached) Indicative of the latter point is a direction throughout the draft that the military contract auditor take into account factors in addition to the usual tests of reasonableness and allocability. These provisions would also require the General Accounting Office to second-guess the auditors in determining whether all of such factors had been properly evaluated. These factors might be made more properly a part of the Contract Audit Manual of the Department of Defense provided they are accompanied by adequate explanation of their limitations. In this respect, it should be recognized that the contract auditor is essentially one who performs a service for the military buyer rather than one who polices the buyer's decisions or who holds an equal position with the buyer in pricing negotiations.

(d) In the attempt to "amplify the treatment of certain items of cost" the draft has entered into a detailed treatment which apparently is an attempt to cover peculiar circumstances of "special cases". While we favor the objective of providing for a more complete treatment of certain items of cost within the framework of the proposed draft of Section XV, the attempt to cover peculiar circumstances of "special cases" results in arbitrary, unilateral and artificial determinations of allowable costs which are not consistent with sound business practice and is very unfair to Government contractors. It would be more logical and equitable to cover these special situations at the time of negotiation of original contract terms.

(e) Several paragraphs of the draft include data which are procedural in character rather than basic costs principles. The inclusion of such data in Part 2 of Section XV will give rise to serious negotiating problems which can better be avoided by setting forth in a related part, such as Part 6, interpretations and other material necessary for the guidance of auditors or contracting officers.

on an individual contract basis; but this does not in itself give the Government the right to take these items out of the category of negotiation and put them in an area of policy without giving industry the same right to negotiate that policy on an industry basis.

Consequently, the revision of the cost principles should be based upon a bilateral approach to the problems. In order to accomplish this, it is our firm belief that a mutually acceptable and more efficient policy and procedure will be attained by permitting industry to participate in the discussion with the Department of Defense of the objectives of each disputed paragraph of the proposed regulation and by permitting industry to re-present its views to final reviewing authority where differences remain unresolved. The National Security Industrial Association is prepared to render any assistance in this respect.

If the problems in the current proposed revision of the cost principles cannot be resolved by such mutual effort, then we believe that the present Part 2 of Section XV should be retained, because it is a more clear cut and a more workable set of cost principles.

Cordially,

Frank L. Fuller

Frank L. Fuller
Committee Executive / for

Paul A. Reck
Chairman
National Security Industrial Assn.
Accounting and Auditing Committee.

FLF/jtm

Enclosures:
(1) Specific comment re DOD proposed draft dtd 20 Apr 56
(2) Ltr to Reuben B Robertson re Interest dtd 7 Feb 56

Proposed Revision of Part 2 of Section XV of ASPR
(Draft of April 20, 1956)

Schedule A

Areas in Which There is Failure to Recognize True Costs

15-203.4	Selling and Distribution Costs
15-204.2(a)	Advertising Costs
15-204.2(c)	Civil Defense Costs
204.2(d)	Compensation for Personal Services
204.2(e)(ii)	Depreciation
204.2(e)(4)	"
204.2(g)	Food Service Costs and Credits
204.2(i)(3)(ii)	Insurance and Indemnification
204.2(i)(3)(iii)	" " "
204.2(i)(3)(iv)	" " "
204.2(i)(4)	" " "
204.2(k)(2)	Maintenance and Repair Costs
204.2(m)(2)	Material Costs
204.2(m)(6)	" "
204.2(o)	Patent Costs
204.2(p)	Pension Plans
204.2(r)(3)	Professional Service Costs
204.2(t)(3)	Rental Costs
204.2(u)(3)	Research and Development Costs
204.2(u)(5)	" " " "
204.2(v)	Royalties and Other Costs for Use of Patents
204.2(w)(2)(ii)	Severance Pay
204.3(c)	Contributions and Donations
204.3(d)	Entertainment Costs
204.3(e)	Excess Facility Costs
204.3(g)	Interest and Other Financial Costs
204.3(h)	Losses on Other Contracts
204.3(i)	Precontract Costs
204.3(e)	Reconversion Costs

Proposed Revision of Part 2 of Section XV of ASPR
(Draft of April 20, 1956)

Schedule B

Areas in Which Specific Contractual Coverage or Authorization is Required

15-204.2(c)	Civil Defense Costs
204.2(d)	Compensation for Personal Services
204.2(e)(5)	Depreciation
204.2(g)	Food Service Costs and Credits
204.2(i)(3)(iii)	Insurance and Indemnification
204.2(i)(3)(iv)	" " "
204.2(i)(4)	" " "
204.2(k)(2)	Maintenance and Repair Costs
204.2(n)	Overtime, Extra-Pay Shift, and Multi-Shift Premiums
204.2(o)	Patent Costs
204.2(r)(3)	Professional Service Costs
204.2(t)(3)	Rental Costs
204.2(u)(2)	Research and Development Costs
204.2(u)(5)	" " " "
204.2(v)	Royalties and Other Costs for Use of Patents
204.2(y)(2)	Taxes
204.2(cc)(4)	Travel Costs
204.3(j)	Precontract Costs
204.3(l)	Reconversion Costs

Proposed Revision of Part 2 of Section XV of ASPR
(Draft of April 20, 1956)

Schedule C

Areas Dictating Accounting System to be Employed and/or Constituting Audit Manual Approach

15-202.1	Direct Costs - General
202.3	Direct Labor Costs
203.1(b)	Indirect Costs - General
203.1(c)	" " "
203.2	Indirect Manufacturing and Production Costs
203.3	Indirect Engineering Costs
203.4	Selling and Distribution Costs
203.5	General and Administrative Costs
204.2(b)	Bidding Costs
204.2(f)	Employee Morale, Health, and Welfare Costs and Credits
204.2(m)	Material Costs
204.2(n)	Overtime, Extra-Pay Shift, and Multi-Shift Premiums
204.2(p)(3)(iv)	Pension Plans
204.2(r)(2)	Professional Service Costs
204.2(u)(3)	Research and Development Costs
204.2(u)(4)	" " " "
204.2(w)(2)(ii)	Severance Pay
204.2(bb)	Transportation Costs
204.2(cc)	Travel Costs
204.2(dd)(1)	General

15-200 Scope of Part.
Comment: This paragraph should be amplified to establish clearly that any item of cost may receive special treatment through specific contract provision.

Suggested Revision:

15-200 Scope of Part. This Part sets forth principles and standards for the determination and allowance of costs in connection with cost-reimbursement type contracts and cost-reimbursement type subcontracts thereunder for procurement of supplies, services, and research and development work, with contractors or subcontractors, other than such contracts and subcontracts to which Parts 3, 4, or 7 apply. This Part does not prevent special treatment of any item of cost by contract provision.

encl (1)

15-201.4 Contractor's Accounting System.

Comment: The regulation should include a provision to demonstrate that it is not the intent of the regulation to require changes in acceptable accounting practices. This provision is felt to be very essential because the proposed regulation contains a great deal of instructional material which might be used by auditors at the working level to require changes in the contractor's established accounting practices. The following new paragraph is suggested.

Suggested Revision:

15-201.4 Contractor's Accounting System. The requirements concerning record keeping and approval of the contractor's accounting procedures and practices are set forth in the "Records Clause" (See ASPR 7-203.7). Failure to mention any generally acceptable method of distribution of cost does not imply that such method is unacceptable. It is not the intent of this Part to require the contractor to change its accounting procedures and practices which have been previously accepted for determining costs under Government contracts.

15-203 Indirect Costs

15-203.1 General

Comment: Subparagraph (b) requires that the objective in selecting a method of allocation of indirect costs should be to adopt a method which will distribute indirect costs in an equitable manner. The subparagraph, however, goes on to provide that the method used must actually produce equitable results and also to prescribe conditions under which an acceptable method shall be subject to reconsideration. If a method has been adopted which is designed to produce equitable results, it is considered improper to require that each particular contract be examined to determine that equity has, in fact, been achieved in the particular instance. The following revision is suggested.

Suggested Revision:

(b) The method of allocation of indirect costs must be based on the particular circumstances involved. The objective should be the selection of a method which will distribute the indirect costs in an equitable manner. The method used in connection with Government contracts shall, in order to be acceptable, conform with generally accepted accounting practices, provide uniformity of treatment for like cost elements, be applied consistently, and produce equitable results. A previously acceptable method shall be subject to reconsideration 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, the volume of production, manufacturing processes, the contractor's products, or other relevant circumstances.

Individual categories of indirect cost are discussed in ASPR 15-203.2 through 15-203.5.

15-203.2 Indirect Manufacturing and Production Costs.

Comment: The requirement that premiums for overtime, extra-pay shift and multi-shift work be excluded from allocation based upon direct labor dollars is unwarranted as dictating the accounting system to be employed by the contractor. Similarly, the statement regarding departmentalization and the factors to be considered in determining the necessity for departmentalization is objectionable as invading management's prerogatives. Accordingly, it is suggested that the paragraph be revised as follows:

Suggested Revision:

15-203.2 Indirect Manufacturing and Production Costs. Indirect manufacturing and production costs consist of items of cost which are attributable to the manufacturing and productive process as a whole. Allocation of indirect manufacturing and production costs on a time basis, such as direct labor man-hours or machine-hours, is a method which generally produces accuracy and equity. Other acceptable methods of allocation, in appropriate circumstances, include direct labor dollars (~~exclusive of premiums for overtime, extra-pay shift, and multi-shift work~~) units processed, and prime costs of units processed. Departmentalization or the establishment of cost centers may be ~~necessary~~ permissable in order to allocate the indirect costs equitably. ~~Factors to be considered in determining the necessity for departmentalization or establishment of cost centers include variety of products, complexity of processes, and relative labor and facility requirements for the various products.~~

15-203.3 Indirect Engineering Costs.

Comment: In this section also the exclusion of premiums is objectionable as dictating the accounting system to be employed by the contractor and should be deleted.

Suggested Revision:

15-203.3 Indirect Engineering Costs. Indirect engineering costs include such items as costs of engineering supervision, engineering administration, and engineering supplies. Direct engineering activities from which indirect engineering costs may arise may include product design, tool design, experimental development, manufacturing and production development, layout of production lines, determination of machine methods, and related blueprinting and drafting. Indirect engineering costs shall be allocated to the benefited contract and other work of the contractor (see ASPR 15-204.2(u)(4)) on the basis of direct engineering man-hours expended, direct engineering labor dollars (~~exclusive of premiums for overtime, extra-pay shift, and multi-shift work~~), or some other equitable basis.

15-203.4 Selling and Distribution Costs.

Comment: The section as written is completely at variance with the current practice as provided in the existing Section XV, which allows selling and distribution activities which are related to the contract products. The following revision is suggested.

Suggested Revision:

15-203.4 Selling and Distribution Costs. The expenses in this group consist of items which represent the cost of marketing the contractor's products and may include such items as contract or order administration, negotiation, liaison between Government representatives and the contractor's personnel, advertising, distribution costs and other like services. Such expenses are allowable as a charge to Government cost reimbursement type contracts where it can be shown that they are related to the contractor's Government business and that the method of allocation is reasonable.

15-203.5 General and Administrative Costs.

Comment: This paragraph urges upon the auditor the use of the "total cost incurred" basis of allocating general and administrative expense, which method is not in general use in industry. Also in the listing of other acceptable methods it fails to include the "direct labor" method of allocation. In order to prevent dictating a preferred method and to permit the acceptance of any recognized method, it is recommended that all but the first two sentences of this paragraph be deleted.

Suggested Revision:

15-203.5 General and Administrative Costs. General and administrative costs consist of items of cost attributable to the overall management, supervision, and conduct of the business. Such costs shall be allocated to all work of the contractor, using any recognized method of allocation if equitable results are thereby obtained. ~~Allocation of general and administrative costs on a total cost incurred-basis (exclusive-of-general-and administrative-costs) is-a method which generally produces equitable results. Other methods acceptable-where the circumstances are appropriate include allocation on the basis of:~~

~~(i) processing-costs (direct-labor, factory overhead, and other factory production costs exclusive of direct materials);~~

~~(ii) factory input costs (processing costs plus direct material);~~

~~(iii) cost of goods completed;~~

~~(iv) cost of sales; and~~

~~(v) sales (where-no more satisfactory method is available)~~

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs

Comment: The draft of this paragraph fails to recognize certain advertising expenses which contribute substantially to the contractor's performance and should be allowable to the extent allocable to Government business.

It is recommended that subparagraph (iii) be added to the paragraph covering institutional advertising where the primary purpose is to promote the name of the company rather than an individual product. Such advertising is very similar to help wanted advertising and is frequently used to attract personnel and professional people such as engineers. Many companies rely upon this type of advertising in recruiting engineers rather than conventional help wanted advertising in the classified columns.

It is also recommended that subparagraph (iv) be added to cover other advertising from which the Government receives benefits. Such advertising under a regularly established program is reasonable for creating in being and maintaining the company's plants, facilities, trained personnel and know-how on which the Government relies for performance. Where advertising programs have been consistent over a period of years, the Government contracts should bear their fair share of the properly allocated current costs of such advertising.

Suggested Revision:

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include 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 sales literature. The following advertising costs are allowable:

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

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

(ii) help wanted advertising, as set forth in (s) below.

(iii) institutional advertising, which is defined as advertising the primary purpose of which is to promote the name of the company rather than individual products.

(iv) Other advertising directly or primarily relating to the advertising of the contractor's products in accordance with a regularly established program and to the extent reasonably allocable to Government business.

~~All other advertising costs are unallowable.~~

15-204.2 Costs Allowable in Whole or in Part

(d) Compensation for Personal Services.

Comment: While this paragraph constitutes a substantial improvement over the draft submitted to industry a year ago, it represents a substantial change from the present regulation in terms of the limitation placed upon deferred compensation plans, and in terms of the disallowance of reasonable compensation to sole proprietors or partners, unless specifically provided for in the contract. In order to maintain the status quo in the present regulation, it is recommended that the paragraph be revised as follows:

Suggested Revision:

15-204.2 Costs Allowable in Whole or in Part.

(d) Compensation for Personal Services. Compensation is allowable. The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits, salaries, wages, royalties, license fees and bonuses. The total compensation of an individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered. ~~Compensation to sole proprietors or partners, however, is allowable only to the extent specifically provided for in the contract.~~ Any plan upon which deferred compensation benefits are based, other than pension plans (see (p) below), shall meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service. ~~Also, the amount allowable under any such plan for apportionment to contracts in any one year shall not exceed:~~

(i) the amount contributed under the plan for that year; or

(ii) 15% of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan;

whichever is the lower.

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

15-204.2(e) Depreciation.

Comment: With minor revisions it is believed this section will adequately handle most of the problems which have arisen on this subject. Suggested revisions would (1) provide in subparagraph 3 ii that depreciation for contract costing purposes in the post-emergency period should be allowed on the unrecovered cost of the facilities, (2) delete the reference to current and immediately prospective production in paragraph 4 on the ground that this provision should include all such facilities reasonably necessary for standby purposes for Government work in general and (3) to forestall misinterpretation of subparagraph 5, provide that because an asset has been fully amortized it should not be considered fully depreciated.

Suggested Revision:

(3)(ii) after the end of the emergency period, shall be computed by distributing the remaining ~~undepreciated-portion-of-the~~ cost of the emergency facility not so recovered over the balance of its useful life. ~~(but-see-(4) below);-provided-the-remaining-undepreciated-portion-of-such-cost-shall-not-include-any-amount-of-unrecovered-"true-depreciation."~~

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

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Special amortization recorded on the contractor's books in accordance with a certificate of necessity is not to be considered as depreciation for the purposes of determining whether an asset has been fully depreciated. Use charges for assets not fully depreciated on the contractor's books are unallowable.

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

15-204.2 (g) Food Service Costs and Credits

Comment: This classification has become a widely used and generally accepted cost of doing business. Such programs have been generally adopted where they prove of direct benefit to the operations of the contractor. The expense of conducting these operations, which is a form of fringe benefit which employees expect, should be clearly allowable and should not be dependent upon an intention of the contractor to operate the services at either a profit or no loss. The gains and losses should be allocated to all benefited activities and losses should be allowable subject only to the test of reasonableness and allocability. This class of expense should not be limited to operations conducted "at the contractor's facilities" because frequently cafeterias or dining rooms and similar services are provided off the premises due to space limitations or the existence of desirable facilities conveniently located nearby.

Suggested Revision:

Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees, ~~at the contractor's facilities.~~ Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees) ~~at the site or sites of contract performance~~, accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable ~~when it is the policy of the contractor to operate such services at a profit or at cost;~~ provided, however, that such losses are allocated to all activities served. ~~When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.~~

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

15.204.2(i) Insurance and Indemnification.

Comment: (3)(ii) Deletion of this subparagraph is recommended because such insurance has become a recognized element in doing business and the entire cost should be allowed.

(3)(iii) These costs should be allowed unless the Government has specifically relieved the contractor or his subcontractors of the risks by contractual agreement.

(3)(iv) Provisions for losses under a self-insurance program should be allowable if such provisions are established on an actuarial or historical basis.

(4) It is recommended that this paragraph be deleted. It is logical to assume that normally both the Government and the contractor will desire to insure that adequate coverage is obtained. It would appear that in the absence of negligence on the part of the contractor indemnification by the Government against liabilities not compensated by insurance would therefore of necessity result from some totally unexpected occurrence which neither party could reasonably anticipate. For this reason, it is patently unfair to make the contractor responsible for insertion of express provisions to cover such contingencies.

Suggested Revision:

(3)(ii) ~~costs allowed for use and occupancy insurance shall be limited to exclude coverage of profit, interest, Federal income taxes, and any other items of cost unallowable under this Part;~~

(iii) costs of insurance or any reserve covering the risk of loss of or damage to Government-owned property are ~~un~~allowable except to the extent that the Government ~~shall have approved or required such insurance or reserve;~~ has specifically relieved the contractor or his subcontractors of the risks by contractual agreement.

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

(iv) ~~costs of providing a reserve for~~ Provisions for losses under a self-insurance program established on an actuarial or historical basis are ~~un~~allowable ~~unless the program has been approved by the Military Department concerned, and~~ subject to the tests of reasonableness and allocability under paragraph 15-201.

(4) ~~The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.~~

15-204.2(k) Maintenance and Repair Costs.

Comment: It is recommended that subparagraph 2 be deleted. In any operating plant and machine there is usually some element of deferred maintenance, and a combination of engineering and management skills is necessary if undue wear, plant breakdowns or other undesirable results are to be avoided. Management's decision as to when to repair is usually based on whatever action, or inaction, as to maintenance will produce a minimum effect on cost. Deferred maintenance arises from such causes as:

1. Inability to close a plant or part thereof, or remove a machine for repair without interfering with a production schedule.

2. The scheduling of periodic repair periods during which accumulated repairs and overhauls are made.

3. The relatively high cost of overhauling a single item as compared with the collective overhaul of a group of items during or following an operating period.

4. The lack of need for future efficiency as in the case of an item which is to be disposed of.

Military auditors and contracting officers will not be able to determine (a) deferred maintenance arising out of abnormal operating conditions and (b) when deferred maintenance has been delayed for a future period. It is believed that the retention of subparagraph 2 will cause an increase in the number of "costs questioned" and can only result in prolonged justification and argument and undue delay in settlement.

Suggested Revision:

(2) ~~Costs of maintenance and repair, which are delayed from a period prior to the contract for some reason such as abnormal operating conditions or~~

~~lack-of-funds-and-are-performed-during-the-contract-period,-are-unallowable unless-specifically-provided-for-in-the-contract.--Likewise,-the-estimated-cost of-maintenance-and-repair-normally-required-but-not-accomplished-during-the period-of-the-contract-are-unallowable-unless-specifically-provided-for-in-the contract.~~

(m) MATERIAL COSTS

Comments (1) No Comment

(2) No Comment

(3) No Comment

(4) The qualification contained in this sentence referring to equitableness of results has been deleted. The criteria of reasonableness and application of generally accepted accounting principles and practices, (paragraph 15-201-2 (i and ii) have already been recited and any further reference to reasonableness or equity seems needless and is at the same time undesirable. There can be no sound reason to further impliment or qualify the factors effecting allowability of cost since these factors in themselves will produce both reasonable andequitable results.

(5) The exclusion under (i) relating to "write-downs" and "write-ups" of value have been deleted on the basis that it violates the factor under 15-201.2 relative to the application of generally accepted accounting principles and practices. It is an accepted accounting principle that owing to technological advances, engineering changes, defects, self-wear, etc. 100% utilization of stock inventories will not be realized, and replacement value may be lower than the original cost. Where the contractor can demonstrate that the methods used to reduce the values of inventories are logical, and have been applied consistently over a period of years, and that prudence was exercised in acquiring the stocks involved, such inventory valuations should be allowed to the extent allocable to Government business.

(6) The proposed clause covering inter-company transfers in the original draft of Section 15 issued March 23, 1955 was not wholly acceptable to industry as evidenced by the revision submitted by NSIA on June 10, 1955, but it was at least susceptible to application and administration to Government contracts. This can not be said of the present proposed draft. The first part of this paragraph, whereby a contractor is not permitted to collect all of his own costs is not only unrealistic, but contrary to the concepts of a cost reimbursement type contract. Certainly, it is not the intent of the clause to deny reimbursement of the same types of costs which are allowed, in fact in other sections of this regulation, From a practical standpoint it would be placing an unfair burden on both the contractor and the contracting officer in attempting to fulfill administrative responsibilities which are inherent in the present wording. The inclusion of factors other than price which would warrant allowance on the basis of cost to the transferor only compounds the difficulties in administration of this clause and certainly places upon the cognizant audit agency a responsibility for evaluation which we doubt can be fulfilled.

The proposed redraft on this paragraph is based on the principle that where a contractor has an established plan for pricing "inter-unit" shipments and can show that such pricing is based on competition, he is entitled to such a price as a part of contract costs. This is further borne out by the fact that the Services will recognize purchases of the same or like items made from sources outside of the contractor's business as a legitimate item of contract cost and which, of course, include overhead, general and administrative expense and profit. There are too many instances at hand where the Contracting Officer has been obliged to refuse to recognize the price of an article normally manufactured and sold competitively even though that price is lower than any that could be obtained from outside sources. If

the Government were contracting separately with each division or department of a large Company for standard items of the kind this clause covers it would expect to pay the going market price and not some lower amount because of the versatility of the Company's organization. Therefore, it would appear that such a Company which is set up to manufacture numerous unrelated items is penalized as compared to a Company which is not in a like position. It is felt that this is basically wrong and must be corrected.

We have, therefore, recommended deletion of the entire paragraph and substituted our proposed revisions.

Suggested Revisions:

(1) Costs of direct and indirect material, and collateral items such as inbound transportation and intransit insurance, are allowable, subject, however, to (2) through (6) below. In computing costs of material, consideration will be given to reasonable overruns, spoilage, and defective work (for correction of defective work, see the provisions of the contract relating to inspection and to correction of defective work.)

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

(3) When material is purchased specifically for and identifiable solely with performance under a contract, the actual purchase cost thereof should be charged to that contract.

(4) If material is issued from stock, any generally recognized method of pricing such material is acceptable if that method is consistently applied. ~~and the results obtained are equitable.~~ Where materials in stock at the commencement date of the contract have a provable replacement cost significantly higher than book cost, the contractor may use a methods of pricing based upon the fair value of the materials as of the date of the contract, but in excess of replacement cost on such date.

(5) Reasonable charges or credits arising from differences between periodic physical inventory quantities and related material control records shall be included in arriving at the cost of performance if such charges or credits (i) ~~do not include "write-downs" or "write-ups" of the value, and~~ (ii) relate to the period of performance of the contract.

(6) ~~Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of:~~

- ~~(i) the cost to the transferor; or~~
- ~~(ii) the prices of other suppliers for the same or substantially similar items;~~

~~whichever is the lower, unless factors other than price warrant allowance on the basis of the cost to the transferor; provided that, in the case of any item regularly~~

~~manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed~~

~~(i) the transferor's sales price to its most favored customer for the same item in like quantity, or~~

~~(ii) the prices of other suppliers for the same or substantially similar items,~~

~~whichever is the lower, unless factors other than price warrant allowance on the basis of the transferor's sale price to its most favored customer.~~

(6) If a contractor has an established method for pricing sales or transfers of materials, supplies and services between plants, divisions, or organizations, under a common control, any such materials or supplies manufactured and sold by any such transferor in the regular courses of its business may be charged to the contract as materials and supplies at a price which does not exceed the lower of (i) the transferor's price customarily charged to its most favored non-affiliated user customer for the same item or service in like quantity; (ii) the prices charged by other suppliers for the same or substantially similar items or services.

All other sales or transfers between such plants, divisions or organizations shall be charged to the contract on the basis of total cost to the transferor.

Materials and supplies furnished by a contractor's prime location, which are manufactured and sold in the regular course of its business may be charged to the contract as materials and supplies at a price which does not exceed the lower of (i) the prime location's price customarily charged to its most favored non-affiliated user customer for the same item in like quantity or (ii) the price charged by other suppliers for the same or substantially similar items.

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

15-204.2(o) Patent Costs.

Comment: It is believed that all costs leading to the issuance of patents as well as infringement, investigation and litigation should be regarded as allowable costs. The wording in the proposed redraft is unduly restrictive inasmuch as it implies that only those costs specifically mentioned are allowable. The last sentence has been deleted since it appears unnecessary and in conflict with the rest of the paragraph.

Suggested Revision:

All costs leading to the issuance of patents, the cost of infringement, investigation and litigation, 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. ~~Upon the written authorization of the contracting officer, 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 (u) amd (v) below.)

15-204.2 (p) Pension Plans

Part 6 of Section XV heretofore set forth interpretations of the cost principles applying to pension and retirement plans. Such interpretations were guiding rather than mandatory. This proposed paragraph includes material previously set forth in Part 6; if Part 2 is to be incorporated in contracts as in the past this will result in the incorporation of procedural matter rather than of basic principles. This can give rise to serious negotiating problems. It would be preferable if the material in Part 2 could be confined to the basic principle that pension costs are allowable. Separately there could be set forth in a related Part, such as Part 6, interpretations and other material necessary for the guidance of auditors or contracting officers.

In addition to the above general suggestion the following comments are offered on this paragraph and have given rise to the suggested revision:

(1) Pension plans of commercial enterprises (other than tax-exempt, non-profit institutions) are already subject to the approval requirements of the Internal Revenue Service. Approval by the Military Departments could be an unnecessary burden and expense since pension plans of individual firms are formulated with the approval requirements of the Internal Revenue Service in mind.

(2) Pension and retirement plans may be established which are dependent upon profits. Such plans, if approved by the Internal Revenue Service, should be acceptable to the Military.

(3) Allowable costs of pension plans should not be limited by the amounts claimed and deductible in the current taxable period. Allocation of cost between years on the basis of Internal Revenue technical limits, which may disallow in one year and pick up in subsequent years, is impractical and should not be required so long as a consistent method of contribution is followed by

the contractor.

(4) Subparagraph 3(iv) has been revised to recognize that contractor's methods of determining costs may already reflect reasonable provisions for the effect of reversionary credits, in which event no special provision should be required. Where special provision for such credits should be made, no particular methods should be prescribed since this is a procedural matter rather than one of basic principles. Such cases should be handled by a method to be negotiated based on individual circumstances involved.

Suggested Revision:

(1) A pension plan is a plan which is established and maintained by a contractor primarily to provide systematically for the payment of definitely determinable benefits to its employees over a period of years, usually for life, after retirement. Such a plan may include disability, withdrawal, insurance, or survivorship benefits incidental and directly related to the pension benefits. Such benefits, generally, are measured by, and based on, such factors as years of service and compensation received by the employees. ~~The determination of the amount of pension benefits and the contributions to provide such benefits are not dependent upon profits. Benefits are not definitely determinable if funds arising from forfeitures on termination of services or other reason may be used to provide increased benefits for the remaining participants instead of being used to reduce the amount of contributions by the employer.~~ A plan designed to provide benefits for employees or their beneficiaries to be paid upon retirement or over a period of years after retirement shall be considered a pension plan if under the plan, eitherthe benefits payable to the employee or the required contributions by the contractor can be determined actuarially. ~~(Retirement plans which are based on profit sharing shall not be considered to be pension plans within this paragraph (p).)~~

(2) ~~Consideration, and approval or disapproval, of all pension plans and the method of determination of the costs thereof shall be the responsibility of the Department to which audit cognizance is assigned and subsequent action taken by that Department will, generally, be accepted by the other Departments. Such~~ Pension plans must meet the qualification requirements prescribed by Section 401 of the Internal Revenue Code of 1954 (P.L. 591, 83rd Cong., 2nd Sess., 68A Stat. 134). Prior ~~to~~ approval of such plans by the ~~cognizant Department, approval by~~ Internal Revenue Service shall be obtained in the case of:

(i) contractors who are subject to Federal income tax, and

(ii) nonprofit or tax-exempt contractors who have submitted their plans for approval by Internal Revenue Service;

~~however, approval of a plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the Department concerned.~~ In the case of all other plans, compliance with the qualification requirements of Section 401 of the Internal Revenue Code of 1954 shall be determined by the

cognizant Department using, insofar as applicable, the regulations, criteria, and standards of the Internal Revenue Service.

(3) ~~To the extent pension plans are approved by the cognizant Military Department,~~ costs ~~thereof~~ of approved pension plans are allowable subject to the following conditions:

(i) the requirements of ASPR 15-201.2 shall be satisfied;

~~(ii) such costs, including excess contributions (see Section 404(a)(1)(D) of the Internal Revenue Code of 1954) shall not exceed~~

~~(A) the amount claimed and deductible for Federal income tax purposes in the current taxable period, or~~

~~(B) in the case of nonprofit or tax-exempt organizations, the amount which could have been claimed and deducted for Federal income tax purposes in the current taxable period had such organizations been subject to the payment of income tax;~~

~~(iii)~~ (ii) in cases where the Internal Revenue Service withdraws approval of a plan or in the case of plans not subject to Internal Revenue Service approval where the cognizant Department using, insofar as applicable, the regulations, criteria and standards of the Internal Revenue Service, determines that approval of the plan should be withdrawn, an appropriate adjustment of contract costs ~~shall~~ may be made for contributions which previously have been allocated to and allowed as contract costs and which

(A) are disallowed for tax purposes; or

(B) in the case of nonprofit or tax-exempt organizations could have been disallowed for tax purposes had such organizations been subject to the payment of income tax; and

~~(iv)~~ (iii) in determining the ~~not~~ reasonableness of pension plan costs allocable to military contracts, ~~and in addition to making appropriate adjustments for credits or gains arising out of normal employee turnover,~~ consideration shall be given, ~~in accordance with (A) or (B) below,~~ to possible future ~~abnormal~~ termination credits or gains which may arise with respect to individuals for whom pension plan costs have been or are being incurred by the contractor but whose employment will terminate before they acquire a vested right to the benefits under such plans. Where the contractor can demonstrate that reasonable provision has been made for the effect of such reversionary credits in his method of determining pension contribution, no special provision for these credits is required. Otherwise, it will be expected that an arrangement

will be made which will result, as nearly as may be practicable, in the Government's receiving the benefit of these credits to the same extent as it originally participated in the related costs.

~~(A) When such abnormal termination credits or gains are foreseeable and can be currently evaluated with reasonable accuracy, an equitable adjustment of current costs to give effect to such anticipated future credits or gains shall be made, either by reducing the current costs otherwise allocable, or by obtaining realistic recognition in the actuary's calculation of current costs, so that the current costs do, in fact, reflect the reduction for the abnormal termination credits or gains which are anticipated, and such adjustments shall be reflected in the contract, in an amendment thereto, or in some other writing binding on the Government and the contractor, or~~

~~(B) When such abnormal termination credits or gains, whether or not foreseeable--~~

~~(I) cannot be currently evaluated with reasonable accuracy, or~~

~~(II) have not been the subject of adjustment under (A) above,~~

~~pension plan costs incurred under the contract shall be subject to retrospective accounting and any necessary adjustment for such subsequent termination credits or gains unless the Government and the contractor agree upon a method of determining such adjustment, or agree upon an equitable adjustment, any such agreement shall be reflected in the contract, in an amendment thereto, or in a separate agreement binding on the Government and the contractor.~~

(4) The allowability of costs of lump sum purchases of annuities or of lump sum cash payments or periodic cash payments made to provide pension benefits for retiring or retired employees other than such costs incurred under approved pension plans shall be subject to consideration on an individual case basis.

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

15-204.2(r) Professional Service Costs - Legal, Accounting, Engineering and Other.

Comment: (1) This paragraph as written singles out the costs of professional services rendered by members who are not employees of the contractor, and establishes factors for determining allowability which are inequitable. Whether or not professional people are on the contractor's staff or separately engaged should not be a factor in determining the allowability of the costs of their services.

(2) In addition, the past pattern of such costs, the impact of Government contracts on his business, the nature of his own organization, etc. should also not be determining factors as to allowability. The scope and extent of Government regulations, the changing requirements of contract clauses and peril of loss in connection therewith make it necessary that the contractor avail himself of professional assistance. As a class, such costs should be allowable subject to the application of the basic principles and standards set forth in 15-201 relating to reasonableness and allocability.

(3) The cost of successful defense of anti-trust suits and the successful prosecution of claims against the Government should also be allowable. The last sentence appears unduly restrictive. Rather than restricting allowability to those instances in which provision is made in the contract, it is recommended that such costs be subject only to the test of reason and allocability. We suggest the clause be rewritten as follows:

Suggested Revision:

(1) Costs of professional services rendered by the members of a particular profession whether as members of the contractor's organization or separately engaged ~~who are not employees of the contractor~~ are allowable, subject to (2) and (3) below, when reasonable and allocable in accordance with the basic principles and standards of 15-201. ~~in relation to the services rendered and when not contingent upon recovery of the costs from the Government (but see ASPR 15-204.3(g)).~~

NSIA SUGGESTED REVISION TO
DOD DRAFT 4/20/56 SECTION XV

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

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

~~(ii) the impact of Government contracts on the contractor's business,~~

~~(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~~ are allowable ~~must be~~ when reasonably supported by evidence of services rendered.

(3) Costs of legal, accounting, and consulting services, and related costs, incurred in connection with organization and reorganization, unsuccessful defense of anti-trust suits, and the unsuccessful 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.~~

(t) RENTAL COSTS (INCLUDING SALE AND LEASEBACK OF FACILITIES

Comments (1) No Comment

(2) The deleted provisions would actually penalize contractors leasing from common control as with the contractors who have conventional leases, even though the rental charges are the same for both or where the charges under the former are actually lower. It would be very rare indeed to find a conventional lease where only the rental rate is equivalent to normal costs, such as depreciation, taxes, insurance and maintenace expenses.

(3) It is recommended that Clause (3) be modified since Clause (1) seems to provide adequate safeguards. This clause apparently seems to protect the Government from a possible situation where rental under a leaseback was set at an arbitrarily high value. The basic rule of reasonableness set forth in Clause (1) which indicates that rates must be reasonable in light of the type, life expectancy, condition, and value of the facilities leased, appears to give the Government complete protection. If this clause is permitted to remain as is in the regulations, the Government would actually be penalizing companies who have sale and leaseback arrangements as contrasted with companies holding conventional eases. It would be very rare indeed to find a conventional lease where the rental rate was equivalent to "normal costs, such as depreciation, taxes, insurance and maintenance expenses," attributable to the facilities leased.

Likewise, it appears the Government also has in Clause (1) adequate protection against any situation where a contractor might arrange option terms under a leaseback, so as to permit re-acquisition of the property at a price substantially less than its value as a result of high rental payments. Note that Clause (1) provides for a check of option arrangements and other provisions of rental agreements for the purpose of determining reasonableness.

Suggested Revisions:

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

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

(3) Unless otherwise specifically provided in the contract, rental costs specified in the sale and leaseback agreement, incurred by contractors through selling plant facilities to investment organization, 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 rental costs ~~such as depreciation, taxes, insurance, and maintenace, borne by the lessor which would have been incurred had the contractor retained legal title to the facilities~~ for similar property from other sources.

15-204.2(u) Research and Development Costs.

Comment: (2) General research covered in this paragraph should be allowable subject to the application of the basic principles and standards set forth in 15-201 relating to reasonableness and allocability rather than being dependent upon specific contract coverage. In addition, the last sentence of this paragraph should be deleted. Agreeing to divulge results is a very unfair condition for determination of allowability because general research is of benefit to all business. By agreeing to divulge results of such research and with no protection or guarantee that such information will not be made available to others, research upon which a contractor may have devoted millions of dollars and for which the Government is only a partial contributor can be forfeited to competitors at no cost to them. This appears particularly inequitable in view of the fact that the Government has no need for such information, since the results of general research can be applied to Government production and the Government can be automatically apprised and benefit from such results without it.

(3) In connection with related research on a product or product line to which a specific research and development contract relates, there is just as much benefit accruing to the research contract as would accrue to a production contract. Therefore, no distinction should be made as to allowability of cost. In addition, the last sentence of this paragraph should be deleted for the same reasons as enumerated in (2) above.

(4) This paragraph requiring research and development projects to absorb indirect costs should be deleted since it is inconsistent with the principles and standards proposed in 15-201.4 which permits the consistent application of accounting principles of the contractor.

(5) Revision of this paragraph is necessary to preclude automatic disallowance of research costs deferred from prior periods pending the determination of the proper accounting disposition of those costs when such costs would otherwise be approved by the Contracting Officer as allocable research costs at the time proper disposition can be determined.

Suggested Revision:

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

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable if reasonable and equitably allocated to all work of the contractor. ~~to the extent specifically provided in the contract. The contractor shall disclose to the Government the purposes and results of such independent general research.~~

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (1) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type ~~production~~ contract; provided the research and development are related to the contract product line. ~~and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost reimbursement type 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, shall not be allocated to that contract unless approved by the contracting officer or allowable as precontract costs (see ASPR 15-204.3(j)).

(v) ROYALTIES AND OTHER COSTS FOR USE OF PATENTS

Comments: Royalties and fees paid for the use of patents are normal expense items and allowance thereof as a cost against Government contracts should not be subject to specific advance approval. The Government is adequately protected by the test of allocability and no further restrictions appear to be necessary or warranted.

Suggested Revisions:

Royalties on a patent or invention, or amortization of the cost of acquiring a patent or invention or rights thereto, necessary for the proper performance of the contract and applicable to contract products or processes, are allowable to the extent ~~expressly set forth in the contract or otherwise authorized by the contracting officer; provided that where the Government has a license or the right to free use of the patent or invention such costs are unallowable; and provided further that where the patent has been adjudicated to be invalid such costs incurred thereafter are unallowable.~~ such costs are allocable to Government contracts.

(w) SEVERANCE PAY

Comments: The proposed draft of item (ii) would make it mandatory that all contracts provide in the final release a reservation that abnormal severance payments would be recoverable. This would create a lack of finality in Government contracts which neither the contractor or the Government would find acceptable.

From an accounting concept the proposed clause is both impracticable and infeasible. The fact that employment periods of terminated employees extend back over a number of years would make it impossible of administration.

Suggested Revisions:

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

(2) Costs of servance 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 servance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on otherwork of the contractor are allowable. ~~shall be assigned to the entire period of employment of the terminated employees and equitably allocated to all work performed in the contractor's plant during that period. A reservation in the final release may be made when it is reasonable to assume that severance pay allocable to the contract will be made in the future.~~

(cc) TRAVEL COSTS

Comments (1) No Comment

(2) The provisions of 15-201.2 (i) and (ii) should be the criteria for the allowability of such costs. No further restrictions are necessary or warranted.

(3) Comments in (2) above apply here as well.

(4) The burdensome and time consuming requirement of obtaining contracting officer approval on personnel movement of a mass or special nature should be eliminated. The proposed change gives the Government the protection required while permitting quick contractor decision and action.

Suggested Revisions:

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

(2) Travel costs incurred in the normal course of overall administration of the business and applicable to the entire business are allowable, and shall be allocated consistent with the contractor's established practice. ~~Such costs shall be equitably allocated to all work of the contractor,~~

(3) Subsistence and lodging including tips or similar incidental costs are allowable either on an actual or per diem basis. ~~The basis selected shall be consistently followed.~~ The method or methods used shall be consistent with the established practice of the contractor.

(4) Costs of personnel movement including those of a special or mass nature are allowable ~~only when authorized or approved in writing by the contracting officer~~ when properly allocated.

~~15-204.3-(e)~~ 15-204.2 (ee) Contributions and Donations

Comment: Contributions and Donations recognized for income tax purposes should be allowable subject to the usual tests of reasonableness and allocability. These items are a necessary business expense. Industry is being looked to and has a civic responsibility to bear its share of expenses related to local, state and national community activities as represented by non-profit health, welfare and educational institutions. Government policy has been to encourage industry in these regards and the costs thereof have been recognized for income tax purposes.

Suggested Revision

Contributions and donations ~~are unallowable~~ to established non-profit organizations such as religious, charitable, scientific and educational organizations, which are recognized as such by the Treasury Department are allowable provided that such costs are reasonable and are properly allocated to all work. The propriety of the amount of particular contributions and donations and the aggregate thereof for each fiscal period must be judged ordinarily in 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.

~~15-204.3-(d)~~ 15-204.2 (ff) Entertainment Costs

Comment: Such costs should be allowable to the extent that it can be demonstrated that such expenses are ordinary and necessary to the business of a contractor.

Suggested Revision

Costs of amusement, diversion, social activities and incidental costs relating thereto, such as meals, lodging, rentals, transportation and gratuities are unallowable. (~~but see ASPR 15-204.2-(g)-(h)-and-(i)-~~).

Comments: Where a contractor has made special plant changes in order to introduce Government contracts into his production, the cost of these contracts is not complete unless it includes both the cost of installation and the cost of restoring the facility to its original condition. This paragraph limits the allowable reconversion costs to the costs of removing Government property and the costs caused by such removal if specifically provided for in the contract. This excludes the costs of removing the contractor's own facilities which were converted to or acquired for the production of Government work and also excludes the costs of reestablishing the facilities consistent with the demands of his regular business. Both of these categories of costs are occasioned by the introduction of Government business and should be allowed as costs of Government contracts.

This section uses the term "incurred", which has been interpreted by the Government to mean "expended". Actually the liability for such costs is incurred at the time the facilities are converted to Government business. Generally reconversion costs are not paid for until after completion of performance of the Government contracts which occasioned them. Furthermore, most of the costs may not be expended until most or all of the contractor's Government business occasioned by the Defence Emergency is completed. Unless accruals for such costs are allowed as costs of the Government work which occasioned them while the contracts are in process, there is no effective way to recover the costs. Accruals in this category are not in the nature of "contingencies" in that a definite liability has been incurred. While the amounts involved may not be susceptible to exact determination in advance, reasonable accruals should be allowed.

Suggested Revision:

Reconversion costs are those incurred in or accrued for the restoration of the contractor's facilities to approximate the same physical arrangement and condition existing immediately prior to commencement of the military contract work ~~and include the cost of removal of Government property.~~ Reconversion costs are allowable. ~~Reconversion expenses are not allowable except that the cost of removing Government property and the restoration costs caused by such removal are allowable if specifically provided for in the contract.~~

~~15-204.3-(e)~~ 15-204.2(hh) Excess Facility Costs

Comment: Industry is continuously faced with changing needs for plant capacity because of changes in production levels. Such fluctuations may result from doing business with the Government. To the extent that excess plant is reserved for Government production the cost of such capacity should be recoverable as a charge against current Government business or recovered under a separate Government contract. Circumstances may not always justify a separate contract.

Suggested Revision:

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

~~15-204.3-(g)~~ 15-204.2 (ii) Interest and Other Financial Expenses

Comment: NSIA views upon this subject were presented to the Honorable Charles E. Wilson in a letter dated 3 September 1954 attached to which was a statement entitled "Allowability of Interest on Borrowed Capital in Military Contract Pricing". Supplementing these, a letter dated February 7, 1956 was submitted to the Honorable Reuben B. Robertson, Jr. by Mr. J. K. Richards enumerating further reasons why these costs should be allowed. A copy is attached.

Suggested Revision:

Interest (however represented), bond discounts, costs of financing and refinancing operations, legal and professional fees paid in connection with the preparation of the prospectus, costs of preparation and issuance of stock rights, and costs related thereto are allowable. ~~unallowable except for interest assessed by State or local taxing authorities under the conditions set forth in ASPR 15-204.2(y) (but see ASPR 15-204.2(aa)(i)).~~

NATIONAL ASSOCIATION of MANUFACTURERS
OF THE UNITED STATES OF AMERICA
2 EAST 48TH STREET · NEW YORK 17, N. Y.

June 1, 1956

Mr. Lloyd H. Mulit
Director of Requirements, Production
and Distribution
Office of the Assistant Secretary of Defense
(Supply and Logistics)
Room 3E822, The Pentagon
Washington, D. C.

Dear Mr. Mulit:

On behalf of NAM's Government Contracts Committee I should like to thank you for having our representatives attend the May 21, 1956 meeting at the Pentagon to discuss the April 20th Revision of ASPR Part 2, Section XV, Contract Cost Principles. In my opinion, this exchange of views creates a favorable atmosphere for a better appreciation between Government and industry representatives of the problems of each.

The NAM representatives at this meeting, Messrs. M. E. Moulton and Edward T. Whitehead, advise that the Defense Department considers it essential to issue the revised set of Cost Principles, with possible minor modifications, in the very near future. We are informed, however, that careful consideration will be given to comments from interested industry groups which are submitted no later than June 4.

Initially, it seems desirable to summarize the understanding reached at the May 21 meeting relative to research and development, compensation and the non-applicability of the new Cost Principles to current contracts.

While industry representatives were given to understand that no change would be made at the present time in the existing ASPR XV with respect to research and development and compensation, it developed at the meeting that the language of the present draft actually represented a material change. It was then agreed that these provisions would be re-examined by your staff to determine whether revision was necessary to avoid any misunderstanding or misapplication.

In view of these apparent discrepancies, we urge that such sections be amended as follows to conform with present Section XV:

15-204.2 (d) Compensation for Personal Services.

Delete the following at the end of the paragraph:

"Any plan upon which deferred compensation benefits are based, other than pension plans (see (p) below) shall meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service. Also, the amount allowable under any such plan for apportionment to contracts in any one year shall not exceed:

(i) the amount contributed under the plan for that year; or

(ii) 15% of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan;

whichever is the lower."

15-204.2 (u) Research and Development Costs.

Delete from paragraph (2) the last sentence which now reads:

"The contractor shall disclose to the Government the purposes and results of such independent general research."

Delete from paragraph (3) the last portion which reads:

"and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost-reimbursement type research and development contracts."

It would also be necessary to change the preceding phrase of the draft so that it would read "are allowable under any cost-reimbursement type contract" instead of "under any cost-reimbursement type production contract". In other words, eliminate the word "production".

Furthermore, it appears that this latest revision may result in contractors absorbing even more of their business costs than under present Section XV. Hence we feel that the revision finally adopted should not under any circumstances be made applicable to current contracts. During the discussion at the May 21 meeting, Mr. Pilson of your office advised our representatives that a statement would be included to the effect that the new Section XV would be applicable only in the case of contracts entered into ninety days after its publication. This would, of course, cover our objection.

We should like to emphasize and supplement the foregoing and are, therefore, enclosing as Attachment A detailed views on a number of provisions which we consider to be of extreme importance to industry. It is our hope that the Department of Defense will be receptive to these recommendations which we believe would prove fair to both Government and industry.

Generally speaking, our comments on the present revision of Section XV are the same as those submitted with respect to the draft circulated about a year ago. These views were forwarded to Admiral Thomas by letter dated June 20, 1955, a copy of which is also enclosed as Attachment B.

We know, of course, that careful consideration will be given to our suggestions and shall be glad to discuss them further at your convenience. In this connection, our representatives advise that the desirability of even more discussions between those drafting policies and industry members affected thereby, was emphasized at the meeting. By so doing, we believe considerable progress could be made toward arriving at statements of principles agreeable to Government and industry.

Sincerely yours,

G.P.F. Smith

George P. F. Smith, Chairman
NAM's Government Contracts Committee

GPFS:rce
Enclosures

NO INCLOSURES RETAINED

ATTACHMENT A

SUGGESTED CHANGES TO ASPR SECTION XV, PART 2
PROPOSED REVISION (April 20, 1956)

15-203.1 General.

(c) The base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for distribution to work performed in that period. The base period shall be representative of the period of contract performance and shall be sufficiently long to avoid inequities in the allocation of costs, but normally no ~~in no event~~ longer than the contractor's fiscal year. When the contract is performed over an extended period of time, as many such base periods will be used as will be required to represent the period of contract performance.

COMMENT

The second sentence in this paragraph includes the provision that the base period for determining overhead would be "in no event longer than the contractor's fiscal year." This arbitrary restriction seems unnecessary and we would recommend that the wording be changed to read as indicated.

15-203.4 Selling and Distribution Costs. Selling and distribution costs arise through marketing the contractor's products and include the costs of sales promotion, advertising, distribution, and other related activities. ~~Generally, such costs are not allowable as a charge to Government cost reimbursement type contracts (but see ASPR 15-204.2(b)).~~ ~~However~~, Subject to the other provisions of this Part, costs in this category, including supervisory and clerical costs, which relate to technical, consulting, and other beneficial services, and which are for purposes such as application and adaptation of the contractor's products, ~~rather than pure selling~~, are allowable if a reasonable benefit to Government contracts is demonstrated. Such costs shall be allocated to the contractor's commercial work and its individual Government contracts on an equitable basis. Because of the special problems that arise in this area, the contractor should identify in its records, by means of sub-accounts or otherwise, the items of selling and distribution cost considered properly allocable to Government contracts.

COMMENT

Before revision, this paragraph states that these expenses are unallowable unless a "reasonable demonstration of benefits to Government contracts" can be shown. Our suggested rephrasing switches the emphasis from generally unallowable to generally allowable. Since bidding expenses are recognized as allowable items of cost in 15-204.2(b), we believe that other types of selling and distribution expenses should be treated in a like manner.

15-204.2 Costs Allowable in Whole or in Part.

(a) Advertising Costs. Advertising costs include 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 sales literature. The following advertising costs are allowable:

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

(ii) Help wanted advertising, as set forth in (s) below.

(iii) General institutional and educational advertising should be evaluated as to allowability in the light of direct and indirect benefits to Government business.

(iv) Product advertising is a selling and distribution expense and should be allowable in accordance with paragraph 15-203.4 to the extent properly allocable to Government business.

~~All other advertising costs are unallowable.~~

COMMENT

These changes will permit consideration of cases where advertising charges are part of Government contract costs.

(c) Civil Defense Costs. 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. Costs of capital assets acquired for civil defense purposes shall be depreciated in accordance with (e) below. ~~Except as specifically provided for in the contract, contributions to local civil defense funds, or to projects not on the contractor's premises, are unallowable.~~

COMMENT

In the public interest, many contractors enter actively into civil defense programs of their community, even to the extent of loaning equipment and personnel to take part in the overall program. As a matter of public policy, the Government encourages support of these programs by industry. Disallowance of such costs cannot fail to discourage this active participation by manufacturing companies. At the very least, provision should be made to make this the subject of special negotiation in the light of all attendant circumstances, without the need of negotiating a special contract provision.

(d) Compensation for Personal Services. Compensation is allowable. The term "compensation" includes all amounts paid or set aside, such as pension, retirement, and deferred compensation benefits, salaries, wages, royalties, license fees and bonuses. The total compensation of an individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered. Compensation to sole proprietors or partners, however, is allowable only to the extent specifically provided for in the contract. ~~Any plan upon which deferred compensation benefits are based, other than pension plans (see (p) below), shall meet the requirements of the applicable provisions of the Internal Revenue Code and the regulations of the Internal Revenue Service. Also, the amount allowable under any such plan for apportionment to contracts in any one year shall not exceed:~~

~~(i) the amount contributed under the plan for that year; or~~

~~(ii) 15% of the total compensation otherwise paid or accrued in that year to the individuals covered under the plan;~~

~~whichever is the lower.~~

COMMENT

In general, the revision appears to recognize that compensation of necessity must be adjudged on the basis of reasonableness. However, an arbitrary limit of 15% is used in determining the allowability of deferred compensation. This limitation nullifies the reasonableness test and should be deleted.

(e) Depreciation.

(5) Unless otherwise provided for in the contract, no use charge shall be allowed for assets still in use which have been fully depreciated on the contractor's books or acquired without cost. Special amortization recorded on the contractor's books in accordance with a certificate of necessity is not to

be considered as depreciation for the purposes of determining whether an asset has been fully depreciated. Use charges for assets not fully depreciated on the contractor's books are unallowable.

COMMENT

To forestall an interpretation by Government personnel to the effect that an asset which has been fully amortized should be condidered fully depreciated, it seems that it would be desirable to insert in this paragraph after the first sentence the additional sentence included above.

(g) Food Service Costs and Credits. Food services include operating or furnishing facilities for cafeterias, dining rooms, canteens, lunch wagons, vending machines, or similar types of services for the contractor's employees at the contractor's facilities. Profits (except profits irrevocably set over to an employee welfare organization of the contractor in amounts reasonably useful for the benefit of the employees at the site or sites of contract performance) accruing to the contractor from the operation of these services, whether operated by the contractor or by a concessionaire, shall be treated as a credit, and allocated, to all activities served. Reasonable losses from operation of such services are allowable when it is the policy of the contractor to operate such services at a profit or at cost; provided, however, that such losses are allocated to all activities served. ~~When it is the policy of the contractor to furnish such services at a loss, losses on such operation shall not be allowed as a cost unless specifically provided for in the contract.~~

COMMENT

Cafeterias, dining rooms and other food services are in the category of 15-204.2(f), "Employee Morale, Health, and Welfare Costs and Credits." It should not be necessary to negotiate a special contract provision to cover this item of expense. Notwithstanding the intent of making a profit, loss or merely to break even, the net cost or profit of operating cafeterias, dining rooms and other food services should be allowed in the same manner as health and welfare activities incurred for the improvement of working conditions, of employee-employer relations and of employee performance.

(i) Insurance and Indemnification.

(3)(iv) costs of providing a reserve for a self-insurance program are ~~unallowable unless~~ if the program has been approved by the Military Department concerned; and

COMMENT

It is recommended that the present wording be revised as shown to eliminate the emphasis on the unallowability of such reserves.

(4) ~~The Government is obligated to indemnify the contractor only to the extent expressly provided for in the contract. Therefore, except as otherwise expressly provided for in the contract, actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are unallowable.~~

COMMENT

Although we are not certain of the exact meaning, it appears to us that Paragraph 4 should be deleted. It is logical to assume that normally both the Government and the contractor will desire to insure that adequate coverage is obtained. It would appear that in the absence of negligence on the part of the contractor indemnification by the Government against liabilities not compensated by insurance would therefore of necessity result from some totally unexpected occurrence which neither party could reasonably anticipate. For this reason, it is patently unfair to make the contractor responsible for insertion of express provisions to cover such contingencies.

(k) Maintenance and Repair Costs.

(2) ~~Costs of maintenance and repair, which are delayed from a period prior to the contract for some reason such as abnormal operating conditions or lack of funds and are performed during the contract period, are unallowable unless specifically provided for in the contract. Likewise, the estimated cost of maintenance and repair normally required but not accomplished during the period of the contract are unallowable unless specifically provided for in the contract.~~

COMMENT

The allocability of deferred maintenance expenses to Government contracts should be a matter of negotiation between the contractor and contracting officer. The stipulation that these expenses are allowed only if they are covered by a specific contractual provision is unduly restrictive.

(m) Material Costs.

(6) Costs of material or services sold or transferred between plants, divisions, or organizations, under common control, shall be allowable only to the extent of:

(i) the cost to the transferor; ~~or~~

~~(ii) the prices of other suppliers for the same or substantially similar items;~~

~~whichever is the lower, unless factors other than price warrant allowance on the basis of the cost to the transferor;~~ provided that, in the case of any item regularly manufactured and sold by any such transferor through commercial channels, a departure from this cost basis is permissible if the charge to the contract does not exceed:

(i) the transferor's sales price to its most favored customer for the same item in like quantity; or

(ii) the prices of other suppliers for the same or substantially similar items;

whichever is the lower, unless factors other than price warrant allowance on the basis of the transferor's sales price to its most favored customer.

COMMENT

It is recommended that the deletion indicated should be approved in consideration of the administrative burden involved in its implementation.

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

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

COMMENT

The last sentence appears unduly restrictive. Rather than restricting allowability to those instances in which provision is made in the contract, it is recommended that such costs be subject only to the test of reason and allocability.

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

(1) Rental costs of land, buildings, and equipment and other personal property are allowable if the rates are reasonable in light of such factors as the type, life expectancy, condition, and value of the facilities leased, options available, and other provisions of the rental or leaseback agreement.

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

COMMENT

We recommend the above changes on the basis that clause (1) provides adequate safeguards. Clause (3) apparently seeks to protect the Government from a possible situation where rental under a leaseback was set at an arbitrarily high value. The basic rule of reasonableness set forth in clause (1), which indicates that rates must be reasonable in light of the type, life expectancy, condition and value of the facilities leased, appears to give the Government complete protection. If clause (3) is permitted to stand, the Government would actually be penalizing companies who have sale and leaseback arrangements as contrasted with companies holding conventional leases. It would be very

rare indeed to find a conventional lease where the rental rate was equivalent to "normal costs, such as depreciation, taxes, insurance, and maintenance expenses" attributable to the facilities leased. Likewise it appears the Government also has in clause (1) adequate protection against any situation where a contractor might arrange option terms under a leaseback so as to permit re-acquisition of the property at a price substantially less than its value as a result of high rental payments. Note that clause (1) provides for a check of option arrangements and other provisions of rental agreements for the purpose of determining reasonableness.

(u) Research and Development Costs.

(2) General research is that type of research which is directed toward increase of knowledge in science. In such research, the primary aim of the investigator is a fuller knowledge or understanding of the subject under study, rather than a practical application thereof. Costs of independent general research (that which is not sponsored by a contract, grant, or other arrangement) are allowable to the extent specifically provided in the contract. ~~The contractor shall disclose to the Government the purposes and results of such independent general research.~~

(3) Related research is that type of research which is directed toward practical application of science. Development is the systematic use of scientific knowledge directed toward the production of useful materials, devices, methods, or processes, exclusive of design, manufacturing, and production engineering (see (1) above). Costs of a contractor's independent related research and development (that which is not sponsored by a contract, grant, or other arrangement) are allowable under any cost-reimbursement type ~~production~~ contract; provided the research and development are related to the contract product line and the costs are allocated to all production work of the contractor on the contract product line; ~~and provided further that the contractor discloses to the Government the purposes and results of the research and development. Such costs are unallowable under cost reimbursement type research and development contracts.~~

COMMENT

Agreeing to divulge results is a very unfair condition for determination of allowability because general research is of benefit to all business. By agreeing to divulge results of such research and with no protection or guarantee that such information will not be made available to others, research upon which a contractor may have devoted millions of dollars and for which the Government is only a partial contributor can be forfeited to competitors at no cost to them. This appears particularly inequitable in view of the fact that the Government has no need for such information, since the results of general research can be applied to Government production and the Government can be automatically apprised and benefit from such results without it.

In connection with related research on a product or product line to which a specific research and development contract relates, there is just as much benefit accruing to the research contract as would accrue to a production contract. Therefore, no distinction should be made as to allowability of cost.

(cc) Travel Costs.

(4) Costs of personnel movement of a special or mass nature are allowable. ~~only when authorized or approved in writing by the contracting officer~~.

COMMENT

Under this sub-paragraph the Government is denying recovery of personnel transfer costs, except as specifically authorized in writing by the contracting officer, when such transfer is of a "special or mass nature". First, "special or mass nature" is a matter of opinion and is not clearly defined. Secondly, if contractors were to accept such a restriction, CPFF contracts would not carry a fair share of these costs which represent present-day normal costs of doing business. Furthermore, dispersion of activities is in accordance with Defense Department recommendations. In summary, we believe the cost of such personnel movement should be allowable, without specific authorization by the contracting officer.

15-204.3 Unallowable Costs.

(c) Contributions and Donations. ~~Contributions and donations are unallowable~~.

Contributions and donations to established nonprofit charitable scientific and educational organizations are allowable provided that such costs are reasonable and are properly allocated to all work.

The propriety of the amount of particular contributions and donations and the aggregate thereof for each fiscal period must be judged ordinarily in 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 the deductibility of the contribution for income tax purposes does not in itself justify its allowability as a contract cost.

COMMENT

The necessity for supporting charitable and educational institutions, etc. is as normal a cost of doing business as is, for example, the payment of local taxes. Continuing support by industry of the country's privately financed educational institutions is of paramount importance to the nation's welfare. No one derives more benefit from such support than does the Government through its research and development contracts.

ATTACHMENT B

COPY

WESTON ELECTRICAL INSTRUMENT CORPORATION

NEWARK 5, NEW JERSEY

June 20, 1955

Rear Admiral L. H. Thomas, USN
Office of the Assistant Secretary
of Defense (Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Admiral Thomas:

Attached is a statement of comments prepared by the Government Contracts Committee of the National Association of Manufacturers upon the draft of a proposed revision of Part 2, Section XV, Armed Services Procurement Regulation.

We compliment you and your staff for developing this draft for industry's consideration. We are all well aware of the difficulties encountered in its preparation and though we have certain serious objections to it, we consider the development of this new draft a major step toward finalizing a substantially better set of contract cost principles than those in effect today.

We firmly believe, too, that the Office of the Assistant Secretary of Defense (Supply and Logistics) is the proper organization within the Department of Defense to have primary responsibility for improving the existing contract cost principles inasmuch as the basic issues have a procurement policy character, overriding in importance the related technical accounting aspects.

We also want you to know of our appreciation for having the opportunity to submit these comments and our readiness to be of assistance to you whenever you may wish. We would welcome the chance to discuss the whole subject with you at your convenience.

Sincerely,

(s) Ross Nichols

Ross Nichols, Chairman
Government Contracts Committee
National Association of Manufacturers

NATIONAL ASSOCIATION OF MANUFACTURERS
GOVERNMENT CONTRACTS COMMITTEE

STATEMENT RE MARCH 23, 1955 DRAFT OF
PROPOSED REVISION OF PART 2, SECTION XV,
ARMED SERVICES PROCUREMENT REGULATION

Our views are broadly divided into General Comments and Specific Comments. In the former category, we consider the following two fundamental issues:

1. Proper Application of the Proposed Contract Cost Principles. Contract cost principles are an important tool in contract administration, but instructions for the use of this tool are lacking. Past and present experience with the misuse of the cost principles indicate the need for firm ground rules governing their use.

2. Extent to which the Department of Defense Will Pay Its Fair Share of the Contractor's Costs. Arbitrary disallowances by the Department of Defense of some of the contractor's true costs are not consonant with sound business practice.

In our judgment, these two issues override other considerations. They should be faced up to and clearly disposed of as a matter of first priority in the total undertaking of revising the existing contract cost principles.

Our views on these two issues underlie the observations which are set forth in the second part of this statement under the heading of Specific Comments. Here we indicate our thoughts on specific paragraphs and language of the proposed revision.

G E N E R A L C O M M E N T S

Proper Application of the Proposed Cost Principles

The merits of contract cost principles cannot be weighed apart from the manner in which the cost principles are used. The question of what cost principles say is, to be sure, logically distinct from the question of how they are used. The reality of the matter, however, demands that the two questions be treated as inseparable. For years now Part 2, Section XV, ASPR has asserted that the cost principles therein are for use in cost reimbursement type contracts, and for years the cost principles have been applied to fixed price contract situations so as virtually to transform fixed price contracts in many instances to cost type contracts.

A bulwark against this undesirable trend in contract administration has been established by Department of Defense Instruction 4105.11 (November 23, 1954). However, this single instruction is not enough by itself to reverse a long-standing practice of treating price revision negotiations as though they were on a cost basis. Military auditors, for example, are still under Joint Letter No. 12, which occasions the treatment of fixed price contracts as cost type contracts by emphasizing the use of Part 2, Section XV cost principles in fixed price contract situations.

The point is that no matter how sound these cost principles may be, they should not be used to derogate contract pricing negotiations to a formula basis whereby price is essentially determined by adding together allowable costs and a profit allowance. There is need for specific instructions delimiting the use of these principles, distinguishing between

two entirely different kinds of contracts--the fixed price type and the cost type. In the absence of such instructions, there is inadequate basis for assuming that the cost principles--regardless of their content--will not continue to be misused in pricing proceedings pertaining to fixed price contracts.

These instructions must not only be controlling over the procurement line of command, they must also be binding upon the audit line of command. Indeed, the whole issue of the proper use of cost principles is wrapped around the relationship between military buyers and military auditors. The proper relationship is one where the buyers have the freedom of decision for determining when and the extent auditors are needed and how their findings are used. Similarly, as auditors are in a service role to buyers, they should not be placed in a position of dominating or second guessing the very ones whom they are supposed to serve. It is submitted that if the buyer-auditor relationship were better defined, much of the misuse of contract cost principles would be corrected.

Our recommendation, therefore, is that the revised statement of cost principles should be accompanied by well-defined instructions delimiting their applicability. Such instructions, which should reflect the above considerations, might be set forth in an expanded Paragraph 15-200 or in Part 1, Section XV. In any event, the cost principles should not be released without adequate guide lines as to how they should and should not be used, otherwise the same old abuses of the past may be expected and the opportunity for accomplishing a major improvement in contract administration will not be realized.

Extent to Which the Department of Defense Will Pay Its Fair Share of a Contractor's Costs

Our standard for measuring the validity of the several paragraphs reciting allowability or non-allowability of contractor costs is stated briefly as follows:

> Unless there is overriding public policy to the contrary, the Department of Defense should pay all of a contractor's costs which are allocable to Department of Defense business in accordance with generally accepted accounting principles as may be reasonably applied to such business.

This is simply recognizing that the Department of Defense should pay its fair share of the contractor's costs. Anything less is unsound business practice.

General rules arbitrarily classifying legitimate costs of a contractor as unallowable for purposes of contract pricing are by and large inimical to the proposition that the government will pay its fair share of costs. Whereas under a reasonable allocation of costs to government contracts the government may very well not share at all or share to only a very limited degree in certain costs, the absolute disallowance of legitimate costs from any consideration regardless of their allocability to government contracts is detrimental to the full and proper use of cost type contracts. The revised cost principles should shift the emphasis from the question of what is allowable to the question of what is reasonably allocable.

Since varying circumstances defy the application of inflexible rules and since sound accounting practice is open to differing judgments, appropriate allocability of certain costs in a given set of circumstances might very well be expected to be a subject about which reasonable men

might disagree. The resolution of differing opinions in such circumstances should be regarded as a matter of negotiation between the contractor and the contracting officer within a broad framework of good accounting practice and fairness. This approach toward handling cost allocation questions is in keeping with the reality that cost allocations in many instances cannot be determined with scientific exactitude and are not properly the subject of arbitrary rules.

S P E C I F I C C O M M E N T S

15-201 - BASIC PRINCIPLES AND STANDARDS. Reference to the exercise of good business judgment as a factor in determining the allowability of costs is repetitive of the test of reasonableness and invites second guessing. Accordingly, the reference should be deleted.

Provision should be made to recognize standard costs and associated variances whenever their use is consistent with the contractor's accounting practice. Such costs are the equivalent of actual costs.

15-202.1 - DIRECT MATERIALS. Costs of reasonable overruns, spoilage and defective work should be provided for.

15-202.2 - DIRECT LABOR. Use of average or standard rates if such is in keeping with the contractor's established practice should be provided for.

15-203.3 - SELLING AND DISTRIBUTION EXPENSES. The broad statement that these expenses are not generally allowable is unfair. The proper approach is to indicate that the government should pay its share of these ordinary business expenses to the extent that they may be reasonably allocable to government contracts.

15-204.1 - ADVERTISING. The severe limitation upon allowable costs of advertising is unfair. The proper approach is to indicate that the government should pay its share of these ordinary business expenses to the extent that they may be reasonably allocable to government contracts.

15-204.2 - BAD DEBTS. The flat prohibition of allowing bad debt expenses is unfair. Again, the norm of reasonable allocability should prevail. This is particularly pertinent to bad debts in connection with subcontracting.

15-204.4 - CAFETERIAS, DINING ROOMS AND OTHER FOOD SERVICES. The limitation upon the allowability of these ordinary business expenses when the subject services are intentionally furnished at a loss is unwarranted.

15-204.5 - CIVIL DEFENSE. The exclusion of contributions for projects not on contractor's own premises is unreasonable. Effective civil defense cannot be localized to individual plant sites.

15-204.6 - COMPENSATION FOR PERSONAL SERVICES. The arbitrary percentage limitations provided as tests of allowability of certain costs should be eliminated in favor of the standard of reasonableness.

15-204.7 - CONTINGENCIES. The blanket disallowance of contingencies is unrealistic. When a liability exists, a reasonable estimate thereof should be permitted.

15-204.9 - DEPRECIATION. As a matter of consistent accounting procedure and good business practice, depreciation recognized by the Internal Revenue Service should be allowed. Double standards are undesirable.

15-204.11 - ENTERTAINMENT EXPENSE. Unless there is an overriding public policy to the contrary, entertainment expenses reasonably allocable to government contracts should be recognized.

15-204.12 - EXCESS FACILITIES. The proposed basis for allowing costs of maintaining and housing idle and excess facilities is too narrow. The government should share an allocable portion of the contractor's costs for carrying idle and excess facilities which are reasonably necessary to his operations.

15-204.15 - INITIAL PRODUCTION COSTS. Provision for possible disallowance of excessive initial production costs should be deleted. If the government does not choose to pay costs of a contractor under the indicated circumstances, it should terminate the contract.

15-204.16 - INSURANCE AND INDEMNIFICATION. Intrusion of procurement agencies into areas which are management functions through approval requirements should be discouraged. The test of reasonableness of coverage and of rates is sufficient.

15-204.17 - INTEREST AND OTHER FINANCIAL EXPENSES. To the extent that these expenses are reasonably allocable to government contracts, they should be accepted.

15-204.20 - MAINTENANCE AND REPAIRS. The allocability of deferred maintenance expenses to government contracts should be a matter of negotiation between the contractor and contracting officer. The stipulation that these expenses are allowed only if they are covered by a specific contractual provision is unduly restrictive.

15-204.25 - OVERTIME, EXTRA PAY SHIFT AND MULTI SHIFT PREMIUMS. Contractor should have reasonable freedom of judgment with respect to premium pay to indirect labor. The unqualified requirement for government approval is needlessly burdensome.

15-204.27 - PENSION AND RETIREMENT PLANS. This paragraph, which now contains material beyond the requirements of a statement of cost principles, should be confined to the proposition that the government should pay such portion of the expense of Internal Revenue Service (IRS) approved pensions and retirement plans as may be reasonably allocable to government contracts. When these plans are not subject to IRS approval, the usual test of reasonableness should apply.

15-204.30 - PROFESSIONAL SERVICES - LEGAL, ACCOUNTING, ENGINEERING AND OTHER. Subparagraph (c) should be dropped. The cost of professional services in connection with organization and reorganization matters and with patent infringement litigation is covered elsewhere (15-204.23 and 15-204.26), and the cost of professional services for the other purposes indicated in subparagraph (c) is an ordinary business expense of which government contracts should bear a fair portion.

15-204.33 - RECRUITING EXPENSE. Costs of special benefits or emoluments should be subject to the contracting officer's approval. Their unqualified disallowance is unwarranted.

15-204.34 - RENTALS OF PLANT AND EQUIPMENT. As the general rule of reasonableness applies, the special regulations on sale and leaseback agreements should be dropped.

15-204.35 - RESEARCH AND DEVELOPMENT. Arbitrary percentage limitations provided as a condition of allowability of costs should be eliminated. The rule of reasonableness should apply.

Similarly, the requirement for a contractor to divulge to the government the results of his independent research should be stricken. The requirement is unfair.

15-204.36 - ROYALTY PAYMENTS. To the extent allocable to government contracts, royalty payments should be recognized without special approval action.

15-204.38 - SEVERANCE PAY. It is impractical to establish in advance a fixed method of allocating to government contracts the costs of mass severance pay. The basis of allocation should be open to negotiation.

15-204.42 - TRAINING EXPENSES. The provisions are unnecessarily restrictive. The rule of reason should apply.

15-204.44 - TRAVEL EXPENSES. The central point should be more explicitly stated; namely, that the government should pay the portion of the contractor's reasonable travel expenses allocable to government contracts. Reference to entertainment expenses should be deleted as this subject is covered elsewhere (15-204.11).

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WASHINGTON 6, D. C.
REpublic 7-6512

June 4, 1956

Mr. L. H. Mulit
Director of Requirements, Procurement and Distribution
Office of the Assistant Secretary of Defense
(Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Mr. Mulit:

We are glad to have this opportunity to comment on the recently proposed revision of Part 2, Section XV, of the Armed Services Procurement Regulation. We appreciate particularly your courtesy in extending the deadline for submission of such comments in order to permit a more representative expression of views on this important subject by the Institute, in behalf of capital goods manufacturers, and by other organizations.

Background

Before addressing ourselves to a detailed review of the proposed regulation, we should like to consider briefly certain larger issues which concern the history of contract cost principles, the present status of those principles, and their probable future scope and application.

During most of the period of effectiveness of the present Part 2, Section XV, ASPR, contracting officers have been permitted not only to employ these principles in the administration of cost-reimbursement type contracts but to use them as a "working guide" in the negotiation of prices under fixed-price contracts. Largely as a result of industry objections that contract cost principles were being frequently misapplied to fixed-price contracts, this permission was revoked by DOD Instruction 4105.11. We have, as you know, already expressed our approval of that directive and we desire to reaffirm our stand.

In revoking this permissive authority to use contract cost principles as a working guide in fixed-price contract negotiations, there was an evident lack of coordination between procurement and audit. As we understand it, military auditors have continued, notwithstanding the provisions of DOD Instruction 4105.11, to follow an internal audit instruction (Joint Audit Regulation

No. 12, August 5, 1949) which authorizes application of ASPR XV cost principles in the preparation of advisory audit reports and segregation of costs without regard to the type of contract involved. The result would seem to be a negation of the intent of procurement by the practice of audit.

General Comments

We are now commenting on the second draft of a proposed revision of Part 2, Section XV, ASPR, the first draft having been circulated for industry comment about a year ago. We understand that the Department of Defense is determined to proceed with early publication of the current proposal--in substantially its present form--subject to an ex post facto review of contributions to profit-sharing plans, charitable contributions and donations, and expenses of general research. We are aware of the considerations prompting such publication by the Department of Defense but we have serious misgivings about the project on at least two grounds.

First, the current proposal is a far more precise and definitive document than the regulation which it would replace and its very definitiveness may be more of a defect than a virtue because of the very nature of costing questions. If it does not in fact enlarge the list of unallowable items of cost, then it does, at the very least, tend toward arbitrary disallowance of contract costs in situations of the widest possible variability and in which, we believe, some area for special negotiation should remain.

In addition, we are informed that the early publication of this proposed regulation anticipates the promulgation of a comprehensive set of cost principles applicable to all contracts. Almost certainly, the publication of the present proposal will upset in some measure the whole complex of pre-existing contractual relationships in this area between the government and its cost-type contractors. And these same relationships face similar and further confusion in the planned publication within the next few months of the over-all set of contract cost principles.

It would be improper, of course, to prejudge a comprehensive set of cost principles not yet in being. But we cannot fail to express our general apprehension at a prospect which appears to us to represent a step backward. Having freed fixed-price contract negotiations from the narrow limits of Part 2, Section XV, of ASPR, by its publication of DOD Instruction 4105.11 noted above, the Department of Defense appears now to be preparing for a retrograde movement.

Assuming, without admitting, that a generally acceptable set of fixed-price contract cost principles could be developed, we are inclined to question the wisdom of its adoption. The effect might well be to impose a strait jacket of predetermined allowability and unallowability upon contract situations the character of which cannot possibly be predicted.

Within this context, let us consider directly the recent draft of Part 2, Section XV, of the Armed Services Procurement Regulation.

ASPR cost principles versus generally accepted commercial accounting principles.--The current draft of proposed contract cost principles makes frequent reference to generally accepted accounting principles. The application of such principles is, of course, a factor directly affecting allowability of costs. We cannot fail to reiterate that cost principles here proposed do not agree in many important respects with general commercial accounting practices.

Inasmuch as our remarks which follow deal at length with individual items of cost, it will suffice at this point to make the general observation that the proposed cost principles disallow categorically a variety of business expenses generally accepted in commercial practice--and by tax authorities--as normal costs of doing business. In our opinion, this incompatibility of military contract cost principles with commercial accounting practice is very often inequitable, uneconomic from the over-all standpoint of the government and, in many cases, wholly unjustified.

Items for special consideration.--As in the past, this latest draft of Part 2, Section XV, ASPR, expressly disallows a number of cost items, the character of which may vary widely as between individual contracting situations. Examples which come to mind immediately are general advertising, charitable contributions and donations, selling and distribution expenses, and entertainment expenses.

We shall have more to say with reference to each of these items of cost at an appropriate place in our detailed comments but we should like to register at this point our general observation that the allowance of these costs--and quite possibly certain others--should be made a matter of special negotiation depending upon individual circumstances in each case.

Specific Recommendations

Our suggestions which follow apply to pertinent subject and paragraph headings of draft regulations, as indicated below. As to those items on which we have not commented, the views expressed in our letter of June 20, 1955 (reproduced in MAPI Bulletin 3286, copy attached) still apply.

Direct costs (paragraph 15-202).--The language of subparagraph 15-202.2, "Direct Material Costs", does not specifically include spoilage, defective work, etc., although we assume that such items of cost would be regarded as allowable within the intent of the phrase "which are directly consumed or expended in the performance of a contract". We are not necessarily suggesting that these items be specifically included, but we should like some confirmation or assurance that spoilage, defective work, etc., are not excluded.

Indirect costs (paragraph 15-203.1).--Under the terms of the new regulation, the base period for allocation of indirect costs can "in no event" be longer than the contractor's fiscal year period. We submit

that this arbitrary restriction seems unnecessary and we recommend that the language of subparagraph 15-203.1(c) be changed to indicate that the base period will not normally be longer than the contractor's fiscal year.

Indirect manufacturing and production costs (subparagraph 15-203.2).--If "units processed" cannot be construed to include "weight processed", then the latter standard should, we believe, be included since many industries use weight processing as a basis for indirect cost allocation.

Indirect engineering costs (subparagraph 15-203.3).--This subparagraph of the proposed regulation indicates that indirect engineering costs shall be allocated on the basis of direct engineering (by dollars or hours). It is entirely conceivable that a contractor may have a contract covering items procured commercially, in which case no direct engineering, as such, would be directly applicable to the contract. Under such circumstances, would the contractor be denied a normal apportionment of engineering expenses as a contract cost? If this is the effect of the proposed language, we believe the regulation should be revised to recognize this situation.

Selling and distribution costs (subparagraph 15-203.4).--We disagree with the proposition--necessarily implicit in this proposed section--that selling and distribution expenses are unnecessary in obtaining government business. As in the case of advertising, these expenses are customary costs of doing business and are especially related to the continuing growth and vigor of the business enterprise and, as such, contribute materially to the whole of the company's productive capacity. Although not perhaps directly allocable to any contract work, the government may nevertheless be the beneficiary of substantially lower production costs made possible by the volume and scale of operations that the contractor has attained through the incurrence of such expenses.

It is, of course, true that the subparagraph as now written would allow as contract costs certain selling and distribution expenses "if a reasonable benefit to government contracts is demonstrated". The whole emphasis of the section, however, is in the direction of disallowing such items of cost; indeed, the contractor must assume the affirmative duty of accounting separately for all items of selling and distribution expenses "considered properly allocable to government contracts" and must thereafter, presumably, be prepared to demonstrate to contract auditors direct benefit to the government from any distribution and selling expenses which he may claim.

We suggest that the emphasis which this language places upon disallowance should be eliminated. At the minimum, we recommend deletion in its entirety of the second sentence as well as the phrase "rather than pure selling".

General and administrative costs (subparagraph 15-203.5).--We should like to suggest for possible inclusion in this subparagraph--as an additional method of acceptable allocation--the relation of the actual or

estimated time of individuals engaged under the contract to total general and administrative expenses.

Advertising costs (subparagraph 15-204.2(a)).--This is one of the cost items to which we have made special reference in our introductory comments. The proposed revision to ASPR, as in the past, would restrict the allowance of advertising costs to institutional advertising in trade and technical journals and to help-wanted advertising.

We feel it necessary to reiterate the consistent position of the Institute with reference to the allowance of advertising costs. Institutional advertising, regardless of the media employed, is a real cost of doing business and the pro rata share of such costs should be allocated under cost-type government contracts along with other general and administrative expenses. At the very least, this item of expense should be allocable to government contracts on the basis of a showing of benefits to the government, direct or indirect, in accordance with the standard established by subparagraph 15-203.4 for the allowance of selling and distribution costs. Again, the narrow restriction which this proposed regulation places on the allowance of advertising costs appears to ignore the situation of the manufacturer who furnishes military items at the expense of his normal civilian business and who, during an emergency period, must resort to institutional advertising for the retention of his normal markets.

We have already outlined our views with reference to the allowability of selling and distribution expenses under cost-type government contracts. Those views apply with equal force to the categorical disallowance by the proposed regulation of product advertising costs which are, of course, a form of selling and distribution expenses, and from which the government has long derived demonstrable benefits in the form of enhanced productive capacity and lowered product prices. Such costs should be allowable subject to normal allocation and subject to the further safeguard of individual negotiation as an item of selling and distribution expenses.

Civil defense costs (subparagraph 15-204.2(c)).--We must confess that we are completely unable to understand the restriction on allowability of civil defense costs to expenditures made on the contractor's premises and the inclusion of an express prohibition against reimbursement for contributions to local civil defense funds. Clearly, the government desires the widespread support by industry of civil defense programs. This we think is a wholly desirable policy and one which is of special importance in smaller communities.

Numerous government contractors enter into the civil defense programs of their respective communities, their participation including not only direct financial contributions but the loan of company equipment and personnel. This active participation by manufacturing companies in local civil defense programs cannot fail to be discouraged by disallowance of contributions to local civil defense funds or to projects not on the contractor's premises. As a minimum and, in

accordance with the general observation included in our introductory comments, we recommend that items now generally disallowed by the proposed subparagraph be made the subject of special negotiation in the light of all attendant circumstances and without the necessity of negotiating special contract provisions in advance. We are taking the liberty of bringing this matter to the attention of Governor Val Peterson, Federal Civil Defense Administrator.

Compensation for personal services (subparagraph 15-204.2(d)).--This section of the proposed revision represents, we believe, an improvement over the language of the proposed revision circulated last year. In general, the revision recognizes that the allowability of compensation for personal services is to be judged on the basis of reasonableness under all the circumstances. This, we believe, is the proper test.

Unfortunately, the subparagraph retains the 15-per-cent-of-total-compensation restriction to which we objected in our earlier statement. The effect is substantially to negate the test of reasonableness upon which the newly drafted subparagraph appears to be based. Moreover, this restrictive test appears unnecessary, in the light of the wholly proper statement that "the total compensation per individual may be questioned and the amount allowed may be limited; and in connection therewith, consideration will be given to the relation of the total compensation to the services rendered".

As we have indicated in an earlier statement, there is the widest variation in industry as among profit sharing and bonus plans and their relationship to straight salaries. Hence, the imposition of an arbitrary percentage limitation would almost certainly produce erratic and inequitable results. The determination of compensation for personal services is a matter for executive judgment and we believe that the reasonableness of total compensation, in the light of the current labor market and general business practice, is the proper criterion for the allowance of costs for personal services.

No mention is made in this subparagraph of contributions to profit sharing plans although such contributions were made allowable subject to certain restrictions in the earlier draft of this regulation. We believe that the present draft should be amended to affirm the allowability of contributions to profit sharing plans subject only to the general test of reasonableness of such contributions.

The cost of stock bonus plans was also made allowable by the earlier draft of this regulation but no mention of the allowability or unallowability of such costs appears in the current draft. Again we suggest a reinstatement of appropriate language making clear that the costs of stock bonus plans are, subject to the test of reasonableness, allowable under cost-reimbursement type contracts.

Finally, the earlier draft of this regulation specifically disallowed as a contract cost the value of stock options. No mention of the subject is made in the currently proposed regulation. We believe that

this form of compensation should be made generally allowable in final regulations and we repeat below our earlier statement on the subject.

> "The disallowance as a contract cost of the value of stock options to contractor personnel is contrary to a growing practice in American industry that is, in many cases, of benefit to the government as well as to the corporation involved. Clearly such options are intended to induce the continuous employment of key corporate employees, the retention of whom may materially affect productivity, efficiency and cost reduction. The cost of such options is recognized as a business expense for tax purposes, and although we are not suggesting that such costs be allowed indiscriminately for government contract purposes, we do believe that such items should be made the subject of special negotiation in individual cases."

Depreciation (subparagraph 15-204.2(e)).--We note that this section authorizes the use of any system of depreciation accounting recognized by Section 167 of the Internal Revenue Code of 1954. We commend this addition to the prior draft.

It appears that the term "fully depreciated" as used in the proposed regulation may be interpreted to include those assets which are fully amortized under a certificate of special amortization, thus excluding recoveries on any substitute basis after five years for certified facilities.

The proposed regulation indicates that no use charge is to be allowed for assets still in use which have been fully depreciated unless such cost is allowable by virtue of a special contract provision. Recognizing that such charges are not deductible for tax purposes, they are, we believe, perfectly legitimate charges in the costing of a product. We recommend, therefore, that consideration be given to allowing a reasonable use charge for such facilities without the necessity of resorting to individual contract negotiations on the point.

Finally, we urge that subparagraph 15-204.2(e)(5) be further amended to include as the second sentence the following statement: "Special amortization recorded on the contractor's books in accordance with a certificate of necessity is not to be considered as depreciation for the purposes of determining whether an asset has been fully depreciated."

Food service costs and credits (subparagraph 15-204.2(g)).--In the absence of a special contract provision, losses on food services provided by the contractor are unallowable as a contract cost where it is the policy of the contractor involved to furnish such services at a loss. The employee benefits of cafeterias, dining rooms and other food services fall, we submit, within the category of "Employee Morale, Health and Welfare Costs and Credits" covered by subparagraph 15-204.2(f) of the draft regulation.

Alternatively, they may be regarded as a type of fringe benefit covered by proposed subparagraph 15-204.2(h). It seems to us unnecessary for a contractor to negotiate specially in order to recoup allocable expenses of supplying food services to employees notwithstanding the presence or absence of an intent to make a profit by the operation of food services. The net cost of operating such services should be allowed as a contract cost in the same manner as the costs of fringe benefits or of health and welfare activities incurred for the improvement of working conditions of employee-employer relations and of employee performance.

Insurance and indemnification (subparagraph 15-204.2(i)).--The costs of providing a reserve for a self-insurance program are declared to be unallowable unless the program has been approved by the military department concerned. We suggest that the regulation be amended to authorize generally the allowance of such costs subject to the restriction that they should not be reimbursed in an amount exceeding rates charged for similar coverage by commercial insurance companies.

Maintenance and repair costs (subparagraph 15-204.2(k)).--Allowability of maintenance expenses deferred from a prior period or to a later period should, we believe, be a matter of individual negotiation between the contractor and the contracting officer. In our view, the present stipulation that such expenses are to be allowed only as they are covered by a specific contractual provision is unduly restrictive and should be appropriately modified.

Overtime, extra-pay shift and multishift premiums (subparagraph 15-204.2(n)).--Expenses of this type are allowable only to the extent expressly provided for in the contract or otherwise authorized by the government. While the language of this section is generally unobjectionable, we feel that it may ignore a situation which we believe it should consider. We have in mind the case in which the manufacturer's production lines contain identical products intended for both civilian and military customers. Under this type of operation it seems wholly impractical to require a separation of overtime premiums on those items intended for delivery under military contracts. If the language now proposed in this subparagraph does not contemplate this type of situation, then we recommend appropriately amendatory language.

Pension plans (subparagraph 15-204.2(p)).--We believe that disallowance of contributions to pension plans where benefits are not actuarily determinable must be reconsidered in the light of the Comptroller General's Decision B122489, dated March 8, 1956, and which is concerned with allowance for contract purposes of the costs of a similar retirement plan of the Rheem Manufacturing Company.

We note that approval of a pension plan by the Internal Revenue Service does not necessarily assure the allowance of the costs of such a plan by the military department concerned, although the rationale underlying this rule is entirely unclear. The regulation should be amended to provide that approval of a pension plan by the Internal Revenue Service will authorize reimbursement of the costs of such a plan under cost-reimbursement type contracts.

Rental costs (including sale and lease-back of facilities) (subparagraph 15-204.2(t)).--We urge the deletion of subparagraph (3) appearing in this section of the draft regulation. We think it unnecessary in the light of the test of reasonableness laid down by subparagraph (1). Taken together, the effect of subparagraphs (1) and (3) as now written is to penalize companies which have sale or lease-back arrangements, as contrasted with companies holding conventional leases.

We think it would be rare indeed to find a conventional lease where the rental rate was equivalent to "normal costs, such as depreciation, taxes, insurance and maintenance expenses" attributable to the facilities leased. Moreover, it appears to us that the government has in subparagraph (1) sufficient protection against any situations where a contractor might arrange option terms under a lease-back so as to permit reacquisition of the property at a price substantially less than its value as a result of high rental payments. We believe that the general test of reasonableness appearing in subparagraph (1) is adequate and we repeat our suggestion that subparagraph (3) be deleted from the regulation.

Research and development costs (subparagraph 15-204.2(u)).--As we have suggested in our earlier statements on this point, we believe that general research on the part of industry should be encouraged by the government as a matter of public policy and that the allocable portions of cost so incurred should be reimbursed under cost-type contracts without requiring as a condition of such reimbursement an agreement that the contractor divulge to the government the results of independent general research. As a condition of contract cost allowability, a government contractor may be required to forfeit under the terms of this proposed regulation immensely valuable rights to the government and, through it, to competitors, at no cost whatsoever to the latter. In this respect, the proposed regulation is, we submit, both inequitable and shortsighted.

If there are cases in which the government feels obliged to require a complete divulgence of the results of research, we recommend that such disclosures be made invariably a matter for special contract negotiation. We recommend further that the last sentence of subparagraph (2) be deleted in its entirety or appropriately modified in accordance with these suggestions.

On this same theory, we see no purpose in distinguishing between the allowability of costs of a contractor's independent related research and development under a cost-type production contract and under a similar research and development contract.

Travel costs(subparagraph 15-204.2(cc)).--The meaning of the phrase "personnel movement, special or mass nature", is by no means clear from the language employed in this subparagraph and would appear, in any case, to be a matter of opinion. Costs of such personnel movement are made allowable only when authorized or approved in writing by the contracting officer.

This restriction, if we understand it clearly, is another example of the government's disinclination to accept a fair share of the normal cost of doing business. The dispersal of defense activities is in accordance with general government policy and specific Department of Defense recommendations. We believe, therefore, that the cost of such personnel movements should be allowable without special authorization from the contracting officer but subject, of course, to the general test of reasonableness under all the circumstances.

Contributions and donations (subparagraph 15-204.3(c)).--We are completely unable to understand the reasons which underlie the categorical disallowance of contributions and donations. Industry regards the cost of supporting established nonprofit charitable, scientific and educational organizations as a normal cost of doing business. Government encourages such charitable contributions as a matter of national policy. Moreover, the federal revenue laws recognize the propriety and desirability of such contributions as a matter of public policy.

Although we do not suggest that any diminution of charitable contributions will necessarily result from this aspect of the proposed regulation, the fact remains that the policy here proposed cannot fail to act as a deterrent to such contributions by manufacturing companies. This is of special importance in smaller communities where failure to contribute to charitable funds would almost certainly result in higher local taxes--which would, of course, be deductible under this same set of proposed cost principles.

The timing of the announcement that contributions and donations are unallowable could not be less propitious. At the very moment that industry is being enjoined by authorities on every hand to assist financially in the improvement of technological education, the Pentagon rules that no portion of such contributions is to be considered reimbursable as a contract cost. Accordingly, we are taking the liberty of bringing this phase of contract cost principles to the attention of the President's National Committee for the Development of Scientists and Engineers.

At the risk of unnecessarily lengthening this discussion, it should be pointed out that government--federal, state and local--is in fact the principal beneficiary of contributions and donations not only in the form of lower taxes as the result of a lessened charitable burden, but through an enlarged and improved system of higher education.

We strongly urge, therefore, that allocable portions of contributions and donations be made allowable items of expense under cost-type contracts subject, of course, to the general test of reasonableness which applies to the reimbursement of any cost item.

Interest and other financial costs (subparagraph 15-204.3(g)).--The express disallowance of interest and other financial charges is

consistent with long-standing Defense policy on the subject. Moreover, this policy has for a number of years been consistently applied to costs incurred under all types of government contracts.

The recent decision of the Armed Services Board of Contract Appeals--Appeal of Wichita Engineering Company--ASBCA No. 2522, holds that interest is no longer automatically excludable as an allowable cost under a fixed-price contract subject to price redetermination. This decision of the Board, confirmed in part by the subsequent Gar Wood Case, would appear to represent a reversal of earlier ASBCA decisions, notably the Rainier Case.

Although we recognize that the Wichita Engineering Company Case is not directly in point, since the cost principles here under consideration apply to cost-type contracts only, we believe that the decision requires a further consideration of the question. Not only does the case represent a significant reversal of the policy heretofore applicable to all types of contracts but it requires legal hair-splitting of the highest order to hold that interest under a cost-type contract is any less of an actual expense than that incurred under a fixed-price type contract.

GENERAL CONCLUSIONS

The Institute's letter of June 20, 1955, on this subject emphasized three basic propositions implicit in our approach to the proposed revision of contract cost principles. We have reviewed that earlier statement of general conclusions on this subject, in the light of the current revision of Part 2, Section XV, ASPR, and we believe that our observations in that letter apply with equal force today. They are, accordingly, reproduced in full below.

> "In the first place, we consider it exceedingly important that this revision be completed in the light of the procurement problems existing today and in the foreseeable future. Procurement continues at a very substantial magnitude even though it is nowhere near the wartime point. There is, of course, a continuing problem in connection with the procurement of aircraft, guided missiles, etc., although no unique purchasing problems are raised by the procurement of the great majority of military supply items. Presumably, we are in the midst of a long period of procurement of goods which has leveled off at approximately $18 billion per year. The same emergency characteristics of procurement which are incident to an all-out war effort or sudden defense build-up are not present. Many corporations upon which the country must rely for great engineering know-how; imaginative, creative research; and down-to-earth production results are now engaged, for the most part, in strictly commercial lines. The government is therefore in competition for the best brains, the best know-how and the best facilities available in the public interest. Thus, the

problem is different than that obtaining in an emergency situation. The problem must be placed in its long-term perspective and we must not permit any part of procurement negotiation to be reviewed, revised or extended without addressing the problem in its long-term perspective.

"Having in mind this quick look at the problem, we believe that the cost principles revision should be oriented to a basic criterion or series of criteria which are fair to the government and to industry. We suggest as a principal criterion that the government should bear a fair share of the normal cost of doing business.

"Equally as important, however, as the basic criterion we have suggested is the procedure for negotiation or implementation of that criterion. Some of the contract costs with which we deal here are, in our judgment, clearly allowable or disallowable by any reasonable man's standard and without too much debate. On the other hand, there is a body of costs which are not clearly definable because their character changes somewhat from case to case. We submit that in this area...the tool of individual contract negotiation should be employed rather than regulatory fiat which will almost certainly produce erratic and inequitable results."

* * * * *

This concludes our observations and suggestions on the currently proposed revision to Part 2, Section XV, of the Armed Services Procurement Regulation. We should like again to express our appreciation for this opportunity to offer our comments on such an important section of basic procurement regulations. If we can be of any further assistance or if you should desire to discuss these matters directly with representatives of this office, please do not hesitate to call upon us.

Cordially,

Charles Stewart
President

CWS:nrh

RAYTHEON MANUFACTURING COMPANY
WALTHAM 54, MASSACHUSETTS

ERNEST F. LEATHEM
ASSISTANT TO THE PRESIDENT

October 21, 1958

Hon. E. Perkins McGuire
Assistant Secretary of Defense (S&L)
The Pentagon
Washington 25, D. C.

Dear Mr. Secretary:

As you requested at the end of our luncheon meeting on October 16, I am writing to confirm the matters about which we talked. These were as follows:

1. The proposal of the National Security Industrial Association of a set of Comprehensive Cost Principles, forwarded to you with its letter of April 29, 1958.

   In the meetings held on October 13 and 14 among representatives nominated by eight industrial or professional associations, in preparation for the meeting with you on October 15, it was found that the NSIA proposals of Cost Principles were acceptable to all present, with the possible exception of one or two relatively minor points. In view of this wide acceptance, I recommend to you, therefore, that you again study these carefully prior to making decisions in the various matters discussed at the October 15 meeting. I understand that you have read the NSIA proposals hastily, but have not had the opportunity to study them completely.

2. Disposal of items not included on the October 15 agenda but to which industry took exceptions or recommended changes.

   I reported to you that it was the feeling of the industry representatives that several of these points are of considerable importance, and that it was believed a line-by-line review would be desirable. It is my understanding that you agreed that Commander Malloy would work personally with a limited group of people selected from industry to make such a line-by-line review. At the same conference we can point out several technical or grammatical revisions

necessary in the outstanding draft. It will obviously be more efficient if this review is made in as small a group as possible, and by persons not wedded to the language presently proposed. I am sure that Commander Malloy completely fulfills these qualifications.

3. Necessity for establishing guide lines to negotiators and auditors.

We discussed whether the framework of Cost Principles proposed in the present DOD draft needs to be preserved, especially in view of the fact that they embody not only some statements of principles but also many specific instructions comparable to those that would be in an audit manual. Anything contained in ASPR will probably be incorporated by reference in contractual clauses. Industry believes, therefore, that such contractual inclusions should be limited to principles and not to specific allowances or disallowances. Thus industry and Government would be free to negotiate on any point when circumstances warranted it, whereas under the proposed Cost Principles format industry would be foreclosed from negotiating on more than thirty items of cost. I understand from you, however, that you felt it is too late to change the framework of the Cost Principles, but that you might call them by some other name to indicate that they are not all intended to be "Principles".

4. DOD commitment for issuance of Cost Principles.

We discussed what commitment, if any, the DOD has made to issue a set of Comprehensive Cost Principles by a given date. I understand that no formal commitment for this has been made, but that informally it is felt that the Department is obligated to issue Cost Principles before January 1, 1959.

5. Time for industry comments.

We discussed whether itwould be acceptable to have the 15-day period, mentioned by you in the October 15 meeting, begin when the transcript of the October 15 meeting has been received rather than beginning at once. You confirmed that it would be satisfactory to submit information 15 days after the transcript is issued, and I have your letter this morning advising that you have so instructed Commander Malloy.

Thank you very much for your continued interest and personal attention to this most important subject.

Cordially yours,

Ernest F. Leatherman

EFL:K

A N 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	1	Applicability	Mr. T. A. Pilson Office of the Ass't. Sec. of Defense (S&L)	Mr. J. Marschalk Strategic Industries Association
1015-1050	2	"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	3	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	4	Advance Understandings	Mr. M. E. Jones Office of Naval Material	Mr. Geo. Hogg, Jr. Electronic Industries Association
1200-1230	5	Advertising	Mr. A. J. Racusin Office of the Ass't. Sec. of Air Force (Materiel)	Mr. M. Moulton National Association of Manufacturers C-E
1230-1300	6	Compensation	Mr. G. A. Middleton Navy Comptroller, Contract Audit Division	Mr. Herbert T. McAnley American Institute of Certified Public Accountants

Time		Subject	Government Spokesman	Industry Spokesman
(Lunch 1300-1400)				
1400-1500	7	Research and Development	Mr. W. Munves Office of Counsel Air Force	Mr. E. Leatham ~~National Security Industrial Assn., Inc.~~ NAM
1500-1530	8	Contributions and Donations	Mr. A. C. Lazure Ordnance Corps, Army	Mr. Herbert T. McAnelly American Institute of Certified Public Accountants
1530-1600	9	Interest	Mr. F. E. Hall Army Audit Agency	Mr. T. Herz U. S. Chamber of Commerce
1600-1620	10	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		

OK

FEB 2 8 1960

Dear Mr. Stewart:

I am attaching a copy of a press release together with a copy of a memorandum from the Assistant Secretary of Defense (Supply and Logistics) to the Material Secretaries of the Military Departments, which deal with the implementation phase of the revised contract cost principles which were issued by the Department of Defense on 2 November 1959. I believe that this information will be of interest to your Institute.

The problem of how to deal with existing cost-reimbursement type contracts was very difficult for us to deal with. While we are desirous of minimizing the administrative problems which will be encountered by contractors in operating under two different sets of cost principles at the same time, we have concluded that conversion to the new cost principles on a contractor-by-contractor basis is not feasible at this time.

Sincerely yours,

SIGNED

G. C. BANNERMAN
Director for Procurement Policy

2 Attachments

Mr. C. W. Stewart
Machinery and Allied Products Institute
1200 - 18th Street, N.W.
Washington 6, D.C.

Prepared by: JMMalloy/rbs/23Feb60
3D 774 X-72026

Identical Letters sent to Addressees on Next Page

Mr. C. W. Stewart
Machinery and Allied Products Institute
1200 - 18th Street, NW
Washington 6, D. C.

Mr. T. Rice
U. S. Chamber of Commerce
1615 H Street, NW
Washington, D.C.

Mr. James D. Secrest
Executive Vice President
Electronic Industries Association
1721 De Sales Street
Washington 6, D. C.

Mr. J. C. Ellis
Automobile Manufacturers Association
Suite 416
1710 H Street, NW
Washington 6, D. C.

Rear Admiral Jas. D. Boyle, USN (Ret)
National Security Industrial Association, Inc.
1107 - 19th Street, NW
Washington 6, D.C.

Mr. Roy Bennett
National Association of Manufacturers
2 East 48th Street
New York 17, New York

Mr. Davis Saunders
Strategic Industries Association
Suite 621
458 South Spring Street
Los Angeles 5, California

Mr. H. T. McAnly
American Institute of Certified Public Accountants
270 Madison Avenue
New York 16, New York

Mr. W. M. Cousins, Jr.
Armour Research Foundation
10 West 35th Street
Chicago 167, Illinois

Lt. General Orval R. Cook, USAF (Ret), President
Aircraft Industries Association of America, Inc.
640 Shoreham Building
Washington 5, D.C.

DETROIT
320 NEW CENTER BUILDING

NEW YORK
366 MADISON AVENUE

AUTOMOBILE MANUFACTURERS ASSOCIATION, INC.

1710 H STREET, N.W. WASHINGTON 6, D.C. REPUBLIC 7-3770

L. L. COLBERT, PRESIDENT
HARRY A. WILLIAMS, MANAGING DIRECTOR

February 24, 1960

Mr. G. C. Bannerman
Director for Procurement Policy
Office of the Assistant Secretary of Defense
(Supply and Logistics)
Washington 25, D C.

Dear Mr. Bannerman:

Thank you for your courtesy in mailing the press release and memorandum on contract cost principles implementation.

This office, in turn, will duplicate these documents so that the members of this organization will have the benefit of these important guidelines.

Sincerely,

James G. Ellis

CR

2 November 1959

Dear Mr. Marschalk:

I am inclosing an advance copy of Revision No. 50 to ASPR which contains the Contract Cost Principles. I am also inclosing a copy of the Press Release which we have issued today on this subject.

The inclosed material is, for all practical purposes, identical to the draft which was furnished you on 29 July 1959. Since we have today publicly announced the publication of the Cost Principles, the attached material may be used by you without restriction.

Again, may I express my thanks to you for your helpful assistance to us in our efforts to bring this project to a conclusion. I am sure that you realize that after some experience is gained in the use of this new regulation, we will be receptive to any suggestions for changes which you may care to make.

Sincerely yours,

Inclosures - 2
1. Contract Cost Principles
2. Press Release

Prepared by: JMMalloy/kh
23 Oct 59 - 72026
Coordinated by Mr. Bannerman

Rewritten by: TAPilson/jm/26 Oct 59
3D774 79391

Mr. John Marschalk
3780 W. 6th Street
Los Angeles 5, California

Identical letters to:
Mr. H. W. Haynes
Boeing Airplane Co.
Seattle, Washington

Mr. Herbert T. McAnly
1356 Union Commerce Bldg
Cleveland 14, Ohio

Mr. E. G. Bellows
475 - 10th Ave.
New York 18, N.Y.

ERNST & ERNST
UNION COMMERCE BUILDING
CLEVELAND 14, OHIO

ACCOUNTANTS-AUDITORS
MANAGEMENT SERVICES

OFFICES IN PRINCIPAL CITIES
ASSOCIATES IN FOREIGN COUNTRIES

November 4, 1959.

Mr. G. C. Bannerman,
Director for Procurement Policy,
Office of the Assistant Secretary
of Defense,
Washington 25 D. C.

Dear Mr. Bannerman:-

Your kind letter of 2 November 1959 addressed to me in care of the American Institute of Certified Public Accountants has been forwarded to my office here in Cleveland.

I quite agree with you that this is of a highly controversial* nature. I will look forward to any opportunity for discussions with you and your associates as the program moves along.

Sincerely yours,

H. J. McAuley

HTMcA/rl

General Partner.

* My personal opinion is that you have done a swell job for our country.

H. J. M.

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. - Washington 6, D.C.*
Telephone: REpublic 7-7474

R. C. PALMER
Chairman, Board of Trustees

R. C. SIMMONS
President

R. M. AKIN, Jr.
Chairman, Executive Committee

R. N. McFARLANE
Executive Director

4 November 1959

Mr. G. C. Bannerman
Director for Procurement Policy
Office of the Assistant Secretary
of Defense (Supply and Logistics)
The Pentagon
Washington 25, D. C.

Dear Jim:

Well, at long last we have Revision No. 50. Thank you for your letter and the advance copies. We've already notified our members that the release has been made and that copies may be received from the Government Printing Office.

I've hurriedly looked over the new Principles and I think they are much more readable than before, and I'm sure some of the provisions will certainly be more acceptable to industry. However, my guess is that it won't be long before we are knocking on your doors asking for a revision of this or that.

Thanks again - I'm going to drop in to see you sometime.

Sincerely,

Jas. D. Boyle
Director of Committees

JDB:cs

NATIONAL SECURITY INDUSTRIAL ASSOCIATION

NATIONAL HEADQUARTERS: *1107 19th Street, N.W. - Washington 6, D.C.*
Telephone: REpublic 7-7474

R. C. SIMMONS
Chairman, Board of Trustees

H. E. ISHAM
President

R. M. AKIN, Jr.
Chairman, Executive Committee

R. N. McFARLANE
Executive Director

24 February 1960 CR

Mr. G. C. Bannerman
Director for Procurement Policy
Office of The Assistant Secretary of
Defense
Room 3E822, The Pentagon
Washington 25, D. C.

Dear Graeme:

Thank you very much for your letter of February 23, together with the two enclosures.

I certainly can agree with you that the problem of the shifting over to the revised contract cost principles is going to give a good many people a large-size headache. We certainly will give out a bulletin which will include the February 10th Memorandum from The Assistant Secretary of Defense and will use the News Release, which you sent, in our next Newsletter.

It might well be that we will ask you for a conference on the general subject of conversion to the new cost principles. I agree with you, on a contractor-by-contractor basis, you would have some job.

Sincerely,

James D. Boyle
Director of Committees

JDB:ih

Ck

Dear Mr. McAnly:

I would like to take this opportunity to thank you most sincerely for the excellent assistance which you provided to my staff in connection with the recent review of the contract cost principles. From all of the reports which I have received, the discussions were most helpful and I am informed that a substantial number of excellent changes were indicated by the discussions. I am aware of the personal sacrifice which you made to assist us in this effort.

I know that you are aware of my intense personal interest in insuring that we have secured the best advice available in connection with the contract cost principles. I think that the discussions which have just been concluded may well set a major precedent for the future handling of similar difficult problems. Again, many thanks for your helpful assistance.

Sincerely,

Paul McGuire

PAUL McGUIRE
Assistant Secretary of Defense
(Supply and Logistics)

Mr. Herbert T. McAnly
1356 Union Commerce Building
Cleveland 14, Ohio

Prepared by: JMalloy/rbs/7Apr 59
3D774 72026

Coordinated by:
G.C. Bannerman _____

Identical letters sent to:

Mr. John Marschalk	Mr. H.W.Haynes	Mr. E. G. Bellows
3780 W. 6th Street	Boeing Airplane Company	475 - 10th Ave.
Los Angeles,5Calif.	Seattle, Washington	New York 18, N.Y.

OR

Dear Mr. Keanly:

I am very anxious to publish our proposed revision of the Contract Cost Principles at an early date. We have made substantial progress in our revision of the principles based on the comments which were made by industry at the 15 October 1958 meeting as well as those presented in written form subsequent to the meeting. I have received many recommendations from the industrial community to the effect that it would be mutually advantageous for a very small group from industry to discuss with members of my staff the exact language which we intend to use prior to releasing the cost principles for publication in the Armed Services Procurement Regulation. My objective is to eliminate future problems of interpretation by this review of the actual language of the Regulation rather than to discuss major changes in policy or approach.

As I indicated in my closing remarks at the 15 October meeting, I am asking 4 individuals, comprising a cross-section of industrial interests, to meet with members of my staff for the purposes indicated above. In view of your great familiarity and long interest in this project, I would greatly appreciate your assistance in this effort. In this connection, your participation would be as an individual consultant and adviser to me rather than as a representative of your company or any particular industrial group.

We feel that the best time for this meeting would be during the week of 30 March 1959. I have asked my staff to provide a revised draft of the Cost Principles to you prior to the meeting and to advise you further with respect to other appropriate arrangements.

I would very much appreciate your early advice as to whether you will be in a position to assist me in this effort.

Sincerely yours,

Parkman McGuire

PERKINS McGUIRE

Letter Drafted from Assistant Secretary of Defense (Supply and Logistics)

Mail Window GS

Prepared by JMalloy/JMA/3/6/59
3E 771 72026

Coordinated by:
Mr. Bannerman

Identical letters sent to: (see attached list)

Mr. Herbert T. Keanly
1356 Union Commerce Building
Cleveland 14, Ohio

Identical letter sent to:

Mr. H. A. Haynes
Boeing Aircraft Company
Seattle, Washington

Mr. Herbert T. McAnly
1356 Union Commerce Building
Cleveland 14, Ohio

Mr. John Marchalk
3780 W. 6th Street
Los Angeles 5, Calif.

Mr. E. C. Bellows
475 - 10th Ave.
New York 18, N.Y.

Ca

17 March 1959

Dear Mr. Ballows:

I am enclosing a copy of a revised draft of the contract cost principles for use in connection with the meeting described in Mr. McGuire's letter of 6 March 1959. It is our desire that you treat this revised draft as being furnished to you for your personal use only in connection with our meeting. It is not our desire or intention that this draft be given any type of distribution to industry groups. As a matter of fact, its distribution within the Department of Defense is being strictly controlled.

The best time for our get-together appears to be at 9:30 on 1 April 1959 in Room 3E 794. I expect that we will spend three full days on this project.

For your information, the other industry representatives at this meeting will be:

Mr. R. L. Rayner	-	Boeing Aircraft Company
Mr. Herbert T. Mainly	-	Ernst & Ernst
Mr. John Marschalk	-	Strategic Industries Association

Please let me know if I can provide you with any additional information concerning this matter.

Sincerely yours,

J. M. Kelly
Cdr, SC, USN
Staff Director, [illegible] Division
Office of Procurement Policy

Mr. B. G. Ballows
475 - 10th Ave.
New York 18, N.Y.

Identical letters sent to:
(see attached list)

Identical letter sent to:

Mr. H. W. Haynes
Boeing Aircraft Company
Seattle, Washington

Mr. Herbert T. McAnly
1356 Union Commerce Building
Cleveland 14, Ohio

Mr. John Marschalk
3780 W. 6th Street
Los Angeles 5, Calif.

Mr. E. C. Bellows
475 - 10th Ave.
New York 18, N.Y.

CD

August 12, 1957

Dear Mr. Leathem:

This will acknowledge your letter of August 5, 1957, your file 57-45Mc on the subject of contributions and donations.

It is not clear from your letter what draft of the proposed Section XV of ASPR you are commenting on. As you know, this section has been cast in several different versions, including at least two changes, since the last time it was submitted for industrial comment. It now appears probable that still another version will go out for comment at some time in the future. I suggest, therefore, that the views expressed in your letter be made known at that time.

Sincerely yours,

SIGNED

G. C. BANNERMAN
Director for Procurement Policy

Mr. Ernest F. Leathem
Assistant to the President
Raytheon Manufacturing Company
Waltham 54, Massachusetts

Prepared by:
GCBannerman/kh
August 12, 1957 - 78177

RAYTHEON MANUFACTURING COMPANY

Law Department
Waltham 54, Massachusetts

Telephone: TWinbrook 3-5860
Cable Address: Raytheon

57-45Mc
August 5, 1957

Mr. Graeme Bannerman
Director of Procurement Policy
Office of Assistant Secretary of Defense (Supply and Logistics)
The Pentagon
Washington, D. C.

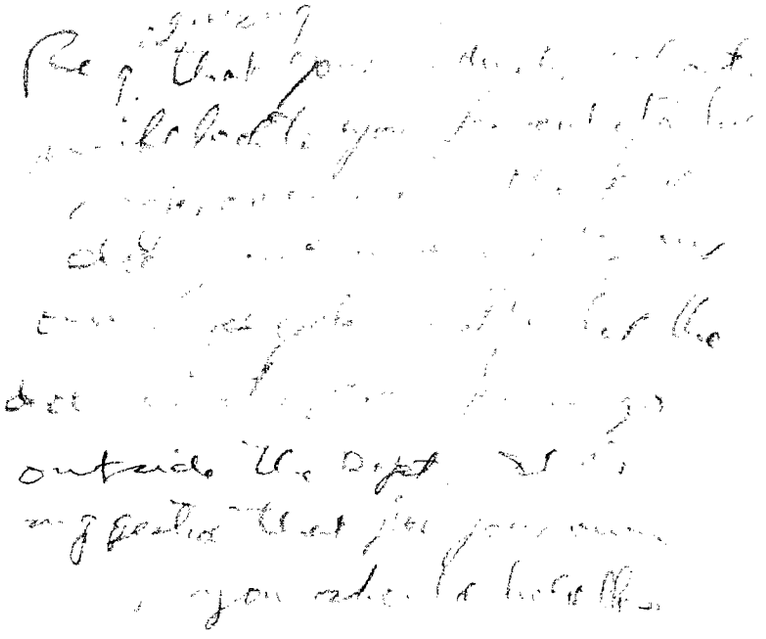
Dear Mr. Bannerman:

Re: ASPR Section XV, Subsection (e), Contributions and Donations

We would like to make the following comment on the proposed Section XV of ASPR, Subsection (e) "Contributions and Donations". It is our opinion that this section does not clearly indicate whether a corporation such as Raytheon Manufacturing Company can charge as a cost on Government contracts contributions which it makes to a charitable organization of its creation, the Raytheon Charitable Foundation.

This Foundation was organized on March 31, 1954. Before organization it was subjected to close investigation and scrutiny by the Massachusetts Commissioner of Corporations & Taxation and by the Massachusetts Bureau of Incorporated Charities of the Department of Public Health. An open hearing was held, in accordance with the requirements of Massachusetts General Laws, Ch. 180, § 6, before incorporation was accomplished.

The section referred to provides that before the Commissioner of Corporations and Taxation may approve the articles of organization of any charitable corporation whose purposes are such that its personal property will be exempt from taxation, the Commissioner shall refer such articles to the Department of Public Welfare which, in the words of the statute:



"shall immediately make an investigation as to the applicants for incorporation, the corporation, or the petitioners as the case may be, and the purposes thereof, and of all material facts, including facts tending to show that the probable purpose is to cover any illegal business, or that the applicants, certifiers or petitioners are not suitable persons, from lack of financial ability or from any other cause, and facts as to the present need for an organization with such purposes at the time and place and with respect to the special circumstances set forth in such articles, certificate or petition."

The following persons are presently acting as Trustees of the Foundation:

Charles F. Adams
Paul F. Hannah
Ernest F. Leathem
Allen E. Reed
David Flower, Jr.
Charles H. Resnick

The primary reason for the establishment of the Foundation was the achievement of a stable level of contributions by the Company to charitable organizations over a period of years without having those contributions subjected to the variations in earnings to which the Company might be subjected from year to year. This result can be achieved by making large contributions to the Foundation during profitable periods, thus obviating the necessity of making any contributions during unprofitable periods, yet still enabling the Foundation to satisfy requests or pledges for contributions from funds already on hand.

The Foundation is exempt from Massachusetts tax both on income and on personal property.

By a tax ruling issued December 5, 1955, the Foundation was ruled to be exempt from federal income tax as an organization described in Section 501 (c)(3) of the Internal Revenue Code of 1954, as organized and operated exclusively for charitable purposes. The purpose of the Foundation is stated in its articles of organization to be:

"to aid by contribution or otherwise any corporation, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes no part of the net earnings of which inures to the benefit of any shareholder or individual and no substantial part of the activities of which is carrying on propaganda or otherwise attempting to influence legislation provided such corporation, community chest, fund, or foundation was created or organized in the United States or any possession thereof

or under the law of the United States or of any state or territory or of the District of Columbia or of any possession of the United States and provided such contributions or gifts are to be used within the United States or any of its possessions exclusively for such purposes and further provided that no part of the net earnings of the corporation shall inure to the benefit of any private member of the corporation or individual and that no part of its activities shall consist of carrying on propaganda or otherwise attempting to influence legislation***."

Gifts are made by the Foundation only to those charitable organizations which are themselves listed as exempt organizations by the Commissioner of Internal Revenue. Examples of such organizations to whom contributions have been made are:

The Greater Boston Community Fund
The American National Red Cross
American Cancer Society
Newton-Wellesley Hospital
Mount Auburn Hospital Building Fund
Massachusetts Heart Association
Boys' Club Foundation Endowment Fund
The Age Center of New England

Although the wording of Subsection (e) referred to above would seem to include the type of contribution made by the Foundation to such organizations, it does not appear that the source of those contributions, namely the contributions of the Company to the Foundation, are within the terms of the subsection. On the contrary, they seem to be by clear implication excluded, since only contributions made directly to the ultimate charitable organization to be benefited is mentioned as chargeable as a cost. The procedure followed by the Company is that, when the Company is solicited directly for funds by charitable organizations, it refers such solicitations to the Foundation and any contributions made by the Foundation are in lieu of contributions by the Company. Were such contributions not made, the loss of prestige referred to in subdivision (iii) of Subsection (e), for example, would just as certainly result as if the Company refused to make such contributions directly to the charitable organization seeking the funds.

We would like to point out that the arrangement found suitable by Raytheon for the administration of charitable contributions is also preferred by a large number of other concerns, among which, to name only a few, are:

Standard Oil Co. (N.J.)(The Standard Oil Foundation, Inc.)
Westinghouse Electric Corp. (Westinghouse Educational Foundation)
Inland Steel Co. (Inland Steel Foundation, Inc.)

Monsanto Chem. Co. (Monsanto Charitable Trust)
B. F. Goodrich Co. (The B. F. Goodrich Fund, Inc.)
International Harvester Co. (International Harvester Foundation)

Sincerely yours,

Ernest F. Leathem
Assistant to the President

RPM:dea
cc: Chairman, ASPP Committee
National Security Industrial Association

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 EIGHTEENTH STREET, N. W. WASHINGTON 6, D. C. REpublic 7-6512

May 18, 1959

The Honorable Perkins McGuire
Assistant Secretary of Defense
(Supply and Logistics)
Department of Defense
Washington 25, D. C.

Dear Mr. McGuire:

You will recall our conference on April 30. I have since been advised by a member of your staff that there may be no further opportunity for the Machinery and Allied Products Institute to review the current draft of proposed comprehensive contract cost principles. In addition, I understand that you and your staff are making every effort to coordinate the current draft with the individual military services and to publish the document in final form at an early date.

We are of course altogether sympathetic with your very understandable desire to issue the so-called comprehensive set of cost principles as soon as possible.

Even though it appears that we may have no opportunity to study the current draft of comprehensive cost principles--and having in mind the hazard involved in making further comment without being in a position to relate it to specific current language--we should like nevertheless to re-emphasize in brief our view that the issue of first importance is the scope of applicability of comprehensive cost principles. We are proceeding on the assumption that any change in the Pentagon point of view on this question, as expressed by government in the conference with industry on October 15, 1958, is simply a matter of degree and that the basic position remains substantially unchanged.

Applicability--The Overriding Issue

It is our concern over the possibility that no substantial change has been made in the scope of the proposed regulation's applicability that prompts us gratuitously to add this supplemental note to prior Institute comments on the subject.

Attempts to cure the applicability problem.--Past statements of MAPI and other industry organizations have iterated and reiterated the suggestion that promulgation of a comprehensive set of cost principles (which is essentially a catalog of unallowable and allowable items) with general applicability would serve to convert fixed-price contracts--in varying degree--into cost-reimbursement agreements. In response to these industry representations Pentagon draftsmen have attempted to so distinguish between the applicability of cost principles to fixed-price contracts and cost-reimbursement type contracts as to prevent the eventuality which industry generally has predicted. These changes in drafting the so-called comprehensive cost principles would seem clearly to reflect a recognition on the part of your staff that industry's suggestions were well taken and that the problem to which our past comments applied was a distinct possibility.

Fundamental fallacy of the approach.--Freely acknowledging the sincerity and the artfulness of Pentagon draftsmen in attempting to distinguish between the effects of applying a single set of cost allowance standards to both fixed-price and cost-reimbursement type agreements, we remain convinced that the approach is fundamentally unsound and that the probable result of across-the-board applicability will be to transfer the disadvantages of cost-type contracts to those of a fixed-price character. This is a matter in which a compromise, a straddle, is impossible. As long as the catalog of allowable and unallowable costs is applicable in any way to fixed-price agreements there is the inevitable tendency toward conversion into cost-reimbursement contracts.

We should add by way of emphasis that the unfortunate result which we have so frequently predicted will not and cannot be avoided by mere rearrangement or reorganization of textual material; or by paying lip service to the eminently sound policy and philosophy to be followed in fixed-price contract negotiation as set out in Section III of the Armed Services Procurement Regulation; or by suggesting that as to fixed-price agreements the catalog of allowances and disallowances be employed in a somewhat different fashion than when applied to cost-reimbursement contracts.

As a footnote to this discussion we cannot fail to take note once again of arguments advanced by the Pentagon spokesman on this subject at public hearings conducted by your office on October 15, 1958. At that time the Department of Defense seemed to argue that the issue of applicability is somehow separable from the content of the regulations to be applied. It seems to us obvious that you cannot discuss applicability without examining that which is being applied. This is not only good law; it is plain common sense.

The Effects of Across-the-Board Applicability of Cost Principles

Without attempting to reargue the case in detail, we should like once again to re-emphasize our principal objections to an across-the-board application of comprehensive cost principles. These arguments are covered

in detail in our statements of November 14, 1958 (pp. 1-12), and December 16, 1957 (pp. 1-10), extra copies attached. We are most strongly convinced that application of cost principles as now proposed to fixed-price and cost-reimbursement contracts alike will result in serious injury to the public interest.

Our reasons for thinking so can be very simply stated. Fixed-price contracts will be effectively converted into cost-reimbursement type contracts; pricing will be by formula, working from the catalog of specific allowances and disallowances. This result will almost inevitably bring in its train a whole series of consequences disadvantageous both to government and to industry.

1. Incentive for gain--the most powerful single force in our whole economy--by which costs are reduced and profits enhanced will be virtually obliterated.

2. The costs of contract administration will, in our judgment, be necessarily increased in substantial amount by reason of the necessity for additional audits, and the whole process of contract administration will be burdened with endless niggling vexations. And this, it should be noted, comes at a time when responsible men are demanding simplification and acceleration of the procurement process.

   In general, procurement will be by audit. You will have expanded audit activity--substantially less procurement efficiency.

3. It will tend in our judgment to reduce further the base of responsible contractors available to the government service, particularly in the field of standard commercial articles or those which require only slight modification for military service. Many such companies--to whom government business is a very minor percentage of their sales total--prefer, as a matter of policy, supply contracts on a fixed-price basis.

4. It will impose upon contract terminations for the convenience of the government a standard of cost and profit allowance which is altogether inequitable under such circumstances.

5. It will focus attention almost exclusively--and we think most unwisely--on questions of cost and profit to the virtual exclusion of total price. Price obviously is not the sole consideration. Insofar as the expenditure of government money is concerned, however, price is of vastly greater importance then either cost or profit.

The effect of the proposal on subcontracts.--An examination of the most recent draft of comprehensive contract cost principles available to the Institute seems to make clear that such principles apply to subcontracting as well as prime contracting. Again, we have no desire to reargue completely the Institute's position with reference to this possibility but, inasmuch as the total dollar value of the defense subcontracts very substantially exceeds the dollar value of defense contracts retained by prime contractors, the question of the applicability of so-called principles to subcontracts becomes a matter of the foremost importance.

In our judgment, such application would have all of the undesirable consequences identified above in connection with our discussion of the proposal's applicability to prime contracts and would, in addition, have at least two other unfortunate results that deserve mention in this statement.

By extending--at least to larger subcontracts--the same enlargement of over-all cost and administrative difficulty, which we foresee for prime contracts, the application of comprehensive cost principles to the subcontracting area will tend to aggravate and multiply these not inconsequential problems. In addition we think an even more serious effect may be a serious disturbance--perhaps in some cases a rupture--of normal commercial relationships.

The Exclusion of Advertised Bids

We have been assured and reassured that it is the intent of the Department of Defense to exclude contracts let as a result of advertised bidding from the applicability of these newly proposed cost principles. At the minimum, in connection with applicability, we trust that this exclusion will be clearly stated so that there will be no ambiguity on the point.

The exclusion of advertised bids from the application of cost principles raises an interesting question. Assuming that the exclusion is correct as to advertised bid contracts--and this is a judgment on which we think there can be no question--why is advertised bid contracting given this treatment exclusively as distinguished from other types of fixed-price contracts? What is the theory which underlies the distinction? What are the characteristics of advertised bid contracts, insofar as applicability of a set of cost principles are concerned, which make them essentially different on this issue from other types of fixed-price contracts?

We fail to see the distinction implicit in the differing coverage and we think it might be a useful exercise for Pentagon draftsmen to consider again the reasons for the exclusion of advertised bid contracts and to consider further if the reasons justifying this exclusion would not apply in the vast majority of cases to other types of fixed-price contracting. We believe this reconsideration will point up a number of matters very clearly--that in many situations where the end result is a fixed-price contract and where negotiation is employed with or without the taking of bids there may be a substantially equal amount of competition present, a

firm and irrevocable price may be just as susceptible of determination, the government interest may be fully protected, and what the government gets for its dollar may be just as good a bargain as in the case of a formally advertised bid contract. This is not to say that these circumstances will prevail at all times but they certainly will obtain if the government procurement officers do their job in the great majority of fixed-price situations. So the exemption of advertised bid contracts in a sense is an admission of the principle which we advance, and we therefore call your attention particularly to it and suggest its logical extension.

The Attitude of Congress and the General Accounting Office

We are aware, of course, of the continuing interest expressed by certain Congressional committees and subcommittees and the General Accounting Office in early publication of a comprehensive set of contract cost principles.

We cannot believe, however, that either Congress or the Comptroller General would support a system which in the long run--in our judgment--promises to be so disadvantageous to the national interest. We are, therefore, constrained to raise the question as to whether or not the very serious disadvantages so briefly summarized above, and repeatedly identified in the past by MAPI and other industry spokesmen, have ever really been pointed out in these terms to appropriate Congressional committees or to responsible administrative officials of the General Accounting Office. As a matter of fact, we are absolutely confident that a full exposition of the case before both agencies would result in agreement that there must be a fundamental distinction between cost-reimbursement type contracts and other defense procurement agreements and that this necessary distinction cannot be achieved by proceeding with the action now proposed. Indeed, it seems to us that recent Congressional emphasis on enlargement of the fixed-price contracting area, and particularly the area of advertised bids, is altogether inconsistent with the philosophy which underlies the applicability provisions of the comprehensive contract costs proposal.

We enclose additional copies of our statements presented on November 14, 1958, and December 16, 1957. They cover in detail a variety of matters other than the one which this letter is intended to emphasize; we should make it clear that we do not wish by implication to withdraw in any way from the position which we have taken on these other points. On the contrary, the Institute stands on its entire presentation but is anxious to emphasize the overriding issue of applicability, and we have taken the extraordinary means of writing this letter in order to so emphasize it.

I am taking the liberty of addressing a copy of this letter to the Secretary, the Assistant Secretary responsible for materiel, and the General Counsel of each military service. Beyond that, having in mind that other departments and agencies of the government may be interested in this issue of tremendous significance, the officers of the Institute will be glad to confer with the Comptroller General or any other interested agency.

I hope you will understand the spirit in which these suggestions are offered. I understand completely why you and your associates in the Department of Defense feel a sense of urgency in issuing as soon as possible a document which has received so much careful study and on which so much time and effort have been expended over a long period of time. On the other hand we are convinced that the issue of applicability is of such crucial importance to procurement efficiency that we have risked "shooting in the dark" to some extent in order to record this further expression of our views.

It goes without saying that if the Institute can be of any further assistance to you or your staff on either a formal or informal basis we are at your service.

Respectfully,

Charles Stewart
President

CWS:c
Enclosures

MACHINERY AND ALLIED PRODUCTS INSTITUTE
1200 EIGHTEENTH STREET, N. W.
WASHINGTON 6, D. C.

CHARLES W. STEWART
PRESIDENT

May 18, 1959

Dear Mr. McGuire:

I think the enclosed further statement on the proposed comprehensive contract cost principles is self-explanatory as to substance but I did want to add this personal word.

When Commander Malloy telephoned me indicating that he and his associates were recommending to you that no further examination of a current draft be permitted we were of course disappointed--not for any reason of organization prerogative, but rather because we feel that at least on the issue of applicability the Institute is in a position to make a unique contribution based on long experience with fixed-price contracting. We naturally defer to your judgment and that of your staff on the decision to move ahead without soliciting further industry comment. And, as I stated in the principal letter, we are quite sympathetic with your wishing to maintain a reasonable schedule of publication.

On the other hand, we have fundamental convictions which we think are in the public interest as well as industry's. We have, therefore, with some reluctance because of your great patience and cooperation with industry on this matter, decided to presume further upon your time by filing this additional statement. We have also taken the liberty of furnishing copies to the individual military services. This is done not for the purpose of pressing you in any way but again in the interest of achieving broader understanding of what we think is an issue of fundamental principle which should not be compromised in any way.

With thanks again for your interest and splendidly open-minded attitude,

Respectfully,

Charles Stewart

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

RB

MEMORANDUM FOR THE ASSISTANT SECRETARY OF DEFENSE (COMPTROLLER)

SUBJECT: Revision, Part 2, Section XV, ASPR

Regarding our recent discussion pertaining to cost principles, attached hereto is a copy of the proposed revision of Part 2, Section XV, ASPR, for application of cost-reimbursement-type contracts.

This revision reflects consideration of comments made by industry during the past year on an earlier proposed revision. In response to requests of representatives of certain industry associations, at a meeting of 21 May 1956, it was agreed to delay finalization of the attached revision, pending receipt and evaluation of written statements of points raised during the meeting and any additional comments on the revision. Final date for receipt of comments has been established as 4 June 1956. It is hoped that revision will be ready for print early in June.

As you know, our staffs jointly have currently underway a related project -- undertaking the development of a "Comprehensive Set of Cost Principles."

Incl: Propd Rev. Part 2,
Sec. XV, ASPR,
dtd 20 Apr 56

Prepd by BGen Ghormley/apo
3D774/74912/31 May 56

Coordinated with:
RD Mr. Mulit _____
AS Cdr.Robtson_____

(for sign. Mr. Pike)

10 August 1959

Mr. McGuire:

Attached are the cost principles comments which you handed me for review last Wednesday.

There is little of substance here which we haven't already heard before and decisions have been made. His principal point is that we have made few concessions to industry from the present Sec XV , and that the additional guidance, along with application to other than cost-type contracts, may be less favorable to industry. There may be some truth to his statement since a strong contractor, in the absence of specific guidance, may be able to negotiate a better deal for himself than will be possible with the contracting officer armed with a more specific statement of the Government's intent. I get this inference from his use of such statements as "The present ASPR has generally been interpreted...."

At this point, I doubt that additional consideration of comments of this nature will add much to the quality of the principles. However, I have made notes of three suggestions for clarification which have merit and which I believe we can make - editorial changes. I will discuss them with Pete.

K.K.Kilgore

Attachment

November 7, 1958

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

Subject: Comprehensive Cost Principles

Dear Mr. Secretary:

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

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

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

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

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

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

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

I. RECOGNITION OF ALL NORMAL AND LEGITIMATE COSTS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

II. REASONABLENESS AND ALLOCABILITY AS ADEQUATE TESTS AND CONTROLS

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

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

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

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

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

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

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

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

III. APPLICABILITY

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

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

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

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

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

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

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

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

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

IV. EFFECTIVE DATE

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

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

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

V. REQUIREMENTS OF PUBLIC INTEREST

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

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

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

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

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

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

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

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

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

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

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

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

VII. INDIVIDUAL ITEMS OF COST

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

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

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

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

Sincerely yours,

Ernest F. Leathem
Associate Chairman
October 15, 1958 Conference

ENC.

ATTACHMENTS

I. TEST OF REASONABLENESS

We propose the following:

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

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

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

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

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

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

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

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

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

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

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

II. ADVERTISING - Section 15-240.2(a)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

VI. INTEREST - Section 15-204.2(a)

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

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

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

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

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

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

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

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

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

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

This matter can be resolved by a joint drafting committee.

ITEMS NOT DISCUSSED AT 15 OCTOBER 1958 CONFERENCE

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

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

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

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

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

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

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

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

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

XI. CONTINGENCIES - Section 15-204.2(g)

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

XII. DEPRECIATION - Section 15-204.2(i)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

XXII. ROYALTIES - Section 15-204.2(jj)

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

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

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

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

XXIV. TAXES - Section 15-204.2(oo)

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

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

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

XXVI. ADDITIONS NEEDED FOR TERMINATION SETTLEMENTS

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

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

WASHINGTON
TRANSPORTATION BUILDING

CABLE ADDRESS
AUTOMAKERS

NEW YORK
366 MADISON AVENUE

AUTOMOBILE MANUFACTURERS ASSOCIATION

NEW CENTER BUILDING - DETROIT 2, MICHIGAN

JAMES J. NANCE, *President*
WILLIAM J. CRONIN, *Managing Director*

FINAL LETTER as Mailed
June 1, 1956

Mr. L. H. Mulit
Director of Requirements
Procurement and Distribution
Office of Assistant Secretary of Defense
(Supply and Logistics)
Washington 25, D. C.

Dear Mr. Mulit:

During the meeting with industry representatives on May 21, 1956, your office granted industry the opportunity to submit further written recommendations and comments concerning the most recent draft of the proposed Revision to Part 2 of Section XV - Contract Cost Principles - of the ASPR. Also, it was agreed that such recommendations and comments would be examined and evaluated prior to the publication of the Revision.

The members of the Automobile Manufacturers Association believe that, in certain areas, the proposed Revision should be changed to further amplify or clarify specific provisions and also that other provisions should be revised to make them more acceptable to industry. The members of this Association have requested that I forward to you their comments and suggestions, which are as follows:

15-200 Scope of Part

It is strongly recommended that this paragraph be expanded to incorporate a statement to the effect that this Part (2) is not applicable to fixed-price contracts including those providing for price redetermination. Until such time as this paragraph clearly so states, there will be Procurement and Audit personnel who will continue to use it as a guide in connection with such contracting despite the Department of Defense Instruction to the contrary. Also, reference to Part 7 should be deleted until such Part has been issued.

15-201.2 Factors Affecting Allowability of Costs

It is believed that the factors affecting allowability of costs, as set forth in this paragraph should be used as a guide by Contracting Officers but that Audit Agencies should not be allowed to pass judgment on the type of determination listed as item (i) and that such limitation should be clearly stated. This can be accomplished by changing item (i) to read "reasonableness, as determined by the Contracting Officer".

Many contracts contain express allowance of certain costs. Therefore, item (iv) should not be restricted to limitations of costs but should be revised to read "any limitations set forth in this Part 2 or any pertinent provisions otherwise included in the contract as to types or amounts of cost items."

15-203.1 General

It is suggested that the third sentence of Subparagraph (b) be revised to read "In order to be acceptable, the method used in connection with Government contracts shall, insofar as possible, conform with generally accepted accounting practices, provide uniformity of treatment for like cost allowances, be applied consistently, and produce equitable results." It is not always practicable for Contractors to adhere strictly to a method because of circumstances peculiar to a particular contract.

15-204.2 (a) Advertising Costs

All of the Contractor's advertising costs that are reasonably allocable to the contract should be allowable. Therefore, it is recommended that this subparagraph be deleted and that the principles of ASPR 8-402 b.(1) be substituted therefor.

15-204.2 (b) Bidding Costs

There should be no question as to the acceptance of reasonable and equitable bidding costs. The last sentence of this subparagraph should read "Bidding costs will be accepted if found, by the Contracting Officer, to be reasonable and equitable."

15-204.2 (c) Civil Defense Costs

Because of the ever-changing situation with respect to civil defense activities, Contractors could be forced into the position of having to contribute substantially to some local civil defense project and should not be precluded from recovering such expense in contract pricing. Therefore, the last sentence of this subparagraph should be deleted, without substitution.

15-204.2 (d) Compensation for Personal Services

The last sentence including items (i) and (ii) should be deleted, without substitution. No limitation should be placed either upon the employer contribution or upon the amount paid or accrued with respect to deferred compensation benefits. There are already sufficient restraints in the area of reasonable costs. Also, in the case of some Contractors, the basic salary or wage is nominal in relation to the additional compensation benefits with the sum of the two being relative to the services rendered. Without such plan the Contractor may not be able to attract and retain personnel necessary for both Government and non-Government business.

15-204.2 (e) Depreciation

Subparagraph (3)(ii) should be deleted and the following substituted in lieu thereof "after the end of the emergency period, shall be computed by distributing the remaining undepreciated portion of the cost of the emergency facility, including any amount of unrecovered "true depreciation", over the balance of its useful life (but see (4) below.)" In instances where the facilities are utilized in the performance of defense contracts during the post-emergency period, Contractors should be permitted to recover in the post-emergency period as an element of contract cost the original cost or the applicable portion thereof of the facilities less "true depreciation" actually recovered during the emergency period.

15-204.2 (f) Employee Morale, Health and Welfare Costs and Credits

It is suggested that "recreation programs" be included in the examples set forth in the first sentence of this subparagraph.

15-204.2 (g) Food Service Costs and Credits

The last two sentences of this subparagraph should be deleted and the following sentence substituted: "Reasonable losses from operation of such services are allowable provided, however, that such losses are allocated to all activities served." Reasonable losses should be allowable, as are other employee morale, health, and welfare costs, and should not be dependent upon the policy of the Contractor to operate the service at either a profit or a loss.

15-204.2 (h) Fringe Benefits

The words "which constitutes, in effect, an implied agreement on the Contractor's part" should be deleted from the last sentence.

15-204.2 (i) Insurance and Indemnification

Subparagraph (4) states that actual losses not reimbursed by insurance are unallowable unless expressly provided for in the contract. This is inequitable as Contractors should be entitled to recover the portion of such losses that is equitably allocable to the contract. It is suggested that this Subparagraph (4) be rewritten to read as follows: "Actual losses not reimbursed by insurance (through an approved self-insurance program or otherwise) are allowable. Such losses shall be allocated to individual contracts on an equitable basis.

15-204.2 (k) Maintenance and Repair Costs

Subparagraph (2) should be deleted since it forces the Contractor to anticipate future abnormal conditions that may be encountered at the time of entering into a contract. Furthermore, it requires the Contractor to convince the Contracting Officer that an abnormal condition will exist in the future. This could be the source of considerable misunderstanding and argument since opinion plays an important role in maintenance and repair items.

15-204.2 (m) Material Costs

In subparagraph (6) the second reference to (i) and (ii) should be changed as they are duplicated within the subparagraph. Also the second item (i) should be changed to read:

> "the transferor's sales price to its most favored customer for the same item in like quantity and under similar circumstances; or"

15-204.2 (p) Pension Plans

The first paragraph of Subparagraph (3)(iii) should be deleted and the following inserted: "in cases where the Internal Revenue Service withdraws approval of a plan, amounts allocated to contract costs subsequent to withdrawal of the approval will become unallowable, if they -". Contract costs allowable under Internal Revenue Service approvals should not be disallowed retroactively but only from the date the approval is withdrawn.

15-204.2 (r) Professional Service Costs--Legal, Accounting, Engineering and Other

The cost of successful defense of anti-trust suits, and the successful prosecution of claims against the Government should be allowable under the provisions of Subparagraph (3) and should be so stated.

15-204.2 (t) Rental Costs (Including Sale and Leaseback of Facilities)

The restriction, set forth in Subparagraph (3), on amounts of allowable rent for facilities covered by sale and leaseback agreements is not equitable. Many contractors would be unable to finance the facilities required and, even if they could borrow the necessary funds, interest on the loan would not be allowed as a cost. However, in order to guard against abuses, the allowable rental on facilities covered by sale and leaseback agreements should be based on the same factors as those in Subparagraph (1) for rental costs of land, buildings, and equipment and other personal property.

15-204.2 (u) Research and Development Costs

Allowability of costs for either general or related research work should not be limited to either those costs "specifically provided in the contract" (Subparagraph (2)) "or are related to the contract product line" (Subparagraph (3)) but should be allowable if equitably allocated to all work of the Contractor. As this subparagraph is now written it could impose a hardship upon a large Contractor whose research activities encompass both "general" and "related" research in a common department or division. In such cases, it would be impractical to segregate the "related" costs from the total costs.

Subparagraphs (2) and (3) provide that the Contractor disclose to the Government the purposes and results of its research and development work, for the cost of such work to be allowable in contract pricing. This condition is unacceptable and should be deleted, without substitution. This condition could require the disclosure of information of the type which the Contractor desires to protect from use by competitors in industry and which he would so protect in the course of his regular business as one of his most valuable assets.

Subparagraph (5) should be deleted, without substitution.

15-204.2 (w) Severance Pay

The second sentence of Subparagraph (1) should be reworded to read "Costs of severance pay are allowable, in each case, if it is paid as the result of (i) legal requirements, (ii) employer-employee agreements, (iii) established policy of the Contractor, or (iv) the circumstances of the particular employment."

The entire first sentence of subparagraph (2)(ii) should be deleted and the following substituted: "abnormal or mass severance payments actually made upon cessation of work when there is no reasonable prospect of continuing employment on other work of the Contractor is allowable. The amount allowable shall be determined by assigning the total cost of actual mass severance payments to the applicable contracts existing at time of severance." Unless this change is made, the provision is most inequitable to Contractors as recovery cannot be made for amounts allocated to contracts completed prior to the date the mass severance costs are incurred.

15-204.3 (c) Contributions and Donations

It is inequitable to disallow contributions and donations which are a normal cost of doing business and which, as good citizens of a community, Contractors are required to make. This subparagraph should be revised to allow such expenses, when the Contracting Officer determines them to be reasonable.

15-204.3 (e) Excess Facility Costs

This subparagraph should be rewritten to read "Unless otherwise provided for in the contract, these costs are unallowable."

15-204.3 (g) Interest and Other Financial Costs

Interest and other financial costs are good costs and should be allowable in contract pricing. Also, interest on borrowings is subject to consideration in the settlement of termination claims as set forth in ASPR, 8-402 b.(14) and should likewise be allowed as cost in connection with cost-type contracting.

15-204.3 (k) Profits and Losses on Disposition of Plant, Equipment or Other Capital Assets

This subparagraph is contrary to the provisions of ASPR 8-402 b.(16) which allows the recovery of such items. It is recommended that the applicable provisions of ASPR Section VIII be substituted for the presently proposed language.

15-204.3 (l) Reconversion Costs

There is no reason for the disallowance of any reconversion costs as they are defined in this subparagraph.

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In summary, it is strongly recommended that industry's views as brought out in the May 21st meeting and as supplemented by additional written comments, such as those contained herein, be incorporated in the Revision prior to publication.

The members of our Association sincerely appreciate the opportunity to submit their comments on the proposed Revision and hope that their views prove to be of assistance to you.

Very truly yours,

/s/ William J. Cronin
Managing Director

RADIO-ELECTRONICS-TELEVISION MANUFACTURERS ASSOCIATION

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NATIONAL 8-3902

May 31, 1956

Rear Admiral L. H. Thomas, SC, USN
Staff Director
Purchasing & Contracting Policies Division
Office of the Ass't. Secy. of Defense (Supply & Logistics)
Department of Defense
Washington 25, D. C.

Dear Admiral Thomas:

On behalf of RETMA I wish to express appreciation for the opportunity of attending the May 21 meeting at the Pentagon to discuss the proposed revision of ASPR Section XV, Part 2. This letter also serves to reply to the informal invitation extended at the meeting to submit comments.

The Accounting and Cost Principles Task Committee of this Association gave full consideration to the revision proposed a year ago; comments and recommendations thereon were submitted on June 20, 1955. We were pleased to note that the current revision indicates your adoption of some of the recommendations advanced by this and other industry associations. However, many other important recommendations were not accepted. The position of our Association with respect to these is unchanged.

We have reviewed the new proposal but feel the need to protest that the time allotted is unreasonably short in view of the impact that it may have on Industry. The approach of this Part 2 is that of an audit manual as distinct from an outline of accounting and cost principles. This can give rise to serious problems in contract negotiation and in the recovery of true costs since ASPR Section XV, Part 2, is made a part of cost-reimbursement type contracts. Contractors' accounting systems are based on the needs of their businesses and have been evolved under competitive conditions. Many of them have been approved by the Departments with which they do business.

Viewed generally, the new draft does the following:

(1) It singles out numerous items as unallowable where the Regulation was formerly silent. This bars both the Government and industry from judging the allowability of items on the basis of reasonableness and allocability of the contract.

6-16

(2) In fifteen instances specific provisions are required in the contract or the item is unallowable. Because of the negative phrasing, contracting officers presumably will have to separately justify the inclusion in contracts of each and every one of these items.

(3) In numerous instances the proposal prescribes the accounting procedures to be followed. These could be at variance with existing procedures of the contractor based on the needs of his business.

(4) It classifies as unallowable items recognized as costs under sound accounting practices and the present policies of the Services.

The adoption of your proposal will present contractors with the serious problem of performing contracts negotiated before the revision under the cost principles of the existing Part 2, and performing contracts negotiated thereafter in accordance with the proposed new requirements. This will result in confusion, administrative difficulties and serious harm to the contractor. The confusion and difficulties will be compounded if, as we understand, the proposed Part 2 is soon to be replaced by yet another revision.

We understand that the paragraphs on General Research, Contributions and Donations, and Profit Sharing Plans are still under consideration. These three categories of costs vitally affect (i) the growth of our industry and its ability to play an important part in the National Defense, and (ii) the ability of industry to contribute its share to the public welfare, and (iii) the ability of industry to grow by virtue of being able to offer incentives to employees. Arbitrary or ill-considered decisions in these areas could have harmful effects completely out of proportion to any relatively small savings to the Government that might be reflected in contract costs.

(1) With respect to the fifteen items classed as unallowable unless the contract specifically provides otherwise, we recommend that these be considered allowable subject to the test of reasonableness and allocability. Where costs have been properly incurred, it seems unreasonable to expect that the contractor will be precluded from recovery either because he was unable to anticipate the incurrence, or overlooked the requirement for their inclusion, or, because of the situation prevailing at the time of the negotiations, was unable to convince the contracting officer of the need for their inclusion.

The language employed seems to direct the contracting officer to class these costs as unallowable and places the burden of justifying the inclusion of special provisions on the contractor. This prejudices the contractor's position from the outset, particularly where so many items are involved. Also, specific justification can depend upon circumstances that may not arise until long after the contract has been negotiated.

As a less desirable alternative to the above, we recommend as a minimum that these fifteen categories of costs be accorded treatment patterned after the existing procedures now embodied in Part 5 of Section XV of the Regulation, that is, state that these costs are allowable when circumstances warrant and indicate that they are to be so considered at the time the contract is negotiated.

(2) The new proposal disallows losses not reimbursed by insurance through an approved self-insurance program or otherwise, unless expressly provided for in the contract. This is one of the items discussed from a general point of view in (1) above. However, the importance of this topic warrants that it be given additional consideration.

Insurance clauses in contracts to a very considerable extent give the contracting officer the right to limit the amount and kinds of insurance contractors carry and to direct them to carry insurance in specific amounts, etc. Under these circumstances, losses in excess of amounts covered by insurance or losses for which no insurance was deemed necessary by the contractor or the contracting officer should be allowable.

(3) In connection with the subject of fully depreciated assets, the recording in the contractor's book of accounts of accelerated amortization should not be considered as depreciation for the purpose of determining whether an asset has been fully depreciated.

(4) The proposal with respect to pension plans does not fully recognize that contractors are committed to pension plans by virtue of union contracts, employee agreements, etc. The costs of such plans are a necessary and true cost of doing business.

Under the proposal the Government may at any time in the future recover any credits or gains that may then be determinable as having arisen from abnormal employee terminations. No corresponding provision is made, however, where later results show that the contractor under-recovered during the period of contract performance.

Specifically, we would recommend that pension plans approved by the Internal Revenue Service should automatically be considered

acceptable by other Government agencies. In addition, approval of a contractor's plan by the military Department having audit cognizance should be mandatory on other Departments.

With respect to credits or gains arising from abnormal employee termination, no specific method should be prescribed. Instead, treatment should be based on whatever method is mutually agreed to be fair and reasonable in light of all circumstances.

(5) As an editorial comment, Paragraph 15-204.2 (cc) seems to have overlooked a statement on the allowability of costs for travel incurred in relation to specific contracts which, depending upon the contractor's system, might be recovered either as a direct charge or in overhead.

(6) Paragraph 15-203.1 (c) sets an arbitrary maximum of one year as the length of the base period. This limit should be for guidance only.

In conclusion, we hope you will find the above comments of value. We are confident that the basic policy of the Defense Department with respect to the recovery of costs under cost-reimbursement contracts is to provide means and assurances for the contractor wholly to recover his legitimate costs. A policy which would provide for anything short of this would, in effect, shift a portion of the cost of contract performance and result in an unreasonable and inequitable burden being placed on the contractor.

Sincerely yours,

E. E. McClaran, Chairman
Accounting and Cost
Principles Committee

mr

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)

The following recommendations grow out of the industry-government meeting concerning Contract Cost Principles held 15 October 1958.

APPLICABILITY: The industry speakers spoke more against the substantive provisions of the proposal than against the revised applicability. Mr. Pilson established the requirements for costs in the procurement process which are embodied in the applicability. It is recommended that no change therein be taken.

ALL COST: As important as this concept is to industry, it seems to us that industry did not establish the necessity of certain costs to government business--entertainment for example. It is recommended that the ALL COST concept not be adopted.

REASONABLENESS AND ALLOCABILITY: We do not feel that industry was persuasive on their contentions here. We recommend no change in philosophy with respect thereto.

ADVANCE UNDERSTANDING: Since there can be no better conclusion of reasonableness and allocability than that which is specifically negotiated, we recommend continuation of the advance understanding concept. Whether the items enumerated thereunder are correct ought to receive further consideration. Industry may have something when it points out the absence of a suitable mechanism for a single, or even three, (A,N, & AF) negotiation. In this, however, the entire contracting officer concept is brought in issue and a suitable solution which will not seriously affect this very important present theory.

ADVERTISING: We thought that industry put up a good case for the allowability of advertising for the purpose of securing subcontracting sources and scarce materials. They put up a reasonably good case for institutional advertising as well. We recommend that the former be allowed and that allowability of the latter, with appropriate limitations, be reconsidered.

COMPENSATION: Industry found the substance of this principle sound. This, consequently, is no current problem.

RESEARCH AND DEVELOPMENT: Mr. Holaday provided the most significant contribution which was to the effect that while it was difficult to separate general and applied research, it was likely that industry substantially did research only for which they could see benefit. He suggested that we do away with the difficult area of applied research and state the principle only in terms of "research and "development". We recommend that this principle be embodied in a proposal and that another joint meeting be held between ASD(S&L), ASD(COMP), ASD(R&E), Dir. Guided Missiles, Dir. Advanced Research Projects Agency, the Departmental Materiel and Research Secretaries

for the purpose of resolving finally this problem. The staff is in the process of preparing a draft principle for this purpose.

CONTRIBUTIONS AND DONATIONS: There was general agreement that this problem did not represent a serious problem in terms of amounts of money. Industry argued persuasively that a certain portion, at least, of their contributions represented the kind of costs which the firm must make and for which they could establish a corporate benefit and stated that the Government, for policy reasons if for no other, ought to allow these costs. We recommend that we think in terms of allowability of this item suitably limited.

INTEREST: Industry argued that interest should be allowed AS A COST instead of considering "the contractor's capital investment in the performance of the contract" in the "fixing of the fee or profit." We believe that the important thing is to consider the problem rather than HOW the cost should be considered. We recommend that the pricing section be appropriately clarified. A draft proposal is being prepared for this purpose.

TRAINING AND EDUCATION: Mr. May established without question that the present coverage is suitable against today's needs and in keeping with the present National Policy. One possible adjustment ought to take place if it is determined to allow "contributions and donations", above.

PLANT RECONVERSION COSTS: Industry evidence was to the effect that serious reconversions from defense to previously manufactured civilian items were serious after WWII. Industry contended that allowability of this expense should not be foreclosed by the principles. We recommend that this item be reconsidered in light of the argument made.

OVERTIME: The industry was satisfied generally with the present policy coverage of overtime in Section XII, ASPR. They did suggest several clarifications which ought to be considered. They were satisfied with the cost principle which simply incorporated the XII principle into the cost principles.

Dear Admiral Boyle:

We are in receipt of your proposal of 29 April relative to the Contract Cost Principles project.

During the process of going forward with the project we feel certain that it will be desirable to incorporate into the finished document many aspects of your draft. As you recognize, however, we are well along with the development of issues with industry growing out of industry comments on the DOD draft dated 19 September 1957. In the interest of expediting completion of the project we find it necessary to continue on this basis until the industrial conference is held. Undoubtedly, one of the items for discussion at that time will be to determine a method of reconciliation of editorial questions and perhaps any substantive questions which appear susceptible for agreement pursuant to the deliberations of the conference.

Sincerely yours,

G. C. BAXTER
Director of Procurement Policy

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Pet to Kiger

PANEL DISCUSSION--COST PRINCIPLES

SEVENTH ANNUAL GOVERNMENT CONTRACTS INSTITUTE
April 28, 1960

To kick this thing off, I have been asked to cover some of the background, labor pains, and general characteristics of what one of my industry friends termed "the monster spawned by Sec. XV of ASPR known as Contract Cost Principles and Procedures." Later, my cohorts will make some comparisons with the old principles, discuss a few of the more important individual cost treatments, and cover some of the legal and other aspects raised.

There is probably no other section of ASPR which received as much attention, by as many people, over as long a period, with as many top level decisions--and reversals thereof--as Section XV. In spite of all this careful attention, I dare say there is not a single individual in Government or industry who fully concurs in the entire package--including myself. But this is understandable in view of the many different, and often conflicting, interests affected by cost principles. The man who buys the hardware would like to bring about, through cost principles, the lowest cost for each piece so that he can buy more pieces. On the other hand, he, or his contracting officer, may not like any cost principles because he fears persecution by Monday morning quarterbacks for having allowed a cost which the rules say is unallowable. Contractors, while agreeing philosophically that cost principles are needed, can't agree on the form they should take. They would like them to be a bill of rights for themselves, without too much detail, and with no unallowables. Research and development specialists--in Government and out-would like the principles so constructed as to promote extensive independent research and development

Comments on May 12, 1959 Draft of ASPR XV

A review of the May 12, 1959 draft of the proposed revision of ASPR XV indicates that it is somewhat improved over earlier drafts, but still falls far short of being a liberalization of the provisions of present ASPR XV. In addition, the language in many places in the draft is ambiguous and/or is not expressive of what we have been given to understand is the intent of the Government.

It is believed that a listing of the costs specified as unallowable in present ASPR 15-205 and the extent of changes made in the May 12 draft will illustrate the fact that the new cost principles do not liberalize, except to a very minor degree, any of the provisions of the present ASPR XV. Following this listing will be another showing the new limitations (as contrasted with liberalizations) imposed by the proposed revision of ASPR XV which do not exist at present.

I. Costs unallowable under present ASPR 15-205 are shown in quotations, and the differences, if any, authorized by the May 12 draft are noted following each quotation in the following table:

"(a) advertising, except 'help wanted' advertising, and advertising in trade and technical journals (see ASPR 15-204 (a) and (r))". The first of these two referenced provisions limits allowable advertising in trade and technical journals to that which "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 new cost principles would specifically make allowable only two additional types of advertising, and both of these have generally been considered allowable under present ASPR XV despite its language. The two added types of allowable advertising are as follows:

(1) "Costs of participation in exhibits - -

(A) upon invitation of the Government, or
(B) which exhibits are for the purpose of disseminating technical information within the contractor's industry; however, such costs are not allowable under this sub-paragraph (B) if the exhibit offers specific products or services for sale;"

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

whatever small addition which the new draft makes to allowable advertising will, in most cases, be more than offset by making unallowable in the new cost principles the "corollary administrative costs" which were not disallowed by present ASPR XV.

The major difficulty with the present ASPR XV and the new draft is that both of them seem to make unallowable more than what has frequently been expressed as the Government's intent to disallow, and this in turn induces well-intentioned Government representatives to label as advertising (and thereby make unallowable) many types of costs which are really normal costs of doing business in the public relations or other similar categories.

It is suggested that the real intent of the Government with respect to unallowable advertising could best be expressed in the following manner:

> "Advertising costs are allowable except for such costs representing advertising which:
>
> (1) offers products or services for sale, or
> (2) is institutional in character, but is placed in media of general circulation such as radio, television, outdoor signs, newspapers and magazines (other than trade and technical journals). However, advertising of this type is allowable when directed toward the development of sources of supply."

"(b) amortization or depreciation of (i) unrealized appreciation of values of assets, or (ii) assets fully amortized or depreciated on the contractor's books of account."

Although the language is not identical, the substance of the new cost principles is the same as that quoted above, and both sets of principles make provision for a use or rental charge when fully depreciated assets are used in performing Government contracts. In this latter connection, the proposed new ASPR XV has limitations not found in the present cost principles.

"(c) bad debts (including expenses of collection) and reserves for such bad debts."

The present ASPR has generally been interpreted not to make unallowable the bad debts arising out of relationships other than those with customers. The new language seems to be intended to fit the actual practice, but the insertion of "customers'" before "accounts" and the omission of "customers' " between "other" and "claims" in the second line may very well result in costs arising from amounts uncollectible from employees and subcontractors being held to be unallowable even though not so treated under present cost principles.

"(d) Commissions, bonuses (under whatever name) in connection with obtaining or negotiating [illegible] Government contract."

In paragraph [illegible], a [illegible]ation has been prescribed

except that the actual practices under the present ASPR language are recognized in the new draft by making such costs allowable "when paid to bona fide employees or bona fide established commercial or selling agencies maintained by the contractor for the purpose of securing business."

"(e) contingency reserves".

The new cost principles differ from the present ones only in the fact that it is intended that they be used in situations (terminations under fixed price contracts, forward pricing of fixed price contracts, etc.) in which present ASPR XV does not apply. However, there is no real broadening of the allowance of contingency costs.

"(f) contributions and donations".

There is no change at all in the new ASPR XV, although some of the earlier drafts did make some such costs allowable.

"(g) dividend payments."

Although not specifically mentioned in the new draft, there is no question but that such payments are still unallowable, if only because they are not considered as "costs" under generally accepted accounting principles and practices.

"(h) entertainment"

Such costs are still unallowable under the new cost principles.

"(i) federal taxes on income and excess profits."

Such taxes are still unallowable under the new draft.

"(j) general research, unless specifically provided for elsewhere in the contract."

Under this quoted language and that in present ASPR 15-502 (z), it has been customary for most contractors to provide in their contracts for allowance of general research and development costs.

The May 12 draft makes basic research and development costs allowable subject to certain limitations not found in most cases where special contract coverage is obtained under the present ASPR. Further, the new ASPR language suggests the desirability of special mention in the contracts for this item of cost (thus paralleling the present requirement) and certain other procedural steps and/or limitations not contained in many present contracts.

It is believed that, for many of the Government's major suppliers, the new draft would curtail, rather than broaden, the allowances for basic research and development. It is also only fair to state that the language of the May 12 draft represents a great improvement over that in some of the earlier drafts, which would have required unrealistic segregations and allocations.

"(k) interest on borrowings (however represented), bond discount and expenses, and financing charges."

The new draft would make unallowable all of the foregoing costs and, in addition, would make unallowable all other interest costs except those assessed by state and local taxing authorities under specific conditions set forth in paragraph 15-205.41. It is believed that the insertion of "on borrowings" after "interest" in the first line of new paragraph 15-205.17 would restore the allowances and disallowances of interest almost to the basis prescribed by present ASPR XV. There appears to be no reason to narrow the allowable interest costs because the Government's interests are fully protected against unreasonable or non-allocable interest charges by the general tests of allowability. Certainly, the language of the new draft is deficient in that would make unallowable (contrary to our understanding of the Government's intent) interest related to principal sums which are themselves allowable (e.g. interest on judgments or arbitration awards in favor of employees or suppliers).

"(l) legal, accounting and consulting services and related expenses incurred in connection with organization or reorganization, prosecution of patent infringement litigation, defense of anti-trust suits, and the prosecution of claims against the United States".

The new draft would continue to treat all of such costs as unallowable, but would also make unallowable the costs of defending patent infringement litigation unless otherwise specifically provided in the contract. It is believed that the present ASPR XV is too restrictive, and certainly there seems to be no proper basis for further limiting it making unallowable the defense of patent infringement claims. No contractor can prevent claims being made against him, no matter how capricious those claims may be, nor can he predict the likelihood of such claims being made with sufficient certainty to warrant special contract coverage. In some cases, it may be essential that a contractor defend against patent infringement claims in order to continue performance of Government contracts and/or to avoid the payment of royalties. In any event, the costs of patent infringement defenses should continue to be allowable costs, and this could be cured in the new draft by the insertion of "prosecution of" before "patent infringement" in the next to last line of 15-205.31(c).

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"(m) losses from sales or exchanges of capital assets, including investments."

Such costs are still unallowable in the new draft.

"(n) losses on other contracts."

The language of the new draft seems to be intended to continue the present disallowances, but may be interpreted to be even broader in that the parenthetical phrase may be construed to make unallowable certain research costs which have been allowed in the past on the basis that they represented the costs of research programs broader in scope than that funded by the Government under a research contract.

"(o) maintenance, depreciation and other costs incidental to excess facilities (including machinery and equipment) other than reasonable standby facilities."

The provisions of the new draft make the same costs unallowable.

"(p) premiums for insurance on the lives of directors, officers, proprietors or other persons, where the contractor is the beneficiary directly or indirectly".

The proposed new cost principles would make "insurance on the lives of officers, partners, or proprietors - - - allowable to the extent that the insurance represents additional compensation". The meaning of this provision is not entirely clear, but it is likely that it will be interpreted as disallowing such insurance when the contractor is the beneficiary and allowing the insurance costs only when the individual is the beneficiary and the insurance is, therefore, like any other employe fringe benefit insurance.

"(q) selling and distribution activities not related to the contract products."

The above quoted provision has generally been administered in a manner which permits the allowance of selling and distribution costs if they are reasonable in amount and are allocated in an equitable manner. The new draft, while using many more words, seems to leave the treatment of these costs identical with their handling under present ASPR XV.

"(r) taxes and expenses in connection with financing, refinancing, or refunding operations, including the listing of securities on exchanges."

These types of costs are still unallowable under the May 12 draft.

From the foregoing analysis, it should be evident that the May 12 draft does not make allowable any of the costs unallowable under present ASPR XV with the possible exception of the very minor change in advertising. Those cases in which the proposed new ASPR section specifically broadens the unallowability of the cited types of costs have been noted in these comments. Of particular concern is the fact that, even where the language of the new draft seems to have effected no change in the unallowability of types of costs, the use of so many more words than are found in the present ASPR is likely to cause many new problems of interpretation and many new questions with respect to matters which have been satisfactorily resolved under the present cost principles.

II. The new draft not only fails to liberalize, but is more restrictive than the present ASPR XV in that it makes unallowable certain costs which are not specifically unallowable under the present cost principles and in that it will now apply to types of contracts other than those of the cost reimbursement nature.

It is true that the new draft prescribes that it be used in connection with fixed price type contracts as a guide only. However, some years ago a similar instruction was issued with respect to the use of present ASPR XV as a guide in connection with fixed price contract negotiations. This instruction had to be rescinded when it became apparent that the ASPR cost principles were carrying too much weight and were otherwise complicating fixed price contract negotiations. There is no reason to believe that the results will be any different if the new cost principles are made applicable as a guide in negotiations of fixed price type contracts. If anything, the new draft would cover a broader field than the prior instruction in that it would also apply to terminations under fixed price type contracts, whereas the ASPR VIII cost principles (developed after lengthy Government-industry coordination) governed fixed price type contract terminations under the prior instruction.

By specific mention, the new draft would make unallowable the following types of costs as to which present ASPR XV is silent:

1. Certain civil defense costs - see paragraph 15-205.5(c).

2. Fines and penalties - see paragraph 15-205.13

   Even assuming that the costs of fines and penalties should be unallowable, the language used in the new draft (aside from the paragraph title) is so broad as to cause the disallowance of costs which are not fines or penalties assessed by governmental authorities. For example, the draft language could be used to disallow the costs of moving inflammable materials found to be stored in a manner violating fire regulations. The new draft could limit the disallowed costs to what is understood to be the Government's intent by inserting "of fines and penalties" after "costs" in the first line of paragraph 15-205.13.

3. The provisions covering insurance and indemnification (see paragraph 15-205.16) contain some limitations not found in present ASPR XV and, in part at least, appear to be in conflict with the provisions of the "Insurance Liability to Third Persons" clause prescribed by ASPR 7-203.22.

4. Maintenance and repair costs (see paragraph 15-205.20) are limited in a manner not found in the present ASPR XV.

5. Paragraph 15-205.29 covering plant reconversion costs specifically disallows certain costs as to which the present ASPR XV is silent.

6. The last sentence of paragraph 15-205.33, dealing with recruiting costs, provides for the non-allowance of certain costs not covered by present ASPR XV.

7. Paragraphs 15-205.34 and 15-205.36, covering rentals and royalties, respectively, make unallowable certain costs not disallowed by the present cost principles.

8. Limitations not found in present ASPR XV are attached to severance payments - see paragraph 15-205.39.

9. Paragraph 15-205.41 concerning taxes contains limitations and procedural requirements not found in present ASPR XV.

10. Paragraph 15-205.43 covering training and educational costs includes limitations not contained in present ASPR XV.

11. There are numerous paragraphs in the new draft which contain descriptions of certain types of costs which are specified as being allowable, but the listings are far from complete. If the language is interpreted to mean that other unmentioned costs under the same general headings are unallowable, the new draft will result in disallowing many costs which have been and should continue to be considered allowable.

In summary, it is believed that any fair and reasonable appraisal of the May 12 draft can only lead to the conclusion that it not only fails to liberalize the cost allowances of present ASPR XV, but it actually will tend to make unallowable more costs than do the present cost principles. Such an appraisal, particularly when made in the light of the actual language of the draft as contrasted with amplified explanations of intent of the drafters, gives rise to a belief that, if made effective in anything very much like the form of the May 12 draft, the new cost principles will have adverse effects on the negotiation and performance of affected Government contracts and subcontracts.